Walker & Dunlop

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Richard Hill: Good afternoon . Thanks for joining us today. My name is Richard Hill. I'm head of commercial real estate research at Morgan Stanley. That includes both the REIT equity side of the business and the commercial real estate debt side of the business.

I have Willy Walker with me today, Chairman and CEO of Walker and Dunlop. Before we started, what I wanted to do was just turn it over to Willy for a moment to give a brief introduction as to Walker and Dunlop and then we'll roll right into maybe some discussions about commercial real estate fundamentals and how multi-family, which is Walker and Dunlop's core business, is positioned within commercial real estate. And then talk a little bit about how Walker and Dunlop is positioned in the commercial real estate cycle at this point in time.

So with that, Willy, I'll turn it over to you.

Willy Walker: Thanks, Richard. Thanks for having us. Walker and Dunlop is the 14th largest commercial real estate lender in the United States. We're a company that was started in 1937 by my grandfather and we went public in 2010. Morgan Stanley worked on our IPO. We went public with margin cap of $220 million. If you'd invested in our IPO, over a five-year trade you would have 192% return on that investment.

And during that five-year period from 2010 to 2015, we broadened the platform of Walker and Dunlop. When we went public, we were doing about $2 billion a year of loan originations. Last year, we did $17.8 billion of total transaction volume. Of that $17.8 billion, $16.6 billion was First Trust Financing and $1.2 billion was investment sales activity, specifically in the multi-family sector.

Of that $16.6 billion of financing activity, $11.3 million was with Fannie Mae and Freddie Mac. So we are one of the very largest Fannie Mae DUS lenders and Freddie Mac seller servicers in the country. Fannie and Freddie, last year, supplied about 40% of total capital to the multi-family industry. And so if you are an owner or a developer of multi-family properties, the role of the agencies in the multi-family finance market is dramatic, important, and Fannie and Freddie during the downturn provided a huge amount of counter-cyclical capital in 2008, 2009, and 2010, and we benefited greatly from being one of their largest partners during that period of time, and we have grown our market presence dramatically ever since.

And I would put forth to you that we, today, are one of probably a handful of names that if you're a large owner-operator of multi-family and you've got a big financing, you're picking up the phone and calling Walker and Dunlop, Wells Fargo, or CBRE as one of the three or four firms that you would sit down and say we've got a big multi-family project to finance, what should we do with it?

And just one final thing on that, Richard. As we've grown originations up to $17.8 billion last year, our servicing portfolio over that period of time from 2010 when we went public, I believe the servicing portfolio was $12 billion at that time. We closed out Q1 with a $51 billion servicing portfolio and we just announced an acquisition of a servicing portfolio from Oppenheimer that has $3.8 billion of unpaid principal balance to it. So our servicing portfolio is getting very close to $55 billion today.

Richard Hill: Great. Well, what I wanted to do was start off with somewhat of a discussion, a broader discussion about commercial real estate and where we are in the cycle, and specifically multi-family. I think there's certainly a healthy debate as to where we are in the cycle right now. So maybe you could give us a little bit of a review of where you think we are in the cycle. Are we late cycle, early cycle, mid-cycle, and specifically as it relates to multi-family, how's multi-family fitting into your view of where we are and what do you think about going forward?

Willy Walker: So there's a ton of noise in the market right now about where we are in the cycle. I think for everybody that thinks that we're in the eighth or ninth inning, there are plenty of people who think that we're in the fifth or the sixth. Our view is we're in the fifth or the sixth and that's purely data driven. It's not that we have a hunch. It's not that certain clients of ours are going along and we're saying we like them versus somebody else who's going short. It all has to do with the amount of supply of commercial real estate that has been developed over the last five years. It has to do with the amount of debt outstanding to commercial real estate that has gone down since the crisis. It has to do with occupancy levels across the country in multi-family right now. I believe the stat that our CFO, Steve, gave me earlier was 93.5% occupancy. Rents have gone up dramatically and because there hasn't been supply, because there has not been a huge new issuance of debt, what you basically have is you have demand for the units and therefore that has pushed rents up, and it's pushed cap rates down and valuations up.

And so I think a lot of people are sitting there saying, well, we're six to seven years into this recovery. Most real estate cycles are six to eight years so we're getting towards the end of what is a typical cycle. And cap rates are low, relatively speaking and therefore people say, low cap rates and sixth or seventh year, I'm out. There's nothing from a fundamental standpoint that says to us that that's a reason to get out.

