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Walker & Dunlop, Inc. (WD)

Q4 2014 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Walker & Dunlop's Fourth Quarter and Full-Year 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 800-753-0348. 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. You may begin.

Claire Harvey
Vice President-Investor Relations

Thanks, Kevin. Good morning, everyone. Thank you for joining the Walker & Dunlop fourth quarter and full-year 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 note that we may reference certain non-GAAP financial metrics such as adjusted net income, adjusted diluted earnings per share, adjusted operating margin, adjusted EBITDA, adjusted total expenses and adjusted income from operations during the course of this call. Please refer to the earnings release and presentation posted on our website for reconciliations of the GAAP and non-GAAP financial metrics and related explanation.

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Investors are urged to carefully read the forward-looking statements language in our earnings release. Statements made on this call which are not historical facts may be deemed forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include statements regarding future financial operating results, 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 the 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 to everyone joining us this morning. We had an excellent finish to the year with one of the strongest quarters in our history. We generated $4.3 billion of transaction volumes in the fourth quarter of 2014, with almost $3 billion executed with the GSEs.

Our fourth quarter 2014 volumes increased just under $2 billion from the year ago quarter or 83%, which drove revenues of $113 million on the quarter, up 32% over the fourth quarter of last year. The combination of strong revenue growth and expense management produced net income of $16.3 million, up 42% over last year, culminating in $0.50 of diluted earnings per share.

Our strong finish turned 2014 into an exceptional year. We grew our annual origination volume for the fifth – sixth consecutive year, and established a new benchmark by originating $11.4 billion of commercial real estate loans, 35% growth over 2013, and a compound annual growth rate of 38% since going public in 2010.

Our record transaction volumes generated $361 million in total revenues, up 13% over 2013, and $51.7 million of adjusted net income, or $1.59 per diluted share, an increase of 24%.

Finally, adjusted EBITDA grew to $84.8 million, up a dramatic 49% over 2013. Steve will go into more detail on our financials, but I'd like to simply say that our Q4 and full year 2014 results reflect the power and potential of the team and platform we have built at Walker & Dunlop.

We started scaling this company in the depths of the financial crisis, and today, our customers and shareholders are benefiting from the scale, brand and corporate culture of excellence we have built.

The business environment today is one of the strongest we have seen in years. Interest rates are extremely low, commercial loan refinancing volumes are accelerating, and commercial real estate assets are attracting capital from both domestic and foreign investors.

The U.S. dollar strengthening is attracting foreign capital to U.S. treasuries, where investors not only benefit from relatively high sovereign debt coupons, but also currency appreciation. Cheap oil and the lack of significant inflationary pressure have many economists pushing back their estimates on when the Federal Reserve will raise interest rates. And with longer maturing U.S. treasury bonds attracting so much foreign capital, it is our expectation that when the fed raises rates, that we will see a flattening of the yield curve. A flattened yield curve will likely make longer-term, fixed rate borrowing more attractive. With over 83% of Walker & Dunlop's 2014

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lending done in the form of long-term fixed rate loans, we see this development as net beneficial to our company and competitive positioning versus commercial banks who typically extend credit to the commercial real estate industry in the form of short-term floating rate loans.

We have talked at length over the past several years about the wave of loan maturities from 2015 through 2017, well as you can see from slide six, it is here. Our Q4 loan origination volumes coupled with our current pipeline reflect a significant increase in loan maturities from 2014 to 2015. What we did not project is that the interest rates would be this low, allowing for the vast majority of loans to be refinanced without the need for an ultra-high leverage first trust mortgage, mezzanine debt, or new equity capital. This market trend plays nicely for Walker & Dunlop, as our scale gives us access to deal flow and the market dynamic means long-term fixed rate loan executions with the GSEs and life insurance companies will remain highly competitive.

We've made consistent investments to grow our capital markets origination team to capitalize on the over $0.5 trillion of non-bank commercial real estate loans set to mature over the next three years. We have successfully grown our brokerage originations at a compound annual growth rate of 55% since our IPO.

As slide seven shows, in the fourth quarter 2014 we originated $1 billion of brokered business, an all-time high. And although we do not expect to repeat that every quarter in 2015, we do expect significant growth from this execution.

Our 2015 growth will come from the increase in loan maturities as well as the addition of Johnson Capital, which doubled the size of our capital markets team and deepened our brokerage footprint in the west and southwestern United States. Thus far the acquisition has been a great cultural fit and our new colleagues generated $204 million of business in the last two months of the year, right in line with our expectations.

In Q4, we crossed over the threshold of 100 sales professionals, positioning us exceptionally well to capitalize on all the opportunities this business environment presents. Since the Great Recession, our company's growth has been driven by our lending operations with Fannie Mae, Freddie Mac and HUD.

We saw the opportunity that existed in agency lending when capital was scarce and we capitalized on the opportunity by acquiring two large agency lending platforms and transforming Walker & Dunlop into one of the largest agency lenders in the country. While we certainly have opportunities for origination growth with the agencies going forward, given the massive refinancing opportunity in office, retail, industrial and hospitality loans, the bulk of our origination growth over the next few years is likely to be driven by our capital markets business.

