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Walker & Dunlop, Inc. (WD)

Q4 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to Walker & Dunlop's Fourth Quarter and Full Year 2015 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 800-753-9197. The archived call is also available via webcast on the company's website. At this time, all participants have been placed in a listen-only mode and the floor will be open for questions following the presentation. [Operator Instructions]

It is now my pleasure to turn the floor over to Claire Harvey. Please go ahead, ma'am.

Claire Harvey
Vice President-Investor Relations

Thanks, Keith. Good morning, everyone. Thank you for joining the Walker & Dunlop fourth quarter and full year 2015 earnings call. I have with me this morning, our Chairman and CEO, Willy Walker, and our CFO, Steve Theobald. This call is being webcast live on our website and the recording will be available later this morning.

Both our earnings press release and website provide details on accessing the archived call. This morning, we posted our earnings release and presentation to the Investor Relations section of our website, www.walkerdunlop.com. These slides serve as a reference point for some of what Willy and Steve will touch on this morning.

Please also note that we may reference the non-GAAP financial metric, adjusted EBITDA, during the course of this call. Please refer to the earnings release and presentation posted on our website for a reconciliation of this GAAP and non-GAAP financial metric and any related explanation. Investors are urged to carefully read the forward-looking statement 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 risk, 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'll turn the call over to Willy.

Willy Walker

Chairman and Chief Executive Officer

Thank you, Claire, and thank you all for joining us this morning. 2015 was an incredible year across the board for Walker & Dunlop; record financing volume, record earnings, entry into new markets and new business lines and overall growth in our platform. Steve will go through our Q4 and full year financial results in detail in a moment, but I would like to begin by talking about the market we find ourselves in today and how Walker & Dunlop plans to compete and win going forward.

The past six weeks have seen a tremendous dislocation in the capital market. It has been unsettling to watch the equity markets sell-off, particularly in the real estate sector, after what has been a very strong year for commercial real estate. At the same time, treasury rates have fallen, while spreads have widened, creating uncertainty in the debt capital markets and potentially impacting the supply of capital to commercial real estate.

There is clearly a risk-off trade taking place right now and investors want to know what exposure companies have to oil and gas, China and a slowing global economy. And although major market swings are always concerning and require extremely cautious management and strategic execution, we feel very about Walker & Dunlop's core businesses today and over the coming years.

We have scaled best-in-class loan origination platforms with Fannie Mae, Freddie Mac and HUD, the three largest sources of countercyclical capital in the commercial real estate industry. We see great opportunity to continue scaling our debt and investment sales brokerage platforms, given their modest size today and significant deal flow in 2016 and 2017. And the capital we have deployed on our balance sheet and through our CMBS platform will become increasingly important to key clients who have needs that cannot be met by other capital providers.

Looking at the broader market, the supply of multifamily housing continues to be constrained as new household formation grows, yet single-family housing is not a realistic alternative for large numbers of Americans. Whether it be student loan debt, the lack of wage growth or simply evolving demographics, many Americans are choosing to rent and that has driven rents and occupancy to higher and higher levels.

The fundamentals underlying multifamily real estate are very strong. And until single-family housing takes off or multifamily development grows to such a level that it creates a glut of supply, fundamentals should remain strong for the sector.

At the end of 2015, not a single at-risk loan in our $50 billion servicing portfolio was 60 days delinquent and the debt service coverage ratio of our at-risk portfolio was approximately 1.9 times. Further, our at-risk portfolio contains very little exposure to the energy sector, with the top 10 oil dependent markets making up only 1% of our portfolio. We feel very good about our loan portfolio and credit position today.

As it relates to the supply of capital to the commercial real estate industry, there are several themes developing. First, many commercial and investment banks are concerned about their exposure to high-yield debt, particularly related to the oil and gas sector and it's unclear whether this exposure will impact their view on commercial real estate lending.

Second, the regulatory environment for banks, particularly commercial banks, is extremely challenging and causing many of them to pullback from commercial real estate lending as capital requirements and regulation increase. It appears early on from discussions with banks and borrowers that construction lending will contract in 2016.

Third, the CMBS market is very volatile as B-piece buyers try to establish new pricing levels for their risk and as swap spreads bounce around due to uncertainty on whether central banks will tighten, loosen or stay put given current market conditions. There is a massive amount of CMBS debt to be refinanced this year and next. So, there is a clear need for CMBS market to find new levels and start to transact again, but when and at what volume is anyone's guess right now.

Finally, the new risk retention rules for securitized loans are going to have a profound impact on the CMBS market. Who decides to retain risk and at what price is a big question mark for the industry today.

Several of these themes should benefit us in 2016. For example, the uncertainty in the equity and debt capital markets will make GSE financing extremely competitive due to investor demand for government-backed paper. The 2016 GSE scorecard not only raised Fannie and Freddie's market rate lending caps by $1 billion to $31 billion each, but also added a quarterly market review, which allows for an increase to the caps should the market be more active than anticipated. The new scorecard also added some new property types to the list of those excluded from the caps, such as buildings that meet high environmental standards.

As you can see on slide three, we delivered record volumes to the GSEs in 2015, capturing 11.9% of Fannie's market share and 10.8% of Freddie's. We grew our Fannie originations by over $1 billion or 25%. And with Freddie, we closed three mega financings during the year, which helped propel a $2.7 billion or 74% year-on-year increase in loan volume with Freddie Mac.

