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Walker & Dunlop, Inc. (WD)

Q3 2014 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Walker & Dunlop's Third 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 11:30 AM Eastern Standard Time. The dial-in number for the replay is 800-723-0520. 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. Please go ahead.

Claire Harvey
Vice President-Investor Relations

Thanks, Zach. Good morning, everyone. Thank you for joining the Walker & Dunlop third 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 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 income from operations, adjusted net income, adjusted diluted earnings per share, adjusted operating margin, adjusted EBITDA and adjusted total expenses during the course of the call. Please refer to the earnings release and

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presentation posted on our website for reconciliations 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 including statements regarding future financial operating results involve risks, uncertainties and contingencies, many of which are beyond the control of Walker & Dunlop, and which may cause actual results to differ materially from 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

Thank you, Claire, and thank you, everyone, for joining us this morning. Q3 was a great quarter and demonstrates the value of creating a market leader in commercial real estate finance. Our leadership position with the GSEs is showing its value every day, and the investments we have made to grow our business are impacting our financial results across the board.

We finished the third quarter with $98.1 million of total revenues, 33% growth over Q3 2013, driven by record origination volumes. We nearly doubled the adjusted diluted earnings per share from the same quarter a year ago to $0.47 per share by increasing origination volumes and gaining economies of scale from our underwriting, asset management and servicing platforms.

And we generated over $20 million in adjusted EBITDA, up 90% from Q3 2013. Our year-to-date numbers are equally as impressive, with loan origination volume up $1 billion or 17%, adjusted EBITDA up $22.8 million or 59% and net income up $4.8 million or 16% over the first nine months of 2013. Our results this quarter and the current trajectory of our business reflect the investments we have made to grow our origination platform, build a market leadership position in multifamily financing and generate long-term revenue streams as our servicing portfolio now totals over $41 billion of commercial mortgages.

I'm going to refer to slides 4, 5, 6 and 7 in this next section of my commentary, if you'd like to bring those slides up. $3.1 billion of origination volumes this quarter is a significant milestone and record for our company. The fact that it was achieved in the third quarter, when our business historically slows down, makes it all the more satisfying.

As you can see on slide 4, the GSEs increased their monthly origination volumes dramatically this quarter from around $1 billion per month through May to between $2 billion and $3 billion per month since the GSE scorecard was released by FHFA.

As slide 5 shows, our leadership position with the GSEs continues to gain us market share. We originated $1.2 billion of loans with Fannie Mae, maintaining our market share at 11.2% on a year-to-date basis, and we originated $1.1 billion of loans with Freddie Mac this quarter, increasing our market share year-to-date to 10.1%, up from 7.7% last year.

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Fannie Mae and Freddie Mac are competing hard for new loans, particularly in the area of affordable housing and small loans. As slide 6 shows, year-to-date, we have originated $394 million of affordable and manufactured housing loans with the GSEs, an increase of 32% over last year. We expect the GSEs to finish the year strong given the amount of capital they have to lend and the amount of business activity we see occurring across the industry.

Our Capital Markets team continues to grow in its size and originations. In the third quarter, our team increased its originations 15% to $665 million, with 70% of the originations through our brokerage network, 28% through the GSEs and HUD, and 2% through our proprietary capital solutions.

As slide 7 demonstrates, this is a dramatic shift from last year when we originated $578 million of loans with 95% going through our brokerage network and the remaining 5% to the GSEs. We expect this mix of originations to continue into the fourth quarter when a year ago, our Capital Markets group originated $839 million of loans, with 93% of those originations being brokered to third-party capital.

Non-bank commercial and multifamily maturities are expected to exceed $0.5 trillion over the next four years and increase 72% from 2014 to 2015. Over the past several years, we've made meaningful investments to add origination talent to our Capital Markets group in an effort to capitalize on that opportunity. We just acquired Johnson Capital on November 1, a fantastic brokerage firm that has averaged $1.3 billion of originations over the past three years, to accelerate the growth in this part of our business. We have done business with Johnson Capital for 20 years, and think extremely highly of Guy Johnson, the firm's founder; and Cliff Carnes, the firm's COO.

If you turn to slide 8, it shows how the acquisition of Johnson Capital increases our market presence. Both Guy and Cliff will be joining Walker & Dunlop to help expand our brokerage footprint, especially in the West and Southwest. Beyond doubling the size of our Capital Markets origination team, Johnson Capital brings with it $576 million of HUD servicing and a history of originating loans with Fannie, Freddie and HUD. Walker & Dunlop's market position, brand, broad product offerings and access to capital should provide the Johnson Capital team with the opportunity to increase their loan origination volume significantly in 2015 and beyond.

Our HUD team finished this quarter originating $163 million of loans, a decrease of 40% from the same quarter last year. Our team continues to perform well in a challenging environment for the HUD product. HUD is designed to be a countercyclical product beyond its core markets of affordable and seniors housing. Although HUD originations are down, we view the market dynamics as an opportunity to become a top five lender by remaining focused on our goal to grow our origination team and generate attractive returns.