As slide seven also shows, we finished 2014 originating $4 billion of Fannie Mae and $3.6 billion with Freddie Mac.

If you turn to slide eight, it shows Walker & Dunlop's market share with Fannie and Freddie. As you can see, we've been gaining market share at a rapid pace. On the year, Fannie Mae originated $28.9 billion in loans while Freddie Mac originated $28.3 billion, giving Walker & Dunlop 12% of Fannie Mae's total originations and 10% of Freddie Mac's, up from 11% and 8% respectively in 2013.

In 2009, we acquired certain assets of Column Guaranteed to broaden our lending platform to include Freddie Mac, and we have grown our originations with them at a compound annual growth rate of 70%, making us one of Freddie Mac's fastest growing partners.

In 2012, we acquired CWCapital to create a market leading position with the GSEs, and as the largest Fannie Mae DUS lender for the third straight year, we have achieved that goal. Both GSEs are winning tons of business in a

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very competitive lending market with abundant capital, and we are honored and extremely pleased to be one of their very largest partners.

Last week, the Mortgage Bankers Association released their estimate of a 7% increase in total commercial and multifamily financing volumes in Q4 2014 from Q4 2013. That 7% increase compares to Walker & Dunlop's 83% growth quarter-on-quarter.

Looking specifically at multifamily financing volumes, the MBA estimated a 15% increase in total multifamily origination volumes over Q4 2013, while W&D grew our multifamily volumes by 73%. And with regard to the GSEs, MBA estimated that volumes were up 33% across the industry as compared to 188% at Walker & Dunlop. We go head-to-head on a daily basis with much larger institutions that have business units that focus on commercial mortgage banking such as CBRE and Wells Fargo, yet we believe our focus and expertise give us a competitive advantage against larger firms.

If you turn to slide nine, it shows the Fannie Mae and Freddie Mac lead tables for 2014. On the left side of that slide, you can see the volumes and growth rates for the top five agency lenders per an analysis by Commercial Mortgage Alert last week.

CBRE's agency lending business grew origination volumes from 2013 to 2014 by 2%. Wells Fargo decreased their agency origination volumes by 2%, while Walker & Dunlop grew our volumes by 21%. 21% growth for W&D is based off of loan deliveries to Fannie and Freddie in 2014, while the numbers in our earning release show 35% year-on-year growth, because we recognize revenue when we rate lock a loan, not deliver it to the GSEs.

The current outlook for the multifamily finance market and GSEs is optimistic. Multifamily occupancies continue to hold steady and are improving in many MSAs. Rental growth and NOIs for multifamily properties continue to strengthen. Positive property fundamentals coupled with historically low interest rates are driving huge market demand for multifamily assets. With respect to the GSEs, the Federal Housing Finance Agency, FHFA, released its 2015 GSE scorecard in mid-January, months ahead of when it had been released the last two years, allowing both enterprises to budget and plan for the entire fiscal year.

As slide 10 shows, the FHFA maintained Fannie Mae's lending caps at $30 billion and increased Freddie Mac's cap from $25.8 billion to $30 billion. The increase to Freddie's lending cap is significant, as it puts them on an even playing field with Fannie for the first time ever. Freddie had a terrific year, and the fourth quarter 2014 was the first quarter ever where Walker & Dunlop originated more business with Freddie Mac than it did with Fannie Mae. It is important to note that just as Freddie Mac did in 2014, both GSEs can exceed their lending caps in 2015 due to small loans, affordable loans, and loans on manufactured housing communities not counting against the caps. So although the cap's sum is $60 billion, it is our estimate that the GSEs will originate between $65 billion and $70 billion in 2015. It is our clear intention to continue growing our market share with these two great partners.

The positive market dynamics that have benefited the GSEs and broader capital markets have had the opposite effect on HUD's multifamily business. As the economy has recovered, and bank and CMBS capital has reentered the market, borrowers have shied away from the long lead times required to get a HUD loan. As a result, we originated $704 million of loans with HUD in 2014, down 38% from the previous year.

Yet even with this significant decline in origination activity, our HUD team was able to achieve their 2014 revenue target due to strong gain on sale margins. As HUD's multifamily businesses declined, we have watched a number of our competitors divert resources and capital away from the business. We see that as an opportunity to continue

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adding resources and scale to our HUD business, particularly in the area of seniors housing, where HUD remains the dominant provider of capital.

HUD maintains its $30 billion capital allocation for the 2015 fiscal year and while it is unlikely they will reach that limit, their business and its economics are such that we will stay the course on our goal of being a top five lender with HUD.

As slide 11 shows our servicing portfolio has grown rapidly through acquisitions and organic growth, and now totals over $44 billion and generated $98.4 million of servicing fees in 2014, an increase of 9% over 2013.

Our servicing portfolio now includes 4,552 loans across the United States, with an average remaining loan life of 10.3 years, and an average servicing fee of 24 basis points. In addition to the almost $100 million in servicing revenue, we earned $17.1 million of ancillary income from the servicing portfolio in 2014, including interest on escrows, prepayment fee income, and assumption fees. This was a 75% increase from $9.8 million a year ago. Ancillary revenues can be volatile, but years like 2014 illustrate the broader value quotient of a servicing portfolio as large as ours.