We have been a Freddie Mac seller/servicer for only seven years, and to grow from zero to over $6 billion in annual loan originations in such a short period of time is simply incredible. Freddie Mac recently forecasted its 2016 volume of $50 billion and we believe that Fannie Mae's market opportunity is similarly large. W&D's leadership position with both Fannie and Freddie positions us extremely well for yet another great year of GSE lending.

Life insurance companies provided an estimated $77 billion of commercial real estate loans in 2015, up from $60 billion in 2014. The increase in bank regulation and capital standards that I mentioned previously should allow life insurance companies to play an even larger role than normal in 2016, predominantly, on higher quality real estate at lower leverage points.

Insurance companies rely heavily on brokers to access deals and structure transactions. We did $3.9 billion of brokerage business in 2015 and have grown our brokered origination volumes at a 49% compound annual growth rate over the past 4 years. As the commercial real estate loan maturities continue to grow in 2016 and 2017, we feel very good about continued growth in our brokerage business.

CMBS is dealing with a double whammy of uncertainty, which makes pricing loans very difficult and the new risk retention rules that kick in later this year. With that said, we see opportunity in CMBS going forward, given the massive amount of maturing loans expected in 2016 and 2017. We were fortunate to have had Fortress as our partner in building our conduit. And now with 100% ownership and control, we believe we can use our access to deal flow, talented credit team and longstanding capital relationships to be an active CMBS lender.

But unlike many of the larger CMBS platforms with high fixed costs, we have the great luxury of carrying a small team that can be patient and discerning about when and how to play in this market. So as we look forward to continued growth in our core loan origination businesses, coupled with the credit strength of our servicing portfolio and strong cash flow it kicks off, yesterday, our Board of Directors authorized the repurchase of up to $75 million in stock over the next 12 months. We have executed on two previous share buybacks that created tremendous value for our shareholders. And we believe the fundamentals of our business going forward will make this plan equally as successful.

I'll come back with more details about what we expect in 2016 in just a moment, but for now, I will turn the call over to Steve to run through our Q4 and 2015 results. Steve?

Stephen P. Theobald

Executive Vice President, Chief Financial Officer and Treasurer

Thanks, Willy, and good morning, everyone. 2015 was truly a banner year for Walker & Dunlop. Continued investment flows into commercial real estate, a swell of maturing loans, low interest rates and steady availability of capital, provided significant boosts to our volumes and top line growth.

We grew transaction volumes 56% to $17.8 billion, adding over $100 million in revenues to our top line. We grew our servicing portfolio by $6 billion, ending the year with a $50 billion portfolio, with an average servicing fee of 25 basis points. The growth in transaction volumes and servicing pushed diluted EPS up 68% to $2.65 per share and generated 47% growth in adjusted EBITDA to $124 million.

We finished the year with a very strong fourth quarter that included the largest portfolio of loans ever financed by Walker & Dunlop. All of the financial metrics for the fourth quarter were in line with the previous three quarters and well above estimates thanks to the strength of the commercial real estate financing market and the strong execution of our team. I'll go through the drivers of our fourth quarter performance in a high level and then discuss our key metrics for 2016.

As you can see on slide four, 2015 saw a positive step change in all of our key metrics and the fourth quarter was no exception. Net income for the quarter was $20.4 million, up 26% from Q4 2014. Earnings per share grew 34% from the prior year to $0.67 per share. Return on equity in the fourth quarter was 17% compared to 15% last year. Personnel cost as a percentage of revenues were 41%, lower than the 43% reported in the prior year. Q4 adjusted EBITDA was $29 million, up 24% from $23.4 million last Q4. All in all, a great end to the year and gratifying to see it all come together.

Total transaction volume for the fourth quarter was $4.7 billion, up 10% from last year's Q4. Slide five shows the detail. Fourth quarter transaction volume was driven by continued strong performance in our GSE lending, which included financing a $1.3 billion floating rate transaction with Freddie Mac and another solid quarter for brokered originations and investment sales.

As slide six shows, our gain on sale margin was 179 basis points, at the high-end of our expected 160-basis point to 180-basis point range and very strong even with the impact of the large Freddie floating rate portfolio. During the quarter, the percentage of our Fannie and Freddie production that was floating rate increased to 51%, almost entirely driven by the large portfolio we originated with Freddie. In fact, the majority of our Fannie Mae loans this quarter were fixed rate, offsetting the margin impact of the large floating rate portfolio.

Total revenues for the fourth quarter were $121 million, a record and up 8% from Q4 last year. You will find the details behind total revenues on slide seven. The main drivers of revenue growth were the increase in mortgage servicing rights and growth of our servicing income. Mortgage servicing rights increased 13% to $36 million, up from $32 million in the prior year fourth quarter due almost entirely to the increase in our fixed rate Fannie Mae loan production. Servicing fees continued to grow, contributing $31 million in revenues, up 17% from last year.

As illustrated on slide eight, our overall annual servicing-related income, which includes servicing fees, escrow earnings, assumption and prepayment fees, has grown by 40% since 2013 to $140 million in 2015. Since pushing our servicing portfolio over the $30 billion mark following the CWCapital acquisition in 2012, we have grown at a torrid pace.

It took us eight quarters following the acquisition to reach the $40 billion mark. Given our recent pace of originations, it took only six quarters to reach the $50 billion mark. With limited near-term maturities in our portfolio and weighted average portfolio note rate of 4.15%, which should keep prepayments at a minimum, we will likely reach the $60 billion mark even more quickly.

Other drivers of revenue included interest income, which contributed over $7 million of revenue during the quarter, primarily from the year-over-year increase in the average size of our interim loan portfolio. Other revenues decreased during the quarter from $7.1 million last year to $6.4 million this quarter as a result of lower year-over-year prepayment fee income as the overall amount of prepayments declined quarter-over-quarter.