At the end of September, our CMBS joint venture contributed $58 million in assets into a securitization with Wells Fargo. The economics of this first deal were in line with our expectations, which Steve will touch on in further detail. There is a strong appetite in the market for new CMBS issuances, and as slide 9 shows, estimates are that between $90 billion and $100 billion of securitizations will close in 2014, up from around $86 billion in 2013. Our CMBS team is seeing steady deal flow, and we are well on our way to originating $200 million by the end of this year and $1 billion of originations by the end of the second quarter 2015.

I'd like to finish my summary of Q3 providing you with a few anecdotes about our recent success. We had a producer join us in 2012 from a competitor firm. He has had a breakout year in 2014 selling W&D's products, so we went back to compare 2013 to 2014. Year-to-date last year, this originator had done $245 million in loan volume, producing $2.5 million in gains from mortgage banking activities. As we said when we embarked on our expansion of capital markets, we would gain access to deal flow and try to drive as much volume through products where we book mortgage servicing rights as we could.

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Year-to-date in 2014, this originator has increased his origination volumes 52% to $372 million. But more importantly, he has increased his mortgage banking income 104% to $5.1 million by doing significant volume with Fannie, Freddie, HUD and our balance sheet. This type of top and bottom line growth is exactly what we set out to achieve as we expanded our Capital Markets business.

A second example of our recent success comes from a meeting at the end of last year with a large institutional investor in multifamily properties who told us they had longstanding relationships with two competitors of Walker & Dunlop and did not want to work with us. Yet in a face-to-face meeting, we convinced them that W&D's market leadership position could provide them with significant value above and beyond the competition. Deal number one went great. Deal number two went even better. $100 million of new business later, we have a very happy client and two very upset competitors.

Finally, I have spent a tremendous amount of time on the road over the past five quarters. I have attended over 140 client meetings year-to-date. It is extremely evident that our clients like what we are doing. They like working with a firm that plays with the big boys, yet provides the touch, feel and service of a small company, and finally, that we have some of the most talented loan originators, underwriters, closers, asset managers and servicers in the industry. Investors in Walker & Dunlop can be exceedingly proud of the market position and reputation that our company carries today.

With that, I'd like to ask Steve to take us through our strong Q3 financial results. Steve?

Stephen P. Theobald

Chief Financial Officer & Executive VP

Thank you, Willy, and good morning, everyone. As Willy said, we had a great quarter and could not be more pleased with our performance. Our team did an exceptional job processing the increased deal flow as we worked through our largest volume quarter ever. And we are all excited about what is to come with the addition of the Johnson Capital team, continued momentum at the GSEs, and the upcoming increase in refinancing activity.

My remarks this morning will expand on several of the topics Willy mentioned, including the mix of loans originated, competition, the acquisition of Johnson Capital, and our CMBS platform. Then I will highlight how our performance this quarter impacted the key metrics we focus on as a management team, including adjusted EBITDA, ROE, operating margin and earnings per share.

Total originations increased 77% to a record $3.1 billion. As slide 10 shows, the mix of the $3.1 billion is significantly different from the mix of the $1.8 billion we originated in the year ago quarter. 73% of our originations in Q3 2014 were with Fannie Mae and Freddie Mac compared to 44% in Q3 2013 as our activity with the GSEs increased 193%. As anticipated, our originations with HUD were down 40% and dropped to 5% of total originations compared to 15% a year ago.

Our brokered originations were down 12% to finish the quarter at 17% of total originations. The decrease in brokered originations stems from the competitiveness of the GSEs as our Capital Markets team originated a higher percentage of its business with Fannie and Freddie. The interim lending was 3% of total originations, while CMBS, new this quarter, was 2% of our volume.

Translated to revenue, the $1.4 billion of growth in volumes increased origination fees by $11.6 million, MSRs by $6.4 million, and net interest income by $3.3 million, which, combined with the $2.1 million increase in servicing fees, produced total revenues of $98.1 million, up 33% from Q3 2013. Revenue growth outpaced total expense growth of 21% as we continued to manage expenses closely and saw the benefits of scale in our business.

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The biggest driver of the expense increase was variable compensation, both commission expense and our company bonus plan, which is driven by the increase in origination activity and year-over-year improvement in company performance.

Net income for the quarter was $15.1 million, up 88%. Adjusted diluted earnings per share were – was $0.47 compared to $0.25 in Q3 2013. Adjusted EBITDA was $20.7 million, up 90% from Q3 2013. The increase in volumes and profitability in what has traditionally been one of our softer quarters is attributable to a rise in general business activity in the commercial real estate space, an increased appetite for products from Fannie Mae and Freddie Mac, and we believe the benefits of our relentless sales and marketing efforts.

We continue to operate in a very competitive environment, and this has resulted in lower servicing fees on new Fannie Mae business, which is reducing our MSRs from 122 basis points last year, down to 89 basis points in the third quarter of this year. Slide 11 shows the trends in gains from mortgage banking.

Origination fees continue to be stable, but were impacted by the lower HUD volumes and our continued success in winning larger loans and portfolios during the quarter.

Our total mortgage banking gain margin was 202 basis points compared to 257 basis points last year and 219 basis points in Q2 of this year. We expect gain on sale margins to remain at these lower levels for the foreseeable future based on the competitive environment and a steady pipeline of larger deals.