We have spent significant time and effort explaining the value of this servicing portfolio to investors, but given that we were trading very close to the book value of the servicing portfolio at one time during 2014, the market is either dramatically discounting the value of our servicing or placing close to no value on our loan origination platform that originated over $11 billion of commercial loans in 2014. And, while we've repeatedly discussed the wave of loan maturities that we view as a tremendous market opportunity from 2015 to 2017, as slide 12 demonstrates, it does not represent a risk to the size of our servicing portfolio due to only $5.3 billion, or 12% of our portfolio, scheduled to mature over the next three years. Even better, the weighted average servicing fee of those maturing loans is only 13 basis points.

There will be scheduled principal payments and prepayments in our portfolio over the next three years. But, with an origination platform, it has grown originations at a compound annual growth rate of 38% since going public and only 12% of our servicing portfolio is scheduled to mature over the next three years. We see tremendous opportunity for significant growth in our servicing portfolio going forward.

With that, let me turn it over to Steve.

Stephen P. Theobald

Chief Financial Officer & Executive VP

Thank you, Willy, and good morning, everyone. We had an incredibly strong finish to the year. And as Willy mentioned, we achieved record revenues and originations for both the fourth quarter and the full year of 2014.

As you can see on slide 13, the strong second half of the year and fourth quarter in particular drove year-over-year improvements in our adjusted operating margin, which was 24% for the quarter compared to 21% in the prior-year quarter. And in our return on equity, which on an annualized basis was over 15% in the fourth quarter compared to 11% in the fourth quarter of 2013. For the year, operating margin of 23% was in line with our target range, while our return on equity of 12.8% is just shy of our long-term goal of low to mid-teens.

Turning now to slide 14, we also achieved significant growth in another key metric, adjusted EBITDA, which grew to just under $85 million in 2014, a 49% increase over 2013. The growth in adjusted EBITDA was due to higher operating income with a higher mix of revenues coming from cash revenue sources rather than non-cash gains attributable to mortgage servicing rights. The record origination volumes during the fourth quarter helped fuel the

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32% increase in total revenues quarter-over-quarter, resulting in our highest quarterly revenue ever of $112.6 million.

As outlined on slide 15, we generated increased revenues in every category; with origination fees, up 28%; MSRs, up 50%; servicing fees, up 10%; net interest income, up 122%; and other revenues, up 20% from the same quarter of last year. For the full year, revenues were up 13%, driven by the strong second half origination volumes, particularly the increase in Fannie and Freddie production.

I will provide a little more detail on our gain on sale margins, servicing fees, and net interest income in a moment. But before I move to the next slide, I want to touch on the increase in other revenues. Both in the quarter and for the year, the increase in other revenues is entirely due to an increase in prepayment fee income. During 2014, we had about the same level of prepayments from the portfolio as we had in 2013. However, the prior year prepayments were mostly HUD loans, for which the borrower pays a prepayment fee, but none of which comes to the servicer. In contrast, the 2014 prepayments were mostly Fannie Mae loans for which we received yield maintenance payments that more than offset the impairment of the mortgage servicing rights related to those loans. I think it is important to point out that at the end of 2014, 84% of our servicing fees from our $44 billion servicing portfolio are from Fannie Mae and Freddie Mac loans, which are fully prepayment protected.

On the next few slides, I will provide some additional detail on the impact of changes in mix on our gain on sale margin. During the quarter, we saw our gain on sale margin decline to 168 basis points from 202 basis points in Q3. While we had seen declines in gain on sale margins during the year primarily from compression in servicing fees on our Fannie Mae production, the fourth quarter decline in margin is due entirely to the shift in mix to a higher percentage of Freddie and brokered business, along with a higher percentage of business in variable rate products, which generally have lower gain on sale margins and fixed rate production due to the lower recorded MSR and little to no premiums on sale.

If you turn to slide 17, you can see that our floating-rate production has increased throughout the year particularly in Q4, driving down gain on sale margins. We love doing this floating rate business because it shows that Fannie and Freddie have created floating-rate products that can compete effectively in the market and it also gives us the opportunity to refinance these loans over the next several years.

Also on this slide is the trend in average transaction size, which has increased significantly. From an overall revenue and cost perspective, we love working on large transactions but they do generate lower gain on sale margins, all things being equal.

Given the current market dynamics, we expect to continue seeing a larger percentage of our business coming from Freddie and brokered. We expect to see variable rate originations remain strong while short-term rates are so low.

And finally we expect to continue working on larger transactions as our brand and expertise allow us to work on larger deals with larger borrowers. These trends are exactly what happens when markets expand and our strategy to increase origination volumes while closely monitoring operation costs has allowed us to withstand gain on sale margin compression while increasing our overall operating margin year-over-year.

We will continue growing all of our revenue streams while keeping a close eye on expenses to maintain that mid 20%s operating margin and a low-to-mid teens return on equity.

Turning now to slide 18 and servicing. We continue to see strong growth from our organic origination activity and very little in the way of prepayments and maturities. We ended the year at $44 billion in outstanding loans up $5 billion from the end of 2013. We added new loans to the portfolio of $9.7 billion while prepayments in maturities

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totaled $4.2 billion or 9% of the portfolio and normal attrition totaled just $460 million. The average remaining life of our portfolio continues to exceed 10 years, and the average servicing fee remains at 24 basis points.