As shown on slide nine, total expenses for the fourth quarter were $87 million, only 2% higher than Q4 last year. Personnel expenses were up slightly from fourth quarter 2014 as higher salary costs were offset by lower variable compensation. As a result, personnel expense as a percentage of revenue was just 41% in the quarter, down from 43% in Q4 of last year, as the primary drivers of revenue growth were not subject to our variable compensation programs.

Operating margin of 28% increased significantly from 24% last year, reflecting the scale and operating leverage we have achieved, as revenues increased nearly $9 million, while expenses were up less than $2 million quarter-over-quarter.

Slide 10 shows the summary year-end balance sheet. There are few items here I would like to highlight. First, we ended the year with almost $2.5 billion in loans held for sale, our highest level ever. Second, as we discussed during last quarter's call, we expected some payoffs in the interim loan portfolio, which have reduced the portfolio's balance to $233 million at year-end. The payoffs in the portfolio helped boost our year-end cash position to $137 million.

As we announced this morning, we plan to utilize up to $70 million of our cash over the next 12 months to repurchase our shares. Given the current sell-off in our stock and our confidence in the cash generation of our business, we think the buyback creates compelling economics for our shareholders. We intend to redeploy cash back into loan growth with the goal to rebuild the interim loan portfolio to around $400 million by the end of 2016.

We also expect to use our cash to fund loans we made through our conduit, WDCPF. Based on the conduit's existing warehouse lines and our strategy to minimize aggregation risk, we would expect to deploy no more than $50 million to $75 million of capital to WDCPF, keeping the total amount of loans on the balance sheet to around $200 million at any given time.

All in all, the fourth quarter 2015 was excellent and the culmination of a fantastic year for Walker & Dunlop. I'd like to spend a few minutes now on 2016 and discuss how we are thinking about our financial metrics going forward. These metrics and our other goals for 2016 are laid out on slide 11.

We continue to focus on revenue growth and believe there are ample opportunities to increase revenues to at least $0.5 billion in 2016. We think much of our growth will come from our lower gain on sale margin products, thus we are anticipating that operating margin may fall slightly, but stay in the mid to upper-20%s range. With our current anticipated mix of originations, we continue to expect our gain on sale margin to be between 160 basis points and 180 basis points.

We also expect to add new loan originators and investment sales professionals to our platform in 2016. But with the increase in revenues and continued careful management of expenses, we expect personnel expense as a percentage of revenues to stay around 40%. Finally, we are targeting a return on equity in the mid-to-upper teens, which we believe continues to be an attractive and sustainable level of return.

With respect to our first quarter in 2016, a year ago we closed two large deals, totaling $1.1 billion in production, and delivered an atypical quarter that ended up, representing 27% of our annual loan volumes. We expect to continue to see large deals being originated in 2016. And while we are in the mix on several, none of those deals are expected to close in the first quarter.

As a result, we expect our first quarter of 2016 to return to a more typical Q1, which over the last six years has averaged 19% of our annual origination volumes. I'd like to take this opportunity to thank our investors for their support and investment in the company over the course of the past year and hope to be able to talk with as many of you as possible in 2016.

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

Willy Walker

Chairman and Chief Executive Officer

Thanks, Steve. In 2015, we set goals to gain market share with the GSEs, deliver a low-to-mid teens ROE, deliver a mid-20%s operating margin and grow earnings at double-digit rate. As Steve just ran through, we delivered on every one of those goals and significantly outperformed on ROE, operating margin and EPS. The culmination of achieving those goals resulted in the most profitable year in the company's history.

As we move into 2016, our goals remain similar to those from last year. The Mortgage Bankers Association is forecasting total financing volumes for commercial real estate at $511 billion, up slightly from $497 billion last year. Within that number, multifamily financing volumes are expected to be $262 billion, also up slightly from 2015.

As I mentioned in my opening remarks, the GSE should account for around $100 billion of the $262 billion in multifamily financing. Our goal is to continue growing with the GSEs, gain market share and continue building our reputation as one of the largest and best providers of capital to the multifamily industry.

Our acquisition of Engler Financial Group and resulting entrance into the multifamily investment sales business has been extremely successful. We added one new team of investment sales professionals to the platform in Washington D.C. during Q4. With a steady flow of debt capital and strong property fundamentals, the multifamily sector should maintain its high transaction volumes as capital flows in and out of properties, benefiting Walker & Dunlop investment sales, as well as our debt financing business. We have a great core team to start the year and we will continue actively recruiting new teams to join us. We expect to see significant growth from our investment sales team in 2016.

Our capital markets group achieved its goal of originating $3 billion to $5 billion of loans in 2015, mostly by brokering loans to life insurance companies and banks on low leverage, high-quality assets. We have not seen the slowdown in the appetite for that type of product and the competition amongst investors for those deals remains fierce. We have hired great talent and acquired one company in pursuit of this goal.

We will continue investing in our loan brokerage business to more broadly meet the financing needs of our customers across the country, particularly, owners of office buildings, retail centers and hotels. The growing volume of commercial real estate maturities in 2016 and 2017 presents a great opportunity for us to continue growing our capital markets business and reach the high-end of our annual origination goal of $3 billion to $5 billion.

2015 was a solid year for our HUD lending operation given how countercyclical HUD capital is. Our HUD origination and underwriting group is one of the very best in the industry and we love having a scaled HUD platform to extend credit in the affordable housing and seniors housing space today and across the multifamily landscape during down-cycles when other capital sources are not present in the market.