With the increased volumes this quarter also came a significant increase in our servicing portfolio and related fees.

As slide 12 shows, the total servicing portfolio now stands at $41.2 billion, up 7% from Q3 2013 and 4% from Q2 of this year. During the quarter, our average servicing fee remained steady at 24 basis points. Servicing continues to generate significant cash flow and attractive returns as the prepayment protective nature of the portfolio has limited the amount of early payout attrition we have experienced despite the historically lower interest rate environment we have operated in over the last few years.

The book value of our mortgage servicing rights is currently $353 million, while the fair value is currently estimated at $436 million.

As Willy mentioned, the acquisition of Johnson Capital furthers our strategic goal of building out our Capital Markets team to increase brokered, agency and proprietary originations across the entire Walker & Dunlop platform. We expect that the addition of the Johnson Capital producers will increase the scale of our platform, enhancing our overall profitability. We have the back office scale to absorb the origination and servicing platforms without adding much in the way of additional head count or other fixed costs as the majority of the 54 employees coming over to Walker & Dunlop from Johnson Capital are producers and largely compensated from their originations.

We will be assuming the leases on a few Johnson Capital locations, and we'll be able to accommodate many of the staff in our existing offices. We have already moved their $576 million of HUD servicing into our servicing portfolio, effective with the closing, and will not need to add any servicing staff. We expect the deal to be accretive to EPS in 2015.

On the CMBS front, we contributed four loans totaling $58 million as collateral through a securitization done by Wells Fargo in the third quarter. The securitization priced at 255 basis points gross and closed on September 29. This was our first securitization transaction and we were very pleased with the execution.

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Given the small amount of collateral and our 20% ownership stake in the conduit, the transaction did not have a significant impact on our financials during the quarter. We are currently aggregating the collateral for our next contribution and would expect this to be done before the end of the year.

I now want to take everyone through the key metrics that we believe are important to measuring the performance of our business. Slides 13 and 14 illustrate these metrics, and it may be helpful to have the slides up as I talk through each one.

Let's start with adjusted EBITDA on Slide 13. Adjusted EBITDA has grown 90% since Q3 2013 and with $20.7 million in the third quarter. How we calculated adjusted EBITDA is included on this slide. As you can see, the largest adjustments are to add back amortization and depreciation expense to net income, while deducting gains attributable to mortgage servicing rights. This is an important metric to us as it represents the trend in cash earnings over time by normalizing for significant non-cash revenues and expenses.

In addition, it is a key metric in determining both our [ph] cost of (19:33) and ability to access debt. For example, because our trailing 12 months adjusted EBITDA increased to $70.1 million at the end of the second quarter, we achieved a 25 basis point reduction in the interest rate on our term debt.

Our increased adjusted EBITDA reveals our ability to continue investing in the growth of our business through the increased cash flows and the opportunity, should we choose to pursue it, of adding additional leverage to our capital structure.

Moving now to slide 14. Operating margin is an important metric for us as it represents the efficiency with which we generate $1 of revenue. Operating margin is difficult to forecast despite the fact that much of our expense base is fixed. The challenge comes in predicting the revenue side of the equation, which is highly dependent upon both the amount and the mix of our volumes. As you can see, we achieved an operating margin of 25% this quarter compared to 19% on an adjusted basis in the year-ago quarter.

As the increase in origination volumes and the higher mix of GSE business offset the increase in our expenses, I think it's important to point out here that the year-over-year increase in expenses was almost entirely driven by increased commissions and annual bonus accruals, both variable costs. Our target for operating margin over the course of a year is mid 20%, understanding that there will be quarter-to-quarter variability in that number.

Turning now to return on equity. We have articulated our goal to deliver a mid-teens ROE. This metric provides a benchmark for the return on capital invested by our shareholders, as well as the earnings that we reinvest in the business each year. This metric also assists us when assessing acquisition opportunities and alternative investments of the capital generated by the business. Year-to-date, we are running slightly below that target at 11.9%. However, annualized ROE for Q3 was 15.1%, indicating we are on the right track.

Finally, we remained focus on getting back to growing our earnings per share. As we highlighted last quarter, the business environment over the back half of 2013 and first half of 2014 created some challenging quarter-over-quarter comps for us.

This quarter marks an end to that dynamic with strong year-over-year EPS growth, and we believe we are well positioned for the next few quarters. With that said, there are some reasons to temper one's enthusiasm.

First, competition remains intense and is expected to continue, which will pressure our mortgage banking gains. Second, HUD, one of our most profitable products, is out of favor in the current market and not expected to grow.

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Third, as we continue to increase the size of our Capital Markets team, we will see a higher percentage of our business done through the less profitable broker channel.

Lastly, our fourth quarter typically contains increased variable compensation as many of our producers are earning their highest commission splits by the end of the year. Despite these headwinds, the origination market is very healthy, and we believe we are entering the 2015 to 2017 period of elevated refinanced activity with good momentum.

With that, let me turn it back over to Willy.