The final piece is we did live through the financial crisis. We did very well through the financial crisis, but in looking at the cohort of loans that were done in 2005, 2006, and 2007 leading up to the crisis, what we aren't seeing today is any kind of lending activity, and I mean any kind of lending activity that resembles what we saw back then. And I can talk you through anecdotally on LTVs, on debt service cover, on servicing fees, on the lack of a competitive bid from CMBS. But there just isn't today stupid lending taking place. And so I think the lack of stupid lending, limited supply of new units, and the general health of the economy's slow growth.

And the final piece as it relates to multi-family is that there are many people who would like to go to that suburban home who can't move there today. And there are two things that are driving that. The first one is just the lack of wage growth, and the second is student debt. There's $1.3 trillion of student debt outstanding in the United States today and there are many, many people who have a student debt burden sitting on them that does not allow them to go and put that down payment on the single-family detached home.

And the final piece on that is just that homebuilders are not building entry level housing today. Homebuilders are building houses at $400,000 and $500,000 price point, not $200,000 and $300,000 price points. And so as we look at -- last year, there was 1.2 million units of housing created in the United States. Okay, 450,000 single family homes and about 600,000 units of multi-family. That's about half of where we were back in 2006.

And so what you're not getting is you're not getting and oversupply of multi and you're not getting anything close to the supply of single family that you had back then. And so people are somewhat trapped being renters. That's going to continue to drive rent growth and it's going to drive occupancy.

Richard Hill: As we move over to the lending side of the equation, the results that I'm talking about -- the wall of maturities, for lack of a better term. So to frame this conversation, there's about $350 billion of loans coming due in 2016. That goes up to around $400 billion in 2017. Not all of those are obviously multi-family loans. It's across all commercial real estate types. But as you think about this, how are the competitive pressures or how is the competitive environment looking today, next year? How are you positioned within that? Who do you think your biggest competitors are? And in fact, are you taking away market share at this point in time?

Willy Walker: So we -- as we have grown, we've grown faster than market. We've been growing faster than almost all of our competitors as it relates to origination volumes as well as revenue growth. The big competitors, I've named two of them, CBRE, Wells Fargo. Holliday Fenoglio is another big competitor, Berkadia, which is a company owned by Berkshire Hathaway and Leucadia, and another big competitor of ours.

But I mean every day we go out and we compete against -- if you look at the lead tables of the top 20 real estate lenders in the United States, every one of them is a household name other than Walker and Dunlop. We kind of like that. I mean when you're going up against Met Life every day, and Wells Fargo, and Goldman Sachs, and Morgan Stanley, and others, and we're right in there, it's great.

At the same time, what do we see happening over the next couple years? First of all, banks are, from a regulatory standpoint, being hamstrung. The HVCRE rule that went into place at the beginning of the year as it relates to construction lending has clearly pulled banks back from construction lending. 150% capital rule to put out a construction dollar is slowing them down significantly as it relates to funding of construction loans. We're not in the construction lending business so that doesn't hamper us.

There are clearly big competitors who have large CMBS platforms. We contribute loans to CMBS platforms but we're not an issuer of securities on the CMBS side. So the risk retention that comes into play in Q3 will impact us, I think, as it relates to the overall market. But we're not an issuer. We're clearly not a B-piece buyer on the CMBS side today so that doesn't impact us that much.

And in the core business of Fannie and Freddie, the regulator just gave Fannie and Freddie additional capacity in their caps proactively to meet, if you will, a significant increase in volumes. And so to your point about these maturities, if the maturities aren't going back into CMBS pools, they're not going onto bank balance sheets. They're then going to end up with life insurance companies and the agencies. And we have grown our life insurance company brokerage business dramatically over the past couple years, and we've got a fantastic market position with the agencies.

So feeling quite good about where we sit as it relates to access to deal flow and ability to process a huge amount of business.

Richard Hill: So one of the themes that I picked up on since we've been chatting for just a little bit now is how fast you've been able to grow over the past couple years. When you look forward, I hear your business having three primary catalysts right now. The capital markets business, the origination business, and then your servicing portfolio. I want to talk about all three of these businesses, but just generically speaking, as you look forward, which of these businesses are you most excited about and what do you think is going to be the primary driver of growth potential going forward?

Willy Walker: Well, if you look at the economics of the business, the origination platform is labor intensive and it's variable cost, but we pay a lot out of commissions. We pay our bankers a lot of money to go find those deals. But then once we get the deals and we book the servicing, it's all gravy after that to us.