At December 31, 2014, the fair value of our mortgage servicing rights was $470 million. As Willy discussed earlier, we expect continued growth in both our servicing portfolio and fee income, as organic growth is expected to continue to outpace maturities, early payoffs, and amortization.

Let me discuss net interest income for a moment, which includes our net warehouse interest, net interest on our interim loan portfolio, and interest on escrow balances, which in total increased a 122% quarter-over-quarter, and 92% over last year.

During both the quarter and the year, net warehouse interest benefited from the increase in origination activity and the higher average balance of outstanding loans held for sale. We also benefited from the dramatic increase in our interim loan portfolio, which is illustrated on slide 19.

We began using our balance sheet for interim loans back in 2012 and saw significant growth in 2014. As you can see from the slide, we grew the portfolio $89.7 million during the year, with new originations totaling almost $340 million, offset by loan payoffs of $250 million. Importantly, 94% of these loans were permanently refinanced by us, and to Fannie, Freddie or HUD, generating total gains on sale of $7.7 million. Credit quality continues to be good and returns on the portfolio have been stellar, with an IRR of 15% for the year.

On the expense front, as you can see on slide 20, total expenses for the quarter were $86 million compared to $67.5 million in the prior year quarter. For the year, total expenses were $276.9 million compared to $252.3 million in 2013. The increase in commission payments due to strong loan originations as well as fantastic financial results which drove higher bonus compensation throughout the organization, increased our variable compensation by 45% for the quarter and 30% for the year.

Base salaries and benefits were actually down year-over-year as a result of the cost cutting measures we took in the fourth quarter of 2013. We did see base salary and benefit expenses increase in the fourth quarter over the prior year quarter due to the Johnson Capital acquisition.

Although overall compensation expense increased year-over-year, compensation as a percentage of revenues remained at 43% for the quarter, flat to last year, and 41% for the year down from 42% in 2013.

Amortization and depreciation expense increased year-over-year as we continued to grow our mortgage servicing rights. The interest expense increased year-over-year due to the term debt we issued in December of 2013, which allowed us to buy back stock and grow our on-balance sheet lending dramatically.

Our provision for credit loss has increased year-over-year in line with the growth in our interim loan portfolio. Credit performance in our Fannie Mae at risk portfolio continues to be phenomenal and did not require significant additions to loan loss reserves. We remain focused on driving efficiencies in the business and managing our fixed cost structure closely. To that point, we were able to reduce other expenses year-over-year and to hold them flat quarter-over-quarter, even after taking on the additional cost of the Johnson Capital platform in November.

Q4 also includes a one-time expense of $1.3 million related to the termination of our joint venture with ARA. ARA was acquired in the fourth quarter, and under the terms of our JV agreement, termination of venture triggered a payment to them for a portion of the future servicing fees on loans that were originated through that venture.

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Because we were paying ARA a portion of the ongoing servicing fee for those loans, this payment is nothing more than an acceleration of servicing fees we would have paid them in the future.

From this point forward, we will receive 100% of the servicing fees related to the loans and will recover the $1.3 million over the next two years, while the loans have an expected remaining life of approximately seven years.

Before I turn the call back over Willy, I want to take a moment to discuss our balance sheet and liquidity. On slide 21, we provide you a summary balance sheet comparing year-end 2014 to year-end 2013. During 2014, we deployed approximately $125 million of cash in a variety of investments, including the buyback of CS's shares, funding the interim loan portfolio, funding our CMBS lending, acquiring Johnson Capital and increasing our pledged securities portfolio.

With all of this investment, we still ended the year with $113 million of available cash, meaning we generated additional net cash of $68 million during the year, demonstrating the cash producing strength of our business.

In addition with a debt to equity ratio of 0.4 and a debt to adjusted EBITDA ratio of 2 times, we have the financial flexibility to add additional leverage as needed to support our future growth. We will continue to deploy capital in a disciplined manner to drive future growth and generate great returns for our shareholders.

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

Willy Walker

Chairman, President and Chief Executive Officer

Thank you, Steve. 2014 was an extremely successful year for our company by almost all measures. We accomplished a great deal that positions us well for sustained success in our industry and in creating value for our shareholders. We entered 2014 with the goal of maintaining our market leadership position as a multifamily lender, expanding our sales force and deploying the $170 million of capital on our balance sheet following the raising of term debt in December 2013. Month-by-month we did just that.

In February, we opened a new office in Tampa, Florida. In March, we repurchased all of Credit Suisse's $2.4 million shares, eliminating an investor overhang from our stock. In June, we opened a new office in Charlotte, North Carolina and launched our CMBS conduit in New York. In July, we saw our serving portfolio surpass the $40 billion mark.

In August, we added origination talent in Tampa in Boston. In September, we added origination talent to our CMBS platform. In November, we acquired Johnson Capital. And by the end of the year, we had originated $11.4 billion of loans, grown our market share with Fannie Mae and Freddie Mac, deployed $44 million of capital on-balance sheet for interim loans, increased our earnings per share by 24% and saw our share price increase 8.5% on the year.