Willy Walker

Chairman, President and Chief Executive Officer

Thank you, Steve. Our strategy is to be a top 5 lender with Fannie Mae, Freddie Mac and HUD; to grow our broker to originations to $3 billion to $5 billion annually; and to grow our access to proprietary capital, enabling us to scale our lending operations, all while maintaining a best-in-class corporate culture. We're at the very top of the league tables with Fannie Mae and Freddie Mac, just outside the top 5 of HUD, rapidly growing our Capital Markets team, and building proprietary capital solutions that are starting to have an impact on our financial results.

The strategy of hiring brokers who gained an advantage over the competition due to our market position with the GSEs and broad product offering with HUD, our conduit, and our balance sheet lending is working and gaining momentum. Our recent acquisition of Johnson Capital and the upcoming refinancing wave should take us well over $3 billion of brokered originations in 2015. We will continue to hire talent to further grow our GSE and Capital Markets origination teams.

Our proprietary lending solutions are delivering bottom-line value to our shareholders. We established a goal of generating 50% of our revenues from servicing and asset management fees by the end of 2017. Since establishing that goal, we have gained significant traction in the bridge lending space.

In 2014, for example, our average interim loan portfolio balance has been $185 million, contributing $0.08 of adjusted diluted EPS. Year-to-date, we have generated 31% of our revenues from servicing fees, asset management fees and net interest income on our bridge lending program.

The interim loan program is exactly what we had in mind when we developed our proprietary capital strategy, delivering exceptional value to our customers and higher returns on invested capital to our shareholders. We have similar expectations for our CMBS platform, which we expect we'll scale and meet the market opportunity in the coming years.

Finally, the best-in-class corporate culture we have maintained for 75-plus years continues to be recognized outside of W&D. This year, we were named one of the 100 fastest-growing companies by FORTUNE Magazine, one of the healthiest employers by Washington Business Journal, a top workplace by the Washington Post, and one of the 50 fastest-growing companies by the Washington Business Journal for the fourth year in a row.

A growing business with exceptional corporate culture and a fantastic market reputation enables us to attract best-in-class talent, from college graduates to commercial real estate professionals with decades of experience.

Having a fantastic brand and operating platform is fundamental to our business, but it is our people, our client relationships and our culture that differentiate us from the competition and enable us to add value to every single

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one of our clients' transactions. We will stay true to our strategy to develop the premier commercial real estate finance company in the United States, and, in turn, continue to enhance the value of this enterprise for our shareholders.

Thank you, all, for joining us today. With that, I'd like to turn the call over to Zach to open the line for questions.

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Thank you. Our first question is coming from Steve DeLaney with JMP Securities. Please go ahead.

Steven C. DeLaney
JMP Securities LLC

Q

Good morning, everyone, and congratulations on a really outstanding quarter. Willy, I guess where I'd like to start is with the GSE multifamily volume, just traditional business, CMA back, I guess, October 24 showed us the sequential trend, $16.2 billion in the third quarter, up 80% over $8.8 billion in the second. Now, you've been around this business a long time. I mean, we generally think third quarter is kind of traditionally a slow quarter, so there's clearly something going on psychologically or whatever within the GSEs.

And I guess, can you just comment kind of what that dynamic is? And I'm wondering if they're essentially operating now as if they are without loan caps, at least with respect to affordable and manufactured housing. Thanks.

Willy Walker
Chairman, President and Chief Executive Officer

A

Sure, Steve. Good morning, and thanks for joining us.

Steven C. DeLaney
JMP Securities LLC

Q

Sure.

Willy Walker
Chairman, President and Chief Executive Officer

A

Particularly as early as it is for you.

Steven C. DeLaney
JMP Securities LLC

Q

No problem.

Willy Walker
Chairman, President and Chief Executive Officer

A

[indiscernible] (27:21). There are two key things that happened. The first is the FHFA scorecard came out in early May, which showed where Director Watt would like to take FHFA over the five years that he is director of FHFA. And that is essentially saying that unlike Ed DeMarco, who had a policy of contract and reduce, Mel Watt has

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come out and said, I am here to act as the conservator of these enterprises and let them do their business on a day-to-day basis, and leave it up to congress to define the future of the GSEs.

As you know, he also reinstated the caps that Fannie and Freddie have for their multifamily lending in 2014 at $26 billion for Freddie Mac and $30 billion for Fannie Mae. But importantly, as you pointed out, he also allowed them, in the scorecard, to do as much small loans, affordable and manufactured housing, as they can possibly do.

So unlike previous scorecards where, quite honestly, there was a box to check in those areas, he has put a very significant incentive in place to allow them to grow their businesses in those specialty products. So what you had was first of all, not to be too dramatic about it, but the game on sign came on in May when the scorecard came out.

The second thing is that if you look at commercial loan maturities, 2014 was a trough year.

Steven C. DeLaney
JMP Securities LLC
Q

Right.

Willy Walker
Chairman, President and Chief Executive Officer
A

They've been coming down to 2014, they stabilized in 2014. And then, as we have discussed previously, they sort of take off in 2015 and 2016. And so, the first half of 2014, particularly January, February and March, the first quarter, had very low activity. It wasn't as if banks were very active. It wasn't as if life insurance companies were very active. There just wasn't a whole lot of refinancing activity going on.