So you sort of have to look at, we don't want to slow down the origination side, but that's not nearly as profitable a business if you were to break it up on the origination side as it is on the servicing side. So we use this origination side to build up the servicing portfolio, which we've done very, very successfully. That then provides us with this long-term, pre-payment protected, revenue stream, which allows us to have huge cash flow. If you look at our EBITDA numbers and EBITDA growth, if anybody here is valuating Walker & Dunlop, if you're working on a PE basis or an EV to EBITDA number, just do your enterprise value to EBITDA calculation on Walker Dunlop and look at what our EBITDA has done. This is a cash cow that we've created.

And so -- and we will continue to do it as long as we continue to originate. The moment that we slow down on originations, what you will see is that our EBITDA even goes up further because we're not booking as much amortization and depreciation when we're not booking new loans. And so then it just really becomes a cash cow. We don't want to get there, because we like adding new originations, but continue to grow the servicing portfolio. But this model has very long tail life to it.

As it relates to growth, we put out to the Street in our Q1 earnings that we were going to grow our origination sales force by 25%. I think that many people saw that and said hold on a second, I thought we were getting towards the end of the cycle. Why are they expanding when other people are sort of standing still? We're a relatively small company. We've got 100 originators today. If we grow that to 125, we're still a fraction of the size of CBRE, Wells Fargo, Morgan Stanley, I mean everybody else who has lots of feet on the street. So we've got plenty of opportunity to continue to grow and add people. Most of those originators are variable cost. We paid them very, very small base salaries and they make all their money in commissions.

So as the market slows down a little bit, we're not sitting there with huge fixed costs of high base salaries. It's all commissions. They eat what they kill. So investing in origination talent right now, to us, we think, A, the market has a longer cycle to it than most people do. Second of all, if the market does cool off a little bit, remember, Fannie, Freddie, and HUD are our largest sources of capital. They're counter-cyclical so when the conduit world goes away, if you're just a conduit business and there's a competitor of ours who is 100% conduit, I don't know what you do when the music stops. You got no servicing stream. You got no other businesses. It's just the pure play. Secondary market freezes up, you're done. That's not us.

And so I look forward to continuing to be able to grow significantly. Servicing portfolio is a very, very attractive piece to it. And then the final piece you said was our capital markets business. The brokerage business is a lower margin business. Some of you may know it's Holiday Fenoglio- Holiday Fenoglio HFF, a fantastic firm, a big competitor of ours. They're kind of a pure play on the real estate cycle. When things are going great, they've got lots of transaction volume. But their servicing portfolio, which is similar in size to Walker and Dunlop's has got an average servicing fee- they don't disclose it, but my tummy would tell me somewhere around four or five basis points. Our average servicing fee is 25 basis points.

Their servicing portfolio is not prepayment protected. Our is 87% prepaid and protected. Somebody prepays -- somebody wants to pay off that loan, they write us a check for the future servicing strip. So the dynamics of our business versus someone like HFS are dramatically different. The thing I think the investors have missed is we've grown as fast or faster than HFS in the up cycle. Yet we’ve got access to counter cyclical capital and this huge servicing portfolio.

So there's a very different story, if you will, as it relates to where are we in the cycle and what does that even look like in any kind of tapering off versus some of the other competitors who we go up against every day.

Richard Hill: Sure. So you spoke a little bit about your servicing portfolio, and it obviously seems like a really big component and differentiator of your business relative to some other businesses. So maybe you can talk a little bit more about your acquisition of the $3.8 billion servicing portfolio and maybe just broadly speaking, if you're interested at more acquisition activity, how are you thinking about growing that servicing portfolio. And then I have a follow-up question after that, which is, look, you have an interesting business. You're really special servicing -- you're servicing driven. Who do you think the best comps are for your business? If it's not a finance company, who do you think has best comps?

So let's deal with the first part, which is how you grow your servicing portfolio.

Willy Walker: So we've grown our servicing two ways -- through organic originations and through acquisition. We acquired certain assets of Column Guaranteed from Credit Suisse in 2009 and doubled the size of our servicing portfolio. We then acquired CW from Fortress in 2012 and again doubled the size of our servicing portfolio. And we've now just gone out and bought this Oppenheimer portfolio. So as we have grown, we have at various times bought chunks of servicing through buying operating platforms.

One of the things that is distinct from single family servicing and commercial servicing is that there is no ability to sell off the excess servicing rights in our business. So you're not going to see a NationStar or an Excess Servicing Right Issuer in our case because the real excess servicing rights that we have are in our Fannie Mae business and Fannie Mae's ultimate collateral to our risk sharing is that servicing portfolio. They've never, ever had to go after someone's servicing portfolio, but if they ask us to hold capital, if for whatever reason we blew through that capital in losses, they would have as an ultimate collateral that servicing portfolio.