Recently announced changes in the HUD's multifamily program, including a significant reduction in mortgage insurance premiums could result in increased popularity of the product, especially if current market dynamics move other capital sources to the sidelines. In particular, HUD's construction program is gaining in popularity and will likely be a significant portion of our HUD production in the coming year, particularly, if there is indeed a contraction in the availability of construction financing from commercial banks.

Our balance sheet lending program originated $185 million in loans and generated $9.4 million of net interest income last year. We started this program in 2012 to compete with banks on short-term floating rate bridge loans for non-stabilized multifamily properties. And since then, we have originated $752 million in loans, we have refinanced 91% of the loans into permanent loans that now sit in our $50 billion servicing portfolio, and we have earned $17 million of interest income on this lending operation with an average ROE of 12% over the past three years. We continue to see good opportunities to lend in this space and, as Steve mentioned, expect to grow the portfolio to somewhere near the $400 million mark by the end of the year.

While the CMBS market is volatile now, the opportunity for growth remains strong, given the significant amount of CMBS loans that must be refinanced in 2016 and 2017. It seems likely that borrowing costs will increase as the market finds a clearing price for new CMBS deals and grapples with the impact of risk retention. In the meantime, we're taking a cautious approach to this business, which will likely lead to lower volumes early in the year as the market sorts itself out.

In Q4, we made an investment in real estate technology company, Rentlytics. Rentlytics provides software to multifamily owners and operators, allowing them to analyze property performance data across their entire portfolio. We have a number of clients who are on the platform and rave about its capabilities.

Our investment is small, but strategic, giving us a window into what is happening in the real estate technology space, where we believe there will be significant innovation coming over the next few years. We will also use Rentlytics software to cut our asset management costs, improve our underwriting processes and generate new revenue streams as we introduce Rentlytics to Walker & Dunlop customers.

In summary, 2015 was a year that generated outstanding operating and financial results. Since going public in 2010, we have grown revenues from $122 million to $468 million, net income from $8 million to $82 million, diluted earning per share from $0.55 per share to $2.65 per share, adjusted EBITDA from $21 million to $124 million, and grown our servicing portfolio from $15 billion to $50 billion. And investors who put money into Walker & Dunlop's IPO saw 191% return on their investment over that five-year period.

Our platform is now more scaled and diversified than ever. Our market position in 2016 should drive growth in total revenues and enable us to achieve double-digit EPS growth once again. And the cash flow we are generating provides us with multiple options for growth and shareholder returns. It is an exciting time to be at Walker & Dunlop and I'd like to congratulate everyone on our team for an incredible run since we went public five years ago and a truly extraordinary 2015.

Thank you for joining us this morning. I'll now turn the call back over to the operator to open the line for questions. Keith?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And we can take our first question from Cheryl Pate with Morgan Stanley. Please go ahead.

Cheryl M. Pate
Morgan Stanley & Co. LLC

Q

Hi. Good morning, guys. Just wanted to touch on the buyback authorization a little bit more, appreciate the color on sort of the growth initiatives balanced with the buyback. Just a couple of quick questions, one, I guess with the stock price where it is, is it fair to assume that we would potentially see this buyback take place earlier rather than later? And secondly, what would be sort of the pivot point to think about if perhaps CMBS came back more quickly or in a larger way? Would that change your view on total buyback?

Stephen P. Theobald
Executive Vice President, Chief Financial Officer and Treasurer

A

Yeah, Cheryl, this is Steve. Good morning. So, as far as the timing, I think how this plays out will largely be driven by when we're able to be in the market, what the stock price is at the time, so can't really project for you exactly the flow over the course of the 12 months that we have the authorization for. But it's certainly our intent to get out there as soon as possible to start executing on the program.

And then, as we have mentioned, we do have opportunities potentially to invest in continuing to grow the bridge loan program, the interim loan program and the CMBS program. And so, as those opportunities arise that [ph] will interplay (29:25) with where we are in the share buyback program as well. But, for now, we think we got sufficient cash and cash generation to accomplish everything that we've set out as our goal today.

Willy Walker
Chairman and Chief Executive Officer

A

I'd only add to that, Cheryl. that if you think about the fact that we only have $175 million of debt on our balance sheet, should other growth opportunities present themselves, whether it be an acquisition or whether it be the growth of some of our existing business lines, we have plenty of borrowing capacity left to be able to potentially add some leverage and continue forward with the buyback program. So I think we have a lot of options, given the balance sheet that we carry today.

Cheryl M. Pate
Morgan Stanley & Co. LLC

Q

Great. That's really helpful. Thanks. Just a second one, if I might on the investment sales business. Just wondering is there any seasonality to consider or how should we think about the growth opportunity over the course of the year and does rates – should we be considering sort of the rate backdrop in conjunction with the growth opportunity? Thanks.

Willy Walker
Chairman and Chief Executive Officer

A

So if you were at the National Multifamily Housing Council annual convention down in Orlando about three weeks ago, you would be very bullish on the multifamily investment sales space, because every owner, operator, developer that I met with had a very, very positive outlook for 2016 and beyond, with continued expectations for investment and buying. So, I don't think that we are going to see much "seasonality".

But one thing that always happens is that as values move around, if you have either interest rate – big interest rate movements and cap rate adjustment, it requires that the market take a pause, people look at where cap rates are, cap rates adjust and then investment sales activity kind of picks back up. I think that that cycle, if you will, Cheryl, has gotten shorter and shorter as people adjust to the market more quickly.