Steven C. DeLaney
JMP Securities LLC
Q

Okay.

Willy Walker
Chairman, President and Chief Executive Officer
A

And although the investment sales activity was still quite good, it wasn't driving the market. I think what you're seeing now is both the agencies fully back in business and providing the capital of the market that they have in the past, as well as the refinancing wave that we have been all talking about starting to hit.

Steven C. DeLaney
JMP Securities LLC
Q

Got it. No, great color. That's very helpful. Thanks. And just one final thing. You, I guess, back in the summer, were able to do the very first Freddie Mac manufactured housing loan, and then you did a whopper of a Fannie Mae loan, $100 million loan in October. So, this – I don't know whether it's intentional or whether in a – forgive me – I don't know in the past how much of this manufactured housing business you've done, but it looks like it's becoming more important. Could you offer some comments sort of on the overall size of that market relative to multifamily? I think I've heard you talk about multifamily as being $80 billion, $90 billion a year, something like that in originations.

Now, within that, are you including the MHC product, or is that standalone and separate as far as a market segment?

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Willy Walker
Chairman, President and Chief Executive Officer

A

So, Steve, as it relates to our capabilities in the manufactured housing space, we were Fannie Mae's largest DUS originator of manufactured housing in 2013. So, we have had a very long track record of significant relationships with manufactured housing owner, operators, and have done a significant volume of business with them through Fannie Mae.

The scorecard for 2014 allowed Freddie Mac to enter that space. And as you accurately say, we did the very first manufactured housing loan with Freddie Mac with their new ability to lend on manufactured housing. As it relates to the specific size of it, I'll broaden it out to small loans, affordable and manufactured housing. And the general numbers that I have discussed with the people at Fannie Mae is that if they have a $30 billion cap but can do as much manufactured small loans and affordable as they want, that's sort of a $4 billion to $6 billion a year opportunity for them, and those are very general numbers, Steve.

Steven C. DeLaney
JMP Securities LLC

Q

Got it.

Willy Walker
Chairman, President and Chief Executive Officer

A

But if you will, through the 2014 scorecard, their effective cap, given their historic volumes in those specialty products, would have moved from $30 billion to $34 billion to $36 billion. And then on the Freddie Mac side, Freddie has not been nearly as active in manufactured housing, small loans or affordable as Fannie Mae. And so, one of the big things that David Brickman at Freddie Mac sees is a huge growth opportunity for Freddie Mac is entering those spaces. And clearly, Walker & Dunlop wants to be a big partner to both Fannie Mae and Freddie Mac in accessing those markets.

Steven C. DeLaney
JMP Securities LLC

Q

Great. And is there any – just a final thing. As you look at your own economics between the loan products, between traditional multifamily and the manufactured housing, is the manufactured housing product, does it have any unique fees or how the margins on that business kind of compare to traditional multifamily?

Willy Walker
Chairman, President and Chief Executive Officer

A

The first thing I'd say is from a credit standpoint, it has been, without a doubt, the best performing specialty [ph] Class U (32:49), if you will, in our servicing portfolio. We – I think I'm correct, and if I'm wrong on this, I'm off by one or two loans. I don't know that we've had a default on the manufactured housing community in all the time we've been lending on them. So, from a credit standpoint, as long as you are doing age-restricted, as well as Class A properties, which is where we've really focused, they are fantastic from a credit standpoint. As far as a margin standpoint, it is a specialty product, so there aren't as many lenders competing for them. And so, you will be able to price those deals, I will say, fully, taking into comment – taking into account what Steve said previously as it relates to margin compression on servicing fees.

The final piece is on small loans. That has been the domain of banks. And when people have a three- or four-unit multifamily property, they typically go to their local bank where they have a checking account and they say, can I

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get a loan for my small multifamily property? Fannie and Freddie have had a difficult time, although Fannie better than Freddie, in accessing that market.

Both are focused on that market as a growth market. And we are focused on how and if we could enter that market again. As you may recall, we exited that market a year ago because banks were dominating that market and it's very difficult to gain access to deal flow. So, it requires a different type of origination platform, as well as significantly lower underwriting cost to make money in the small loan space. But the numbers that Fannie and Freddie have given me are that 40% of the multifamily market is small loans.

So, Fannie and Freddie, up until now, have predominantly been operating in the 60% of the large loan space. So, getting into that smaller loan space, which they say is 40% of the market, is a huge growth opportunity.

Steven C. DeLaney
JMP Securities LLC
Q

Absolutely. Now, that there's – especially since there's no cap there, right? So – and if there's a cap, you might as well focus on the more efficient larger product. Well, listen, Willy, thank you so much for the time and for the comments this morning.

Willy Walker
Chairman, President and Chief Executive Officer
A

Thanks, Steve.

Operator: And we'll go next to Bose George with KBW. Please go ahead.

Chas Tyson
Keefe, Bruyette & Woods, Inc.
Q

Hey. Good morning, guys. This is actually Chas Tyson on for Bose. Just want to ask you quickly about the obviously, much higher GSE volumes this quarter and probably going forward as well. Your Freddie market share has been increasing pretty substantially over the course of the year by our count. Do you think that's kind of you're at a sustainable run rate market share kind of going into next year when maybe there'll be a little more visibility on caption and there won't be this kind of huge catch-up, or is it kind of artificially high right now?