I'd like to talk for a moment about our shareholder returns and stock price. As the CEO and second largest shareholder in Walker & Dunlop, I take Walker & Dunlop share appreciation very seriously. As both Steve and I just discussed, we repurchased 2.4 million shares from Credit Suisse in March of last year.

We felt that our stock was significantly undervalued at a trailing 12 PE of 12.8 times. And we repurchased all of CS's shares at $14.50, which has generated a greater than 20% return on investment in nine months. Fortress Investment Group owns just over 8 million shares of Walker & Dunlop stock after selling 2 million shares in early November 2014. Fortress has held this investment in Walker & Dunlop for well over two years and they've been a

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fantastic partner and shareholder. It is our expectation that Fortress will sell down its position over the coming years and we look forward to Fortress' shares getting into a broader group of shareholders over time.

As Steve mentioned, we currently have $113 million in cash on our balance sheet and we may use some of that cash to selectively buyback shares when we see opportunities like we did with Credit Suisse. The fundamentals of our business improved throughout 2014 and are very strong entering 2015. It is our assumption that quarterly owned origination volumes in 2015, unlike 2014 will follow a more typical pattern of stronger volumes in Q2 and Q4, and weaker volumes in Q1 and Q3.

However, with the dramatic increase in refinancing volumes year-over-year, we should see volume increase in Q1. We have grown revenues at a compound annual growth rate of 31% over the past four years, during a period when commercial loan refinancing volumes have decreased every single year. We have grown our servicing portfolio to be the eighth largest commercial loan portfolio in the country that has an estimated fair market value of $470 million and will generate over $100 million in revenue in 2015. The cash flow that the servicing portfolio generates provides us with a durable flow of funds that enhances our financial flexibility; to reinvest in our business, to buy companies, to invest in new businesses or to return capital to shareholders.

The theme for 2015 is focus and continued growth. We will work to maintain our position as one of the largest providers of capital to the multifamily industry by remaining the largest Fannie Mae DUS lender and moving up to be in the second largest Freddie Mac seller servicer. We will achieve our longstanding goal of originating between $3 billion and $5 billion of brokered business and also strive to be a top five HUD lender. We will use our strong balance sheet for our bridge loan program and to fund the growth of our CMBS conduit. We will continue to add the very best mortgage bankers in the country to our platform, and finally we will strive to achieve double-digit earnings growth to outperform the market and meet our shareholders' expectations for a fast growing entrepreneurial company that has built a scaled lending business that can compete with the largest financial services firms in the world. I want to thank and congratulate all of my colleagues at Walker & Dunlop for a fantastic 2014.

With that, I would like to ask the operator to open the line for any questions.

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QUESTION AND ANSWER SECTION

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

Bose George
Keefe, Bruyette & Woods, Inc.

Q

Hey, guys. Good morning, and congratulations on a good year. Just first on the gain on sale margin trends, you guys noted that it's largely on the mix shift. Just been thinking about how that moves next year, it looks like Freddie Mac had a huge increase in their volume in the fourth quarter. So it seems like that might have disproportionately impacted it, so if Freddie Mac is better spaced out next year, does it suggest that the blended margin ends up being higher than you guys did this quarter?

Willy Walker
Chairman, President and Chief Executive Officer

A

Bose, good morning , and nice to have you on the call. The- look, Fannie and Freddie both go in and out of the markets at various times during the year, and it's very clear that we had an extremely strong Q4 with Freddie, we also had a very strong Q4 with Fannie, but relatively speaking, did more with Freddie for the first time ever. And in Q1, right now, I would say if you look out at the marketplace, Freddie is winning more than Fannie but as always happens the two of them sort of enter and exit the markets at various times. So, it's very hard to sort of project what every quarter will be like and whether the volumes of Fannie or Freddie go up or down.

So, it's hard to project forward. I would say that we have a lot of momentum with Freddie Mac right now. As the slide that we pointed to in the call shows, we've had outstanding growth with Freddie over the past couple of years and gained lots and lots of market share. And so, I would just say that I think that that would probably continue and as a result of that they will become an increasing percentage of our overall origination volumes and their business on an MSR basis, as you well know is less MSR, [ph] rich (36:27), I guess you'd say, than a Fannie Mae loan.

Bose George
Keefe, Bruyette & Woods, Inc.

Q

Okay. That makes sense. Thanks. And then just on your sort of expectations for the $65 billion to $70 billion for the GSE production this year, actually the number for 2014, was that in the high 50? It looks like 20%ish growth potentially for them.

Willy Walker
Chairman, President and Chief Executive Officer

A

So, Freddie had a capital of $25.8 billion, Fannie had a cap of $30 billion in 2014. So, if you look at the $65 billion to $70 billion that we put forth, yes, off of what they had in that cap, but importantly both in 2014, both of them had the same opportunity to originate as much in small loans, affordable loans, and manufactured housing loans as they wanted, and those loans wouldn't count against the cap. So, as you see in Freddie Mac's numbers, they had a cap of $25.8 billion, but they did $28.3 billion. The reason they did $28.3 billion is that the small loans, affordable loans and manufactured loans didn't count against the cap and therefore they could flow through the cap. Fannie had the exact same opportunity but didn't exceed its cap. So it's our expectation, given with the

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amount of flow business we're seeing in the market, or market rate, plus their focus on specialty products of small loans, manufactured loans and affordable loans that they will both exceed their caps in 2015.