But anytime, for instance, last year when the GSEs pulled back in Q2, it took about six weeks for the investment sales market to sort of sort out whether there was going to be continued supply of capital from the GSEs, what the impact on the market was going to be and then for the market to start transacting again.

And so I think that the sell-off in the equity markets over the last six weeks clearly has a lot of people's attention. But the treasuries dropping down to 1.75% and spreads on GSE financing staying relatively stable, Fannie just raised by a little bit under 10 basis points yesterday, but GSE spreads have remained – in comparison to most other spreads, GSE spreads have remained very tight. I think multifamily owner/operators feel that there really hasn't been a major market shift and, as such, the transactions continue to go on.

Cheryl M. Pate
Morgan Stanley & Co. LLC

Q

Okay, great. Thanks very much.

Operator: Our next question comes from Jade Rahmani with KBW.

Jade Rahmani
Keefe, Bruyette & Woods, Inc.

Q

Good morning. Thanks for taking my question. Firstly, I wanted to ask if you or any other players – similar types of companies have thought about the potential to create a REIT to hold your servicing intangibles, which could free up capital and also improve tax efficiencies? Do you think this is something that could be possible? And also, how do you think the GSEs would evaluate that?

Stephen P. Theobald
Executive Vice President, Chief Financial Officer and Treasurer

A

Yes. Jade, I think we've certainly explored this option in the past. But at this point in time, the agencies have not been supportive of splitting the servicing. And so as a result, you don't really get the opportunity to do that.

Jade Rahmani
Keefe, Bruyette & Woods, Inc.

Q

Okay. Appreciate that. In terms of market volatility, have you guys experienced an impact? For example, brokered loans in 4Q were down around 30% quarter-over-quarter. Are you seeing a continued slowdown in that channel in 1Q and do your 2016 goals assume a pickup in volume in 2Q and beyond?

Willy Walker
Chairman and Chief Executive Officer

A

So, I talked, Jade, about our goal of $3 billion to $5 billion of annual brokered originations and that it's our expectation that we can get to the high-end of that range. So, I think, directly to your question, yes, we believe that 2016 will be a very strong year for brokered originations.

Jade Rahmani
Keefe, Bruyette & Woods, Inc.

Q

The comments you provided focused on the debt market. How would you characterize sentiment on the part of sponsors? Are you seeing any increased caution and impact on sponsor underwriting? I think you alluded to it, but have you seen cap rates in the multifamily space begin to increase as yet?

Willy Walker
Chairman and Chief Executive Officer

A

No, we haven't. There are clearly certain markets where investors are pausing and saying, let's wait and see what happens in the oil and gas sector, for instance. And so markets like Houston, from an investment sales standpoint, have slowed down, but from a lending standpoint, the fundamentals are still strong.

And as it relates to sponsor equity prices, I would only point to equity residential, which, from an equity value standpoint, has held up extremely strong during the sell-off in the equity markets over the last six weeks. And I think that is emblematic of people's view, not only of EQR being a great company, but also the strength of multifamily housing during any kind of overall market softness, if you will.

Back to the point I made in my comments, multifamily fundamentals appear extremely strong right now at this time in the cycle. And should we have a slowing in growth in the U.S. economy, many of those people that might aspire to own a single-family home are unlikely to be able to get to that and will likely be renters for some time to come.

Jade Rahmani
Keefe, Bruyette & Woods, Inc.

Q

And in terms of M&A, which is something you guys have pursued in the past, does the steep declines in stock prices present opportunities? And if so, what areas do you think are possible expansion sectors you might look at?

Willy Walker
Chairman and Chief Executive Officer

A

So we have been quite acquisitive in our history and I think have done a fantastic job of acquiring companies, successfully integrating those companies and growing our platform dramatically, because of those acquisitions. You've seen a considerable sell-off in the valuations of brokerage firms, real estate services firms and the PEs of all those companies have come down considerably.

As a result, many of the companies that we've been talking to over the past several years that, for whatever reason, we may have been interested in, if you comp their value to the publicly traded comps, there's some real opportunity there for us today that may not have existed in the past as those companies were trading at much higher PEs.

So, we see lots of opportunity given the strength of our balance sheet, given our track record as far as buying companies and not only creating value for Walker & Dunlop shareholders, but creating huge amounts of value for the people who sold us those companies. As you may recall, we bought Column from Credit Suisse back in 2009 and we bought CW from Fortress in 2012. And in both of those deals, Credit Suisse and Fortress took stock in Walker & Dunlop and did very, very well holding that Walker & Dunlop stock after the acquisitions.

So we are, as you can imagine, looking at a lot of opportunities, and that's part of the way we've grown the company. And I wouldn't be surprised if we continue to grow it that way.

Jade Rahmani
Keefe, Bruyette & Woods, Inc.

Q

Thank you for taking my questions.

Operator: We will take our next question from Steve DeLaney with JMP Securities.

Steve C. DeLaney
JMP Securities LLC

Q

Good morning. Thanks for taking the question. Willy, I'd like to start by asking to clarify your response to Cheryl when you were talking about loan pricing. So if we go back to like the middle of 2015, it would appear that CMBS AAA spreads are somewhere 60 basis points to 70 basis points wider, depending on where your starting point is. But I believe I heard you say that Fannie Mae just bumped their rates by 10 basis points, could you put that in the context of, say, mid-2015 forward, so we could get a sense for how resilient the agency loan pricing has been versus the private market? Thank you.