So when you want to buy Fannie servicing, you must buy an entire enterprise. And that's why we bought Column in 2009 and CW in 2012. The Oppenheimer portfolio is a HUD portfolio. It has no Fannie or Freddie in it. Servicing fees on HUD are sort of between Fannie servicing fees at the top of the spectrum and Freddie servicing fees at the -- I guess in agency world, in the bottom. Below that would be life insurance company servicing fees.

But HUD servicing is pre-payment protected. We don't get a check when it gets paid off, but it's got lots of protections in it. So typically, a HUD loan goes ten, nine, eight, seven, six, five, four, three, two, one and then it's open at PAR from there on out. But we have not disclosed yet what the average servicing fee on the portfolio will be, but we will. But I'd put it somewhere in the teens. And we paid $45 million for it.

And the interesting thing about it is we love the dynamics of the portfolio and just buying the portfolio, but what we also get out of it is refinancing opportunities, interest rate reduction opportunities today to bring the coupon rate down on those loans. And then finally it presents us or introduces us to a whole new set of clients, people that we've never worked with before that Oppenheimer had been working with, that we now have the opportunity to introduce our originators do.

So we love the deal and it continues us on a trajectory of continuing to grow our servicing portfolio. We grew our servicing portfolio from $30 billion to $40 billion in two years, from $40 billion to $50 billion in 18 months and we talked about the fact that we'd like to shorten the cycle time from $50 billion to $60 billion and given that we're at $55 billion halfway through the year, I think we're well on our way to getting there.

Richard Hill: So I want to spend a little bit more time on the fee-based side of this business. What I think is really interesting is maybe a comparison to an asset manager or a (inaudible) manager, and my colleague, Michael Cypress, who covers the asset managers has written recently about the ability for fees to really drive growth going forward and provide a diversifier going forward. Do you think that is ultimately how your business is going forward? And do you think that's really the best comp for Walker and Dunlop as you continue to grow your servicing platform?

Willy Walker: So who to comp us to. That's a question that lots of people ask. There really isn't a pure play. I would purport to you that Berkadia, which is the old GMAC financing arm that turned into Cap Mark, that then was taken over by Leucadia and Berkshire Hathaway and is Berkadia today is probably the closest pure play comp except for the fact that they're privately held by Berkshire Hathaway and Leucadia. So you're not going to get any data there.

But beyond them, there isn't somebody else who is looked at being both a broker and a lender. So everyone that we compete against is either in the brokerage world and the lending world. And as you know, Richard, the valuations between the brokerage firms and the lenders is dramatically different. On the lending side, people are looking at some multiple of book or some premium to book. On the broker side, they're looking at some PE number that for the last two to three years has been in the low 20s. Dropped down to the low teens in the first quarter and is building itself back up to sort of 13 to 18 times earnings.

We today I think are trading somewhere around ten times. As I said previously, we've grown as fast or faster than any of those brokerage firms, but we have the characteristic of this lender that has these long-term revenue streams. But we're not sort of picking up that higher multiple. I would put forth to you when we were a smaller company, the issue of GSE Reform was very much out there. So we went public in 2010 and went on our IPO Road Show, half of our conversations were about GSE Reform. It's 2010, the House and the Senate were controlled by the Republicans and everyone said Fannie and Freddie are going away.

Well, we now travel around and talk to investors, nobody, and I mean almost nobody asks us about GSE Reform. It's just not an issue that anyone is concerned about. If you go believe that GSEs are sort of here forever. Now, whether they get recapped and spun out or whether they become part wardens of the U.S. government, or whether they do something else with them, nobody really believes that the GSEs are going anywhere.

So our core businesses with Fannie and Freddie from a risk standpoint, I think that sort of risk discount we had has been removed. And at the end of the day, we have -- we did $17.8 billion of deals for the last year. What that gives us access to deals that few other people have. There are lots of funds -- KKR, Ares, there's a much smaller real estate focused fund out on the West Coast called Mesa West. They're fantastic asset managers but they get their deal flow through brokers. So every deal that comes into them is bid off against five, or ten, or fifteen other bidders.

When we get a deal that comes in and we want to put it on our balance sheet, it's our deal. It's a client of ours who needs us to do something for them. They have bought a property that they want to rehabilitate and then lease up. We'll put it in our balance sheet for a period of time and then we'll take it out for a permanent loan. They've got a deal that's going on, and they want a preferred equity investment. We can do the preferred equity investment. They're not taking that marketing it to the world. They're looking to us for a solution.