Willy Walker
Chairman, President and Chief Executive Officer
A

Chas, I don't – to call it artificially high, I think if you look at the slide that we pointed you to in the presentation, our market share with Freddie has been growing very consistently since we started lending with Freddie Mac in 2009. And it's moved up progressively year-on-year. And I will tell you, we are absolutely thrilled to have the type of scale we have today with Freddie Mac. Freddie is being very, very innovative and competitive in the markets today. And the Freddie product and the Fannie product are distinct products. They compete differently at different times, and they compete differently on different assets at different leverage levels, at different price points, at different terms. There's a big difference.

So, I'll just say that we are exceedingly pleased with the growth that we have seen with Freddie Mac. I've been very straightforward in saying that we want to be the largest Freddie Mac seller servicer in the country, and we'll continue to grow our originations to get to that point. But there are some pretty significant competitors between here and being number one. We're number three at the end of 2013, but we've had significant growth with Freddie over this year.

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Chas Tyson
Keefe, Bruyette & Woods, Inc.

Q

Got it. And then just kind of turning to the acquisition of Johnson. What's your – what's the acquisition outlook for you guys? And is there anything else kind of that you're seeing out there that might be attractive? And if you are, is the sizing similar to Johnson Capital, or if you could just give some color there, that'll be great.

Willy Walker
Chairman, President and Chief Executive Officer

A

So, it's a very robust marketplace right now as it relates to people either acquiring companies, selling companies with the refinancing wave that is sort of upon us now. People are trying to gain market share and expand their platforms. So, the larger enterprises are looking for acquisitions and some of the smaller enterprises are trying to either acquire or be acquired. So, there's plenty of M&A activity going on. Johnson was somewhat unique and that we've known Johnson Capital for a very long period of time. They've been a correspondent to Walker & Dunlop and fed us with a significant amount of Fannie Mae deal flow over the years. And they also have an origination platform, from a location standpoint, that adds nicely to the growth of W&D from origination standpoint.

So, are there other opportunities out there? Lots of them. From a scale standpoint, as Steve mentioned in his comments, we're generating a significant amount of cash right now. And we also have the capital that we raised last year through our debt offering that we are looking to deploy. So, I think we're sitting in an extremely good position to [ph] be used (38:31) that capital for additional acquisitions or to fund our lending operations.

Chas Tyson
Keefe, Bruyette & Woods, Inc.

Q

Okay. That's helpful. And then just a quick one on Johnson as well, I know you guys had pointed to about $1.3 billion on average originations over the last couple of years. Was any of that – considering you guys have already been doing business with them, was any of that baked into your numbers already, just trying to get the incremental?

Willy Walker
Chairman, President and Chief Executive Officer

A

So, there – did we put out an intangible on – to [ph] burn it off (39:03) for new originations or where do we stand on that?

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

No, we haven't. We'll do all the purchase accounting in the fourth quarter here before the end of the year.

Willy Walker
Chairman, President and Chief Executive Officer

A

Okay.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

[indiscernible] (39:10) So we haven't done any. But I think, Chas, the answer to your question is we were a correspondent with Johnson on the Fannie Mae side. We didn't do all of their Fannie Mae business, but we

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probably did most of it. But we did not do any of their Freddie or HUD business, so that's all incremental to us. And they're primarily a brokerage shop. There wasn't...

Chas Tyson
Keefe, Bruyette & Woods, Inc.

Q

Got it.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

...a lot baked into our numbers already.

Chas Tyson
Keefe, Bruyette & Woods, Inc.

Q

Okay. So, just fairly immaterial?

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Yes.

Chas Tyson
Keefe, Bruyette & Woods, Inc.

Q

Okay. That's helpful. Very impressive quarter, I guess.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Thank you.

Willy Walker
Chairman, President and Chief Executive Officer

A

Thanks.

Operator: And we'll go next to Jason Stewart with Compass Point. Please go ahead.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Hi, good morning, and congratulations on a good quarter. I wanted to follow up on the volume and seasonality that Steve was, I think, starting to go down a little bit. Clearly, we didn't see any seasonal impact in 3Q and the GSEs still have some catch-up to get to their cap in 2014. But could you give us, Willy, how you're thinking about seasonality into year-end?

And then at the current run rate, at least through September, looks like the GSEs are sort of trending towards their cap, how you think they might react in early 2015?

Willy Walker
Chairman, President and Chief Executive Officer

A

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So, Jason, you've been very good at tracking the publication of the GSE volumes on a month-to-month basis. And as you accurately state there, September numbers were very strong. And I would expect it will have October numbers from Fannie pretty soon.