Willy Walker
Chairman and Chief Executive Officer

A

So, Steve, I don't have right off the top of my head where spreads were back in mid-2015. But to your point, as it relates to – let's go back to August of 2015. In August of 2015, if you recall, the 10-year treasury rallied by about 20 basis points, but spreads in the agency world gapped out between 15 basis points to 18 basis points. And as a result, borrowers sat there and said, well, hang on a second, we just got a 20-basis point pickup in the treasury rate, yet, my overall coupon rate only went down by about 2 basis points, and so we had a pretty significant widening.

Fannie and Freddie over the last six weeks have held and then you just saw this, what I just said was, I think it's an 8-basis point to 9-basis point depending on the maturity length of loan widening that Fannie announced yesterday. So they have held throughout this period as you've seen what a 25-basis point rally in treasuries from 2.01% down to 1.75%, somewhere around there; 25 basis points, 26 basis points.

So unlike last year, where basically they gapped out almost one for one on the rally in treasury, this year if you're a borrower, you pick up somewhere between 15 basis points and 20 basis points so far. That doesn't mean that the agencies don't widen as the rest of the market widens. But so far, if you had a deal into the agencies, you have been able to benefit greatly by the rally in the treasuries.

Steve C. DeLaney
JMP Securities LLC

Q

All right, that's helpful. And so far, I'm getting the impression that your lenders are not seeing borrowers step back from opportunities because of loan pricing, would you – is that an accurate statement in a general sense?

Willy Walker
Chairman and Chief Executive Officer

A

Yes. If you think about where our debt is being priced right now on a standard sort of 75% LTV, Tier 2 multifamily loans, the pricing depending on the deal, leverage, IO, what have you, is going to be somewhere between 4.25% and 4.75%. Most people in the commercial real estate space, who can get 10-year fixed rate funding at 4.25% to 4.75% will take it all day long.

And so the real question becomes how much capacity the agencies have, how much capacity do the life insurance companies have because if life insurance companies on lower leverage deals are competing head-to-head with the agencies, whether the banks step in for any portion of this. And quite honestly, CMBS, which would do the occasional sort of, if you will, higher leverage somewhat un-stabilized multifamily deal, that supply of capital is off the table right now.

And so, if you have a deal that is of that like, if you will, you're either going to have to wait for it to get stabilized to be able to do agency financing, life insurance company financing or potentially bank financing. But our client base is very much in that sort of 65% to 75% LTV loan, great quality assets, and they have plenty of access to deal flow right now and that is making it so that they are refinancing as well as still transacting.

Steve C. DeLaney
JMP Securities LLC

Q

Thank you, Willy. So one final thing quickly on the conduit, it sounds like you are committed. We had another lender, you may have noticed, drop out last night, a public company. Sounds like though that you're seeing this is more of an essential product within the capital markets part of your business and that you're committed to kind of ride out this rough term.

When risks retention kicks in late next year, there's some thought that anyone who wants to be a significant player with the major underwriters may have to step up and take [ph] down their share (42:53) of retained bonds. Is that something that you and the team have thought about and does your commitment to the conduit business go as far as possibly having to hold some retained risk?

Willy Walker
Chairman and Chief Executive Officer

A

So, Steve, I'd first say that there is a dramatic difference between Walker & Dunlop and Redwood as it relates to our CMBS business. My understanding of Redwood was that CMBS was a diversification play for them at a time when their single-family securitization business didn't really have great growth dynamics to it.

As you well know, we have a very significant presence in the commercial real estate space and have access to a tremendous amount of deal flow. So, us staying in the CMBS space makes perfect sense to our core business versus someone like Redwood exiting, because it was a diversification play into a new market where they really didn't have a very significant brand or market presence.

Steve C. DeLaney
JMP Securities LLC

Q

Sure.

Willy Walker
Chairman and Chief Executive Officer

A

The second thing on risk retention, if you think about the Fannie Mae DUS program, we've been holding B-piece risk on the tens of billions of dollars of loans that we've originated for Fannie Mae since we got into the Fannie Mae business 29 years ago. And although that risk is held off balance sheet through our risk sharing obligation with Fannie Mae, we feel very, very expert at underwriting loans and retaining risk.

So, as the market moves towards the risk retention model, there is clearly the opportunity for a company with the skills that Walker & Dunlop has and the access to deal flow, for us, to potentially say we're going to hold that risk on our balance sheet, potentially raise the fund to hold that risk or potentially, as Jade asked previously, create or acquire a mortgage REIT to put that risk into. So, I think that we have lots of options available to us.

And given that we are not a bank, the risk retention rules that sit on top of banks are distinct from Walker & Dunlop's risk retention as it relates to capital standards. So, we feel quite good. I'm not announcing anything today, but we are looking at this very hard and think that we can play a significant role in figuring out opportunities in this market.

Steve C. DeLaney
JMP Securities LLC

Q

Great. Appreciate the color, Willy, and congrats on a strong quarter.

Willy Walker
Chairman and Chief Executive Officer

A

Thanks, Steve.

Operator: We'll take our next question from Charles Nabhan with Wells Fargo.

Charles J. Nabhan
Wells Fargo Securities LLC

Q

Hi, good morning. You touched on some of the market trends you're seeing in energy-centric markets, but there's also – we've also seen an uptick in construction in a number of non-energy related markets. So, I was wondering if you could comment on what you're seeing there and if you're seeing a pause – you saw a pause in the fourth quarter due to rising construction in some geographies.

Willy Walker
Chairman and Chief Executive Officer

A

So, Chuck, I was talking yesterday with somebody who had, in front of them, a tremendous amount of data off of a CoStar terminal. And during the conversation, they started talking about rents declining in San Francisco by 3% during the month of January. And this person started going on and on about how San Francisco fundamentals are still very strong, but 3% rental decline in January was concerning.