Bose George
Keefe, Bruyette & Woods, Inc.

Q

Okay. Great. That makes sense. Thanks a lot.

Willy Walker
Chairman, President and Chief Executive Officer

A

Yep.

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

Brandon B. Dobell
William Blair & Co. LLC

Q

Thanks. Good morning, everybody.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Good morning, Brandon.

Brandon B. Dobell
William Blair & Co. LLC

Q

Just wanted to, maybe start with a couple of things towards the end of the presentation. Steve, given you've got 2 times debt in terms of leverage, how much more capital would you be okay with deploying? Is there a leverage number that we should think about as where you start to get uncomfortable with the amount? Or is it going to have to depend on what kind of capital or into what kind of opportunity that capital is deployed?

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Yeah. Brandon, yeah, from our perspective, I think if you go back to when we did the original term loan transaction back in December of 2013, our trailing 12 month EBITDA was somewhere in the $50 million range, which translated to just under 4 times EBITDA level. I think from our – we are a BB minus rated company and would like to stay at least at that level if not higher. And so I think 4 is probably a natural cap on that. Obviously, with $85 billion – or $84 billion – or $84 million of EBITDA in 2014, that would be substantially more debt than what we've got on the balance sheet right now, [ph] like (39:33) 4 times.

Brandon B. Dobell
William Blair & Co. LLC

Q

Got it, okay. On the servicing portfolio, could the – gross dollars added this quarter were pretty fantastic, maybe a sense of those dollars added, what does that look like from an average servicing fee? It feels like most of them are prepayment protected except for maybe the Johnson dollars that were added. Just trying to get a sense of that leading edge of growth in the servicing portfolio, what does that look like relative to the existing base in terms of how you think about risk, attractiveness, fees, visibility, those kind of things?

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Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Yeah. So, Brandon, basically what got added in the year was pretty much in line with our ongoing average servicing fee.

Brandon B. Dobell
William Blair & Co. LLC

Q

Okay.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

And, you blend it all together. So, really not much change from the standpoint of what's going into the portfolio.

Brandon B. Dobell
William Blair & Co. LLC

Q

Okay.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

As Willy mentioned, what's coming out of the portfolio over the next few years is actually coming out at less than our average servicing fee, at least with respect to scheduled maturities based on the business that we've done back in 2005, 2006, 2007 timeframe. That business was coming on at lower servicing fees. So, I think 13 basis points is the average of servicing fees on the loans that are maturing over the next three years.

Brandon B. Dobell
William Blair & Co. LLC

Q

Okay.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

But, right now, we're still putting in 24 basis point business.

Brandon B. Dobell
William Blair & Co. LLC

Q

Got it, okay. And then, shifting over to the -- I guess again, on sale margin, and there is mix issues both within terms of product as well as capital provider, given the amount of business out there to do especially with that chart you referenced about, refinancing opportunities and how competitive both the agencies are being with each other as well as their capital sources, how do we think about the 2015 trajectory on those -on gain on sale margin, given your comments about expectations for strong origination growth. So will we continue to see these things slide at the same pace, is there a floor, just given what the mix is probably going to shift to in 2015, that we should think about?

Willy Walker
Chairman, President and Chief Executive Officer

A

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Brandon, I think there are couple of things that have to be kept in mind. The first one is that we're going to originate loans and go to the most appropriate execution for that loan. And what we're seeing in the market today is exactly what we knew would happen. Capital comes back in, competition drives deal-by-deal margins down, and the way that you, if you will, combat that, is to grow your revenues, grow your origination volumes and manage your costs very well. And that's exactly what we did in 2014 and particularly in Q4. So, there is – I think that there is quite a bit of focus on loan by loan, we have margin compression. At the end of the day, if you look at Q4 in 2014, what we did effectively was grow the top line and manage cost to be able to have margin expansion on the year at the operating and the net income level. So, we'll continue to do just that. I think the other thing that if you look at it as it relates to us versus a number of our competitors and you cover a number of them. You look at the overall profitability and operating margin of our business and comp us against many of the other firms, we still have in a number of instances, 600 basis points to 700 basis points of additional margin in our business versus the pure brokerage competitors today.

So as much as we're very focused on a deal by deal what we make, I think Steve went through very clearly the mix shift of doing larger loans and then also doing variable rate loans, and the variable rate loans actually is a fantastic story because on the variable rate loans, A; we've got products that are actually winning, where two years ago, Fannie and Freddie didn't have variable rate products that we're going to win. So A, we're thrilled that we're winning them. Second of all, we're only booking MSRs typically on a 5-year or 7-year floater for two years. So if those loans stay on our books for longer than two years, the servicing income that comes into us is not used to amortize our mortgage servicing right. It all comes into cash. So if they stay on over two years, we get pure cash flow into the company, and the other issue that is on those floaters, we have the opportunity to refinance them in a very short period of time. So if they come back to us in year 3 or year 4 and say we need to redo this, we have another bite at the apple. So as much as it has what appears to be somewhat of a negative effect on our MSRs today, it actually is a huge business opportunity for us and I would back up to the previous comment, which is just that we're thrilled to be winning this business, where two years ago we were not.