Q4 is always a busy quarter. It's the year-end, it's typically the strongest quarter of the year. And as we said previously, as we look out across the industry and see the amount of activity, there's a lot going on right now. And so, they have – they are playing, if you will, catch-up to get to their caps. I'm not sure whether they – either of them actually gets there. But they've got the capital, they've got the market position right now, and they're working extremely hard to deploy as much capital as they can. As it relates to 2015, as you know, in our business, we have sort of a quarter to two-quarter, if you will, visibility, on what volumes look like. But if you look at the refinancing volumes in 2015, Jason, and what is coming up for refinancing, both in the agency space, life insurance space, bank space and CMBS space, the volumes are extremely compelling. And so, there is a big opportunity out there, and it is up to us and our sales team to go out and get that opportunity. But from just the macro numbers, 2015 should be a very strong year. And if the agencies continue to operate the way that they are operating today, they will be a very significant market participant.

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

Yeah. And to add to that, they are, I think, both aggressively competing, which is why we're also seeing the margin decline that we've seen.

Jason M. Stewart
Compass Point Research & Trading LLC **Q**

All right. And so – I guess, in the follow-up, the – when we look at the servicing fees, I think you call Fannie out in particular as maybe seeing more pressure than the others. I mean, any more details or nuances to how that interplay is working between the different products? I mean, is there more pressure on Fannie and when, if at all, do you think it hits your average servicing fee, I think which has been pretty stable for the last – at least a couple of quarters?

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

Well, if you look at the growth, Jason, in the servicing portfolio, I think the numbers that Steve put out were that we grew the portfolio 4% year-on-year and 2% quarter-on-quarter. It's a pretty darn big portfolio with $40 billion of mortgages in it. And it has very, very limited refinancings coming up in it over the next couple of years.

So what is there is there and is sitting at a 24-basis-point average servicing fee. The area where you're seeing margin compression is both on larger deals, where there are two factors. One, there's, generally speaking, more competition for them. And the second one is that on very large deals, we are capped on the amount of risk sharing we are allowed to take with Fannie Mae. And the way that they cap that is that we only take risk on certain part of the UPB, which then depresses our average servicing fee over the entire loan, but we still may be making very strong servicing fees for the piece that we're taking risk on.

Does that make sense? So if it's a $120 million loan and we can only take risk on the first $60 million, if it was a 30 basis point servicing fee, we're only taking risk on $60 million of it, which means that our average servicing fee on that is actually 15 basis points, even though on the $60 million that we're taking risk on, it's at 30 basis points. So that will show up in our numbers as being "margin compression" but it's just a larger loan where we're taking modified risk sharing.

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The other piece to it is in the adjustable rate mortgages that we are originating right now. Many, many borrowers, given how low interest rates are today, are opting to go with adjustable rate mortgages, both the capped arm product and the structured arm product.

In those situations, we are not booking mortgage servicing rights for the life of the loan. So a seven-year structured arm that we go do, we will book only two years of mortgage servicing rights on that loan. And then what ends up happening is if that loan sits on the books longer, we will then just have no amortization expense to go against the MSR, and we will just bring in the servicing income. So, one of the things that has happened as we have booked pretty big structured arms, you're getting a smaller, mortgage servicing right against the UPB that we've booked. But if the loan stays on our books, you're going to get the cash flow from that in the out-years where we haven't booked an MSR.

So, those are two drivers in the overall servicing calculation that bring that number down. But there is no doubt that two years ago, when Fannie and Freddie were – were three years ago, is probably a better example, dominating the market on a larger loan, you could be booking 40 to 50 basis points of servicing. On a larger loan today, you're going to be booking between 20 and 30 basis points. But the bottom line for us is that we are winning.

A year ago, when the banks were competing on variable-rate loans, they were winning that business. Today, Fannie and Freddie's adjustable rate mortgages are so competitive, they were winning that business. And so, obviously, we would prefer to win that business at lower servicing rates than lose it to a bank.

Jason M. Stewart
Compass Point Research & Trading LLC
Q

Well, that's great color. And I think that thinking about the average fee as it pertains to risk versus servicing is probably important for us to think about. One last one, and it's not something that we talk about a lot, but because there's – because obviously, there's no delinquencies.

But when you look out at the next year and you look at these loan maturities, how are you thinking about deal structure and credit? And maybe this is more macro than particular to what's going on in your portfolio, but how are you thinking about credit and the structure of these deals as these loan maturities come up next two, three years?

Willy Walker
Chairman, President and Chief Executive Officer
A

We are in a very competitive market, as both Steve and I said in our comments. And as we have seen in previous cycles, when everybody and their brother thinks that there's lots of money to be made in a certain market, they tend to overreach to be a significant player. One of the nice things for us is that we are such a significant player in this space that we don't need to overreach.

With that said, borrowers are exceedingly demanding today and are pushing lenders everywhere they possibly can because they heard that some other borrower got X, Y, Z terms on loan and they want the same. And so, you need to have an extremely disciplined credit culture inside of a company to be able to say to both the borrower, as well as the loan originator, that you won't do certain things.

And I would put forth that in our two largest businesses with Fannie and Freddie, our track record speaks for itself. And their track records speak for themselves as it relates to their losses during the downturn after having gone through the 2004 to 2007 period and competed quite effectively during that period of time.