And during the course of the conversation, he said, oh, hang on a second, month-to-date in February, rents in San Francisco are actually up 4%, so the whole 3% slip off in January has already gotten back into the rents in the first week and a half of the next month. I think it's way too early to, if you will, declare victory or defeat as it relates to what this cycle is going to do. I think the biggest thing to look at is the following.

Leading into the last recession in 2008, you didn't have any of the fundamentals in rental growth that you have seen over the last several years and you also didn't have nearly as tight a housing market. You got a lot of supply of single-family housing. And as a result of that, people had alternatives and some multifamily properties didn't fare well in 2009, 2010, although, as you know, multifamily held up better than any other commercial real estate asset class.

Given the rental growth that people have seen over the last several years, as well as – and by the way, that person yesterday pointed out that rents in San Francisco have gone up by over 50% in the last 10 years. The rental growth you have seen, the very, very high occupancy levels in multifamily properties and the lack of supply of single-family housing makes it so that as this economy moves forward, whether it's at a 2% GDP growth, 1% GDP growth or, heaven forbid, it goes negative, we're looking at very strong demand for rental housing.

And so, yes, there are some markets that have fallen off, but I think it's a little bit too early to declare whether they're going to see longer-term trends continue forward. Clearly, there's been a lot of condo development in Miami, which could impact rents in Miami. We haven't seen it so far. Clearly, oil and gas is going to impact Houston. Houston rents have held up, although Houston office vacancies have spiked. So, if you see Houston office vacancies go from 11% to 15%, which we have, that's clearly going to have some impact on the overall housing market. But when and to what degree is, I do not know.

Charles J. Nabhan
Wells Fargo Securities LLC

Q

Okay. As a follow-up, you also touched on some of the dislocation in the CMBS market and potential pullback in activities from banks and life insurance companies, but I was wondering how big do you think the FHFA would allow the agencies to contribute to the overall lending in the multifamily space?

Willy Walker
Chairman and Chief Executive Officer

A

So if you do the math, Chuck, on last year, Fannie and Freddie had a 35% market share doing the record volumes that they did; Freddie doing $47 billion, Fannie doing $42 billion, so the two of them $89 billion of a $256 billion market. There's been a lot of talk, as FHFA worked through the 2016 scorecard, that 40% was the sort of market share that they didn't want to see the agencies go through. And so if you do the math on a 200 – what is it? $261 million (sic) [$261 billion] (49:32) market, $100 billion, that's 39% market share for Fannie and Freddie.

So, doing $100 billion in $261 billion market is clearly, if you will, fine as it relates to FHFA sitting there saying, Fannie and Freddie's market share is too much. Now, let's go to – the market is $261 billion, but nobody else shows up to provide capital, and Fannie and Freddie surged through to $120 billion or $130 billion. I think it really depends on, if you will, what happens in the market, is there a competitive bid. And the FHFA will follow that very, very closely.

The reason they put in their quarterly look back on their activities is they want to make sure that there is adequate liquidity in the market. And so, as I sat around at a roundtable at the Mortgage Bankers Association conference last week in Orlando and spoke to a roundtable of commercial bankers, they were all sitting there saying, well, what says to FHFA that we're making competitive bid if we're [ph] 20 wide (50:40) of Fannie and Freddie, and therefore not lending in the market.

And to be honest, I couldn't really answer their question other than to say to them, FHFA will watch the market. They're not going to sit back and just let Fannie and Freddie gobble up market share. And at the same time, if there is no other capital out there to meet the needs of the market, FHFA has expressed that they will allow Fannie and Freddie to expand out.

Charles J. Nabhan
Wells Fargo Securities LLC **Q**

Great. Thank you, guys.

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

Yeah.

Operator: And we'll take the next question from Brandon Dobell with William Blair.

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

Thanks, guys. Steve, maybe one for you, I look at the – I think, let's call it, the guidance or at least directional commentary about gain on sale range of 160 basis points to 180 basis points, maybe some color around what could push that towards the high-end or maybe above that or the low-end or maybe below that range. Is it a mix? Is it going to be seasonality mix? Just want to make sure I understand how you guys are thinking about the livelihood of that different numbers within that or outside of that range.

Stephen P. Theobald
Executive Vice President, Chief Financial Officer and Treasurer **A**

Yes. So, Brandon, thank you and I appreciate your question. So the mix is really the driver and it's a combination of mix of Fannie versus Freddie versus brokered. Those are the primary drivers. But within that, if we do – typically, larger transactions have a lower gain on sale margin and floating rate transactions, because we book a smaller mortgage servicing right, end up having lower gain on sale margins.

So, the mix master of floating versus fixed, large portfolios versus standard flow business, Fannie versus Freddy versus brokered ultimately drives that makes. And I think our view is, if you look back at the last four quarters, with the exception of, I believe, Q2 when we hit the 200-basis point mark, we've been in that 160-basis point to 180-basis point range.

Brandon B. Dobell
William Blair & Co. LLC
Q

Okay. And I guess as a segue from that, given the trend of last couple of quarters away from fixed, should we continue to see more floating? And is there something within the, I guess, the programmatic mix at the different capital sources that's accelerating that or is going to keep that floating fixed mix going towards floating?

Stephen P. Theobald
Executive Vice President, Chief Financial Officer and Treasurer
A

Yes. So, we've seen over the last, really, year and a half an increase in the popularity of floating rate as a general matter. A lot of that's driven by, again, the larger portfolios have tended to be floating rate deals.