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

Got it. Okay. So kind of the segue way question off of that was just given your guys' comments about the right operating margin range or target operating margin range, doesn't seem like there's any change to that with the lower fees, just the cost structure is going to be matched up to how that fee trajectory looks, is that a fair way to discover it right now?

Willy Walker — A
Chairman, President and Chief Executive Officer

That is exactly the punch line and that is exactly how we're managing the business. There's no way other than doing what we're doing to be able to deal with a highly competitive market environment, that's the way you deal with it. You grow revenues and you manage costs.

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

All right.

Willy Walker — A
Chairman, President and Chief Executive Officer

And at the end of the day, it's our responsibility to continue to maintain operating margins or grow them and continue to increase earnings per share.

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Stephen P. Theobald
Chief Financial Officer & Executive VP
A

And I also think Brandon, within the other dynamic there within the overall origination mix is; A) we have a lot more feet on the street in the capital market space than we had during the year with the Johnson Capital folks coming in at the end of 2014, plus if you look at the wave of the maturities, a lot of that wave is non-multifamily commercial real estate, which is what that team is going to be going after.

Brandon B. Dobell
William Blair & Co. LLC
Q

Yeah.

Stephen P. Theobald
Chief Financial Officer & Executive VP
A

So, all things being equal, while we're certainly intending to grow all of our executions, there's an outsized opportunity to grow in the brokerage space, which is going to drive the overall margin down, but to Willy's point, from an operating margin perspective, that is a 100% scale business, there's very little in the way of fixed costs and for us to expand that business doesn't require a bunch more cost or investment to process. We don't underwrite it, we don't close it.

Brandon B. Dobell
William Blair & Co. LLC
Q

Yeah.

Stephen P. Theobald
Chief Financial Officer & Executive VP
A

So, the more we do the better-off we are at the end of the day, from an overall operating margin standpoint.

Brandon B. Dobell
William Blair & Co. LLC
Q

Got it. And then a final one from me. Sound like you are pretty confident that Q1 originations are going to be up year-on-year, maybe a little more color there, I know there is an impact on Johnson, but it's relatively small compared to the overall origination pipeline, so maybe there's a little more color on how much we should expect it to be up, I guess, on a gross basis, but also in organic basis? Thanks.

Willy Walker
Chairman, President and Chief Executive Officer
A

Yeah. As you know Brandon, we're not giving guidance, and so I won't give you a number or any type of growth off of last year. I think what we're very – what we're seeing and what we expect to see in the year is that, as I said, a return to Q2 and Q4 being the strongest quarters of the year from a financing activity and then Q1 and Q3 being the lower, but with that said as you can see both in our Q4 activity and what we're seeing in the market today, given the amount of refinancing activity that is going on, volumes will be up Q1 over Q1. And so, that's the color we're giving on it, but I would just say that as both Steve and I said in our prepared remarks there's a lot of activity in the market today. And a year ago right now, you may recall there was almost no activity in the markets, either from a refinancing or from an investment sales standpoint. So, it is quite a different mid-February 2015 from where the overall market was in 2014.

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Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Yeah. I think, think about it a little bit, if you go back to Q4 of 2013, we ended the year with not a lot of momentum, because the agencies had been pulling back so they had a flurry of activity and that led to frankly a pretty slow first quarter last year. And the scorecard didn't come out until May.

So, I would expect we had a lot more momentum obviously going into the, into the first quarter of this year.

Brandon B. Dobell
William Blair & Co. LLC

Q

Okay, that makes sense. Thanks a lot, guys. I appreciate it.

Operator: [Operator Instructions] Our next question is from Jason Stewart with Compass Point. Your line is now open.

<[05QJ6L-E Jason Stewart]>: I wanted to follow up on Willy your comment on margin on a loan-by-loan basis. If you held [ph] channeled (49:14) fixed floating constant, would there be any margin compression?

Willy Walker
Chairman, President and Chief Executive Officer

A

On a loan-by-loan basis, Jason, what we've looked at, no. In other words, if you look at a Fannie Mae Tier-2 loan at – on a smaller loan size, $15 million deal, there has been very, very little margin compression from a servicing fee standpoint. And so, what we have – what we've seen is, we have grown therefore we're doing larger loans, we have done more floating rate business, which I just talked to Brandon about the difference in the way we book MSRs on that. And then, there is the mix shift from doing more at Freddie Mac, which from just an MSR booking standpoint, we book lower MSRs on our Freddie business, because we don't take risk on those loans. And then, more on the brokerage channel, which is all in the diversification of Walker & Dunlop's origination platform.

So, clearly, there are certain deals, where, go back to the previous example. I said, it's a $15 million Tier-2 loan with Fannie Mae, where three years ago, when there were very few capital sources out there, the servicing fees were richer, because there just wasn't the competitive bid. That has come in. But, what we have seen so far does not cause us, as far as compression, its still – on a loan-by-loan basis with Fannie Mae, we've not seen dramatic difference other than the mix and the size of loans and the type of loan as far as variable rate versus fixed rate.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Okay, that's certainly helpful. And then, how much of the decline in Freddie's fixed business or increasing floating business in the fourth quarter do you think was in response to them trying to get to their cap, and dealing with that drop in interest rates?