So what we see as an opportunity, a huge opportunity, is take that distribution network and raise funds around it. Raise a B-piece fund, raise a mezz fund, raise a preferred equity fund, and take that capital and put it into that distribution network. And as such, I think that we will get better quality deals, higher yield, and lower risk. And so we today have about $250 million of loans sitting on our balance sheet. We'd love to go and raise a fund, and take that collateral and put it into the fund, and then start to earn asset management fees off of that fund and other funds that we go and build up around it.

And I think that if we're successful at doing that, people will start to look at WMD as more of an alt asset manager and less as either a broker or a lender. And I think then what you get is multiple expansion. The alt asset managers trade somewhere between 13 and 15 times earnings. We're trading today between 10 and 12, 12 on a great day and 10 on a normal day. And so I think that as you build up that asset management business and you couple it with our servicing business, 38% of our revenues in Q1 were non-origination fee revenues. So they were servicing income and interest income, 38%.

I think once we get that up over 50%, people sit there and go that's more of an alt asset manager than it is either a brokerage firm or a lender and we get that premium bond.

Richard Hill: Great. So I think we have about four minutes left. I want to open it up for some questions but it sounds like a really exciting time for Walker and Dunlop. You had previously announced a stock buyback. How are you thinking about that? Because, you know, obviously a tremendous amount of growth potential with Walker and Dunlop. How are you thinking about that?

Willy Walker: The Board allocated for us to do $75 million. As we announced on our Q1 earnings call, we've done $6 million in Q1, $7 million in Q1. It's there clearly at $24.50 stock price given that we were at $32 at the end of 2015 is not where we'd like to see the stock price. But quite honestly, I leave that to Steve, our CFO, Steve Theobald, and he's in the market and out of the market at certain times. I think that we feel that the stock is cheap and at certain times, we'll go and buy it.

At the same time, we knew that we had the Oppenheimer portfolio to go buy for somewhere around $50 million. We've been doing quite a bit of hiring. We've bene investing in our on balance sheet lending. We've been investing in our conduit and so we're also sitting there looking at our capital. We ended 2015 with I think $130 million on the balance sheet. We ended Q1 at about $100 million. And so we're generating about $10 million of cash a month right now, somewhere around there, $8 million to $10 million a month.

So we're adding back a lot. We've got tons of borrowing capacity if we want to, but we're just trying to watch where the stock price is, where we think buying it back makes a lot of sense, and also what we're using our capital for in other places.

Richard Hill: Well, I do want to make sure we open it up to questions. And at this point, does anyone have any questions for Willy?

Unidentified Audience Member: You mentioned potentially raising a fund to contribute the loans held on balance sheet to a vehicle and charging asset management fees. How do you view the fundraising environment for a potential vehicle today and what kind of -- how are you thinking about the fee stream from that kind of vehicle?

Willy Walker: Fundraising environment is very challenging right now, but I would say to you that we have a couple big advantages. The first thing is that we put over $900 million of loans on our balance sheet over the last three years. And so anyone who wants to look at the collateral that we would contribute to a fund can go in and look at it file by file, how we've underwritten the loans, how they performed, and how we took them out. So unlike someone going to try and raise their first fund, we have a real track record that's demonstrable.

Second of all, there's $250 million of collateral that will go into the fund. So the day one when someone invests, they're getting a coupon. We're not sitting there saying give us the capital and wait for us to go originate the loans. And the third piece to it is we've got a lot of institutional relationships. We've been -- we are a voracious user of warehouse lines from big commercial banks. We lend to sponsors across the country, whether they be Blackstone, or KKR, or a huge number of big institutions that have raised capital from the likely suspects to invest in this fund.

And so I believe that we have a real head start as it relates to that, but it's a very challenging environment today. What we need to do to make ourselves -- to make this a successful play would be to build an $8 billion to $10 billion asset management business, and that's going to take time.

So I think that what we'll probably do is raise a couple funds and get into the business, and then I wouldn't be surprised if we looked to do an acquisition at some point where we would acquire assets and sort of turbo charge the growth. That's the plan for right now and it's always a challenging environment to raise capital, particularly when you're doing it for the first time. But this isn't sort of our first trip to the rodeo, if you will, as far as doing things like our IPO, doing a term loan B. We've done a lot of capital raising in our day.

Richard Hill: Any other questions before we complete? Willy, I really appreciate you joining me today. It's great to hear about the Walker and Dunlop story and talk about the growth potential going forward. So thank you very much.

Willy Walker: Thank you, Richard, very much. Appreciate it.