Brandon B. Dobell
William Blair & Co. LLC
Q

Got it. Okay.

Stephen P. Theobald
Executive Vice President, Chief Financial Officer and Treasurer
A

So, typically, your fund investors, your PE investors tend to gravitate towards floating rate. A lot of our standard flow business on both Fannie and Freddie really tend to gravitate more towards fixed rate. So, to the extent that we still see a lot of activity in the fund space in multifamily financing this year, then I think we'll still see elevated levels of floating rate deal flow.

Brandon B. Dobell
William Blair & Co. LLC
Q

Okay. And then on head count, any sense or color on where you guys finished 2015 versus 2014 in terms of origination headcounts or producers, frontline guys and women? And what's your expectation for 2016 would be and if there is a particular part of the head count store that you're really putting some emphasis on for 2016? Obviously, you mentioned expanding investment sales into new markets, but are there other places do you think we should know about? Kind of bigger head count plans that you guys have excluding acquisitions, obviously?

Stephen P. Theobald
Executive Vice President, Chief Financial Officer and Treasurer
A

Yeah. So, Brandon, it's a little hard to compare. I think, net, we're up on the production side. Keep in mind that part of that is we had no investment sales business at the end of 2014 and acquired Engler in April of 2015. But what we have been able to do is increase – essentially, we've increased production staff year-over-year, while holding smaller increases in non-production staff.

So we kind of look at percentage of overall staffing in the production unit versus our support units and that's how we get leverage in the platform. I think it's fair to say that we love all of our businesses and we're continuing to recruit and hire and look for opportunities to increase production staff across the board. So, there's no singular emphasis, if you will, on capital markets producers versus multifamily producers. And then as we've discussed in the past, we continue to actively recruit on the investment sales side to build that platform out nationally.

Brandon B. Dobell
William Blair & Co. LLC
Q

Okay. And then final one for me, as you guys think about the, I guess, the increase to rhetoric during 2016 in the political race about what they may do for the agency. The rally at FHFA thinks about positioning volumes, positioning the story relative to what has happened in the past couple of years. Do you expect any change, expecting more noise in 2016, I guess, good or bad on volumes as politicians get more involved in the discussion?

Willy Walker
Chairman and Chief Executive Officer

A

No.

Brandon B. Dobell
William Blair & Co. LLC

Q

All right, thanks a lot.

Operator: [Operator Instructions] We will go next to Fred Small with Compass Point.

Fred T. Small
Compass Point Research & Trading LLC

Q

Hey, good morning. Quick question just on the loans held for sale at the end of the quarter. Is that all related to – the increase sort of quarter-over-quarter, is that all related to a specific transaction like the Holiday when you announced or what drove the increase?

Willy Walker
Chairman and Chief Executive Officer

A

Yeah, Fred, the $1.3 billion portfolio that we did in the fourth quarter closed at the end of December, so that was sitting in our loans held for sale balance at the end of the year.

Fred T. Small
Compass Point Research & Trading LLC

Q

Okay. So is that off the books now if we were to see like a snapshot of end of January or what's the sort of pace or velocity for that coming down?

Willy Walker
Chairman and Chief Executive Officer

A

Yeah. So, typically, when we close loans we hold them in our warehouse for about 45 days.

Fred T. Small
Compass Point Research & Trading LLC

Q

Okay, so not end of January, but...

Willy Walker
Chairman and Chief Executive Officer

A

That deal closed at the end of December.

Fred T. Small
Compass Point Research & Trading LLC

Q

Okay. So not end of January, but it will be out of there. That balance should normalize by the end of the quarter?

Willy Walker
Chairman and Chief Executive Officer

A

That's correct.

Fred T. Small
Compass Point Research & Trading LLC

Q

Okay. And then have there been any other changes on sort of financing or haircuts on the warehouse?

Willy Walker
Chairman and Chief Executive Officer

A

No, none.

Fred T. Small
Compass Point Research & Trading LLC

Q

Okay, cool. And on the CMBS business that you took the – the JV you took control of, what was overall the margin in that business? I don't know how much you did in the fourth quarter, but the overall margin in that business in the fourth quarter and what are your expectations for the gain on sale margins there going forward?

Stephen P. Theobald
Executive Vice President, Chief Financial Officer and Treasurer

A

Yeah. Fred, the business was essentially immaterial to us in 2015. We did a little over $300 million – or the venture itself did a little over $300 million in production for the year. So, it didn't really move the needle from a financial perspective. Right now, I think as we tried to lay out, we're being pretty cautious with respect to lending in the market at the moment. So, I wouldn't expect any change in that certainly for the first quarter.

Willy Walker
Chairman and Chief Executive Officer

A

But we're modeling to 2% gains when we do get back to securitizing, which we think is a perfectly, if you will, prudent level of gain. That's an adjustment to models down from 2.5% in 2015.

Fred T. Small
Compass Point Research & Trading LLC

Q

Awesome. Thanks a lot.

Operator: And it does appear we have no further questions, so I'll return the floor to our presenters for closing comments.

Willy Walker
Chairman and Chief Executive Officer

Great. Thank you, Keith. I just want to thank the W&D team again for an absolutely fantastic 2015. As one of my directors said in our recent board meeting, you guys knock the ball out of the park and are taking a nice, slow run around the basis. And I said to them, actually, we're already back in the dugout and getting ready for the next game. And so congratulations to our team.

Thank you, Claire and Steve, for all your work on this earnings call. And I appreciate everyone who participated today, taking the time out of their day to listen to our comments. Thank you.

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