Willy Walker
Chairman, President and Chief Executive Officer

A

I don't think it is them getting to their cap, Jason. I think it's the fact that borrowers saw rates continue to fall and they said, I will take advantage of this. So, there were plenty of borrowers throughout 2014 that sat there and said, okay, the Fed is going to raise, the Fed is going to raise, I might want to jump on fixed rate. And then, all of a sudden, as you accurately say, rates continued to go down and I think may borrowers said, why don't I go with a

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three-year or five-year floating rate instrument, I don't think rates are going to move that quickly. And if they do, I can always – the variable rate instrument has a year lock out, and then from there it's open to prepayment with a 1% penalty. And so, it's a very flexible instrument and so, a lot of borrowers said, I want to go float.

And as I said in my comment to Bose, the beauty of it is that in 2013 when the banks were out there, Fannie and Freddie didn't have a floating rate product that could compete with the banks, and in 2014 they did, and we won. So, that big growth in floating rate product for us is a huge win because we won the deals, and not only did we win the deals, we got another bite of the apple when they come back around for either another floater or for a fixed rate loan.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

I think if you go to the slide that we showed, the mix of fixed variable rate lending, it doesn't show up that much, but if you look at Q3 of 2013, there was a little bit of a spike in our variable rate mix. That was the quarter when the banks came in and basically took all the business away from the agencies because they weren't competitive and couldn't offer the same kind of floating rate product, that's business we lost in 2013 and we won in 2014.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Right. It seems to me looking at these numbers that what- you're holding on to the core business and your market share in the fixed product, but what you are adding on the margin is just a different product that's increasing volume and net-net that's pushing your overall gain on sale down, but your core margin by product doesn't seem to be changing by much and I just wanted to make sure that my math was [ph] footing (53:22) with what you guys were seeing? You're can agree or disagree with that if you want to, otherwise I'll move on to another one.

Willy Walker
Chairman, President and Chief Executive Officer

A

I would agree with that and I would just say to you that as the markets continue to – I mean one of the things that is somewhat just a little bit on the side of that, Jason, is that in 2014 the real competition was between Fannie and Freddie. And so we will see what happens in 2015 as it relates to other market participants. Right now in the multifamily world, it is really a two horse race. Do conduits win deals? Yes. Do life insurance companies, did they start the year saying low leverage Class A properties, we want to win, certainly. And do banks come in on either construction loans or bridge/short-term floaters and win. Plenty of borrowers of ours have big relationships with banks and banks when they want to win will win, but I think generally speaking, the agencies are extremely well positioned for another great year in 2015, and I would go back to what Steve said in his remarks which is that the FHFA scorecard came out earlier than we've ever seen it. It basically is business as usual for both Fannie and Freddie and that has both GSEs very focused and very excited about what they can do in 2015.

I would add one other piece to the relationship between Fannie and Freddie which is that Freddie is dead-set on beating Fannie in 2015 to be the largest provider of capital in the multifamily market, and Fannie is dead set on 2015 in maintaining its positioning as the largest provider in capital to the multifamily market. So the competition between the two of them will be, I believe, quite fierce throughout the year, which as one of the largest partners to both of them I think positions Walker & Dunlop very well.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

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Good, thank you. And then, I appreciate the estimate of the affordable/small loan balance at market size. Is there any difference in your market share or your expectation for market share there versus the core market that subject to the cap?

Willy Walker
Chairman, President and Chief Executive Officer

A

So, we were – in 2013, we were the third largest Fannie affordable lender, and we didn't get into their top three in 2014. In 2014, we were Freddie Mac's number one very low income originator, and we were also their largest manufactured housing originator. And, manufactured housing is a – if you will, a specialty product where Walker & Dunlop have fantastic client relationships, and loan origination professionals who are completely expert in that space. So, as it relates to affordable very low income and manufactured housing, I would say that we are very well-positioned there.

On the small loans, you may recall, Jason, that we exited the small loan business back in November of 2013. We were getting beaten by the banks, it is a very distinct business model to what Walker & Dunlop does. And, as everyone can see from our 2014 numbers, we are growing in our average deal size, not shrinking in our average deal size.

So for us to spend a huge amount of time running after $0.75 million or $0.5 million multifamily loans, it is just a very distinct business model. So, we have been approached by both GSEs to say can you guys originate a lot of small loans for us. And, so far, we have shied away from it, because it is a very, very different business from what we do.

But, as it relates to affordable and manufactured housing, we have the relationships and access to deal flow to be a significant contributor to both Fannie and Freddie along in those lines.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Great. Thanks for the color, and congrats on a strong end to the year.

Willy Walker
Chairman, President and Chief Executive Officer

A

Thanks, Jason.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Thanks, Jason.

Operator: And it appears we have no further questions at this time. I'll now the turn floor back over to Willy Walker for any additional or closing remarks.

Willy Walker
Chairman, President and Chief Executive Officer

Thank you, everyone for joining us this morning. I'd reiterate my thanks to all of my colleagues at W&D for a fantastic 2014 and we look forward to talking to many of you again throughout 2015. Have a great day.

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

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