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With that said, we're not seeing anything today that is reminiscent of 2007. But at the same time, we are also seeing full proceeds. We are seeing very limited amount of mezz, but mezz is starting to find its way back into the market. And as it relates to our credit performance, we finished the quarter with this cleaner portfolio as we have ever had and fantastic credit performance than what we have on the books today. But that only makes us more diligent about what we're doing today and how we're competing.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Yeah. And, Jason, I have to add that within the portfolio we have, we look out several years ahead to look at the upcoming maturities and factor that into our loan loss methodology. So, to the extent that there's anything in here that we would be concerned about, we get ahead of that from an allowance standpoint. There's nothing in there right now that causes us a lot of concern. I think we also benefit from the fact that on a relative – relative to the size of our portfolio, we don't have that much maturing in the next three years.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Got it. Thanks for the color and taking the questions. Appreciate it.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Yeah.

Operator: [Operator Instructions]. We'll go next to Charles Nabhan with Wells Fargo. Please go ahead.

Charles Nabhan
Wells Fargo Securities LLC

Q

Good morning, and congratulations on the quarter. I was wondering if you could comment on some of the newer structures and programs we've seen from the GSEs thus far this year and the impact that may have had – that's had on overall originations, and whether you see some newer programs in the pipeline that might enhance the competitive positioning of the GSCE and, I guess, result in a tailwind to originations as well.

Willy Walker
Chairman, President and Chief Executive Officer

A

Sure, Charles. They have both been quite innovative, I'd say Freddie a little bit more so than Fannie. And that's predominantly because Freddie is being allowed into some spaces where they weren't allowed into previously such as manufactured housing. And they also, to meet their scorecard objectives, need to do quite a bit in the affordable housing space where Fannie is really – had a much easier time of originating affordable loans than Freddie Mac has.

As it specifically relates to products, I mentioned previously, the capped arm and the structured arm. Both of them are competing very, very well against floating rate products from other providers of capital. And the other product that they have both rolled out in Q3 is a pre-stabilization product, so asset is not fully leased up, but is on a good glide path to leasing up, and they'll now do a [ph] pre-state (51:28) product.

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The other one is Freddie Mac has a product that's an Index Lock where you can go out and before we are ready to completely lock the rate on the loan, we can lock in the index. So you can go forward and lock the treasury rate that we will fund the loan on.

And that has allowed Freddie Mac to pick up a lot of deal flow. Life insurance companies, Charles, were quite effective at allowing people to early rate lock on deals. And with where interest rates have been, many, many borrowers are obviously, highly sensitive to where rates are going. And when rates rally, they jump to try and lock. The Index Lock that Freddie Mac has rolled out this year has been a fantastic product and captured a lot of deal flow for them.

So, those would be just a couple of the areas where they're innovating. I would put forth that if you back up a year ago to our call a year ago right now, it was a very different story where we didn't know what the future of the GSEs is going to look like, and both of them were basically doing business as usual. Today, they are innovating. Today, they are growing, and we, as one of their largest partners, are benefiting greatly from the, if you will, breath of fresh air that has come in to both of their operations.

Charles Nabhan — Q
Wells Fargo Securities LLC

Okay. That's helpful. And just had a couple of quick follow-ups on the Johnson Capital acquisition. First of all, could you break down the – their – although you've commented on the $1.3 billion in originations, but could you break that down by GSE and HUD? And as a follow-up to that, I was wondering if how we should think about the impact of the acquisition on personnel expenses relative to revenues going forward?

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

To check, I'll give that a shot. So, the $1.3 billion is their average over the last three years. So, there's obviously, some year-to-year ...

Charles Nabhan — Q
Wells Fargo Securities LLC

Variability.

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

... variability in that number. But I'd say, on average, 20% to 25% of their origination volume has been either Fannie, Freddie or HUD, and the rest has been brokered, as an average. Yeah, we brought on 54 employees. More than half of that 54 is on the production staff. And then there's a good amount that are analysts that support the production staff. And there's very few of the 54 that are really more kind of operational or back office folks. So, most of it – most of the 54 folks are on the production side.

Charles Nabhan — Q
Wells Fargo Securities LLC

Okay.

Willy Walker — A
Chairman, President and Chief Executive Officer

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Chuck, the big opportunity here is twofold. One, to convert more of their originations into originations where we book mortgage servicing rights or interest income, and the other is being on a larger platform like Walker & Dunlop with the brand we have and the access to capital that we have to take the average originations per originator up to a new level. And we've been quite successful at doing that previously with both our Column acquisition, as well as our CW acquisition, and we are very focused on doing the exact same thing with Johnson Capital. We have found originators really love being on our platform from both a culture standpoint, as well as a product standpoint. And our leadership position with the GSEs is fantastic when approaching clients on multifamily, and can also be used as an entry point to get into a client that might own multi but also owns retail, office and hospitality.

Charles Nabhan
Wells Fargo Securities LLC

Q

Okay. Well, I appreciate the color. Thanks again for your time.

Willy Walker
Chairman, President and Chief Executive Officer

A

You bet.

Operator: And at this time, I'm going to turn the call back over to Mr. Willy Walker for any additional or closing remarks.

Willy Walker
Chairman, President and Chief Executive Officer

Great. Thank you, everyone, for joining us this morning. Thank you for the questions, and we hope you all have a great day.

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

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