

Walker & Dunlop, Inc.
Form 10-Q
November 08, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 001-35000

Walker & Dunlop, Inc.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

80-0629925
(I.R.S. Employer Identification No.)

7501 Wisconsin Avenue, Suite 1200E

Bethesda, Maryland 20814

(301) 215-5500

(Address, including zip code, and telephone number, including
area code, of registrant's principal executive offices)

Not Applicable

(Former name, former address, and former fiscal year if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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As of November 5, 2012 there were 34,618,820 total shares of common stock outstanding.

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Table of Contents**PART I****FINANCIAL INFORMATION****Item 1. Financial Statements****Walker & Dunlop, Inc. and Subsidiaries**

Condensed Consolidated Balance Sheets

September 30, 2012 and December 31, 2011

(In thousands, except share and per share data)

	September 30, 2012 (unaudited)	December 31, 2011
Assets		
Cash and cash equivalents	\$ 82,613	\$ 53,817
Restricted cash	6,991	7,164
Pledged securities, at fair value	32,080	18,959
Loans held for sale, at fair value	1,293,320	268,167
Loans held for investment	16,426	
Servicing fees and other receivables, net	28,443	18,501
Derivative assets	37,986	10,638
Mortgage servicing rights	294,704	137,079
Goodwill	53,401	
Intangible assets	12,490	1,196
Other assets	20,250	7,075
Total assets	\$ 1,878,704	\$ 522,596
Liabilities and Stockholders Equity		
Liabilities		
Accounts payable and other accrued expenses	\$ 108,941	\$ 76,163
Performance deposits from borrowers	12,188	10,425
Derivative liabilities	17,881	5,223
Guaranty obligation, net of accumulated amortization	20,114	9,921
Allowance for risk-sharing obligations	16,844	14,917
Warehouse notes payable	1,279,947	218,426
Notes payable	83,000	23,869
Total liabilities	\$ 1,538,915	\$ 358,944
Stockholders Equity		
Stockholders equity:		
Preferred shares, Authorized 50,000,000, none issued.	\$	\$

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Common stock, \$0.01 par value. Authorized 200,000,000; issued and outstanding 33,449,119 shares in 2012 and 21,748,598 shares in 2011.		334		217
Additional paid-in capital		234,981		81,190
Retained earnings		104,474		82,245
Total stockholders equity	\$	339,789	\$	163,652
Commitments and contingencies				
Total liabilities and stockholders equity	\$	1,878,704	\$	522,596

See accompanying notes to condensed consolidated financial statements.

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Condensed Consolidated Statements of Income

(In thousands, except share and per share data)

(Unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Revenues				
Gains from mortgage banking activities	\$ 53,400	\$ 21,562	\$ 107,136	\$ 69,678
Servicing fees	13,307	8,757	32,513	24,517
Net warehouse interest income	1,248	1,052	3,259	2,828
Escrow earnings and other interest income	708	342	1,772	1,115
Other	1,463	1,643	6,568	6,621
Total revenues	\$ 70,126	\$ 33,356	\$ 151,248	\$ 104,759
Expenses				
Personnel	\$ 32,173	\$ 11,343	\$ 61,177	\$ 33,413
Amortization and depreciation	17,000	6,267	31,002	16,258
Provision for risk-sharing obligations	(848)	937	1,126	3,447
Interest expense on corporate debt	388	180	719	646
Other operating expenses	9,635	4,977	20,843	12,260
Total expenses	\$ 58,348	\$ 23,704	\$ 114,867	\$ 66,024
Income from operations	\$ 11,778	\$ 9,652	\$ 36,381	\$ 38,735
Income tax expense	4,680	3,573	14,152	14,886
Net income	\$ 7,098	\$ 6,079	\$ 22,229	\$ 23,849
Basic earnings per share	\$ 0.28	\$ 0.28	\$ 0.97	\$ 1.10
Diluted earnings per share	\$ 0.28	\$ 0.28	\$ 0.96	\$ 1.10
Basic weighted average shares outstanding	25,091,153	21,629,463	22,881,795	21,614,062
Diluted weighted average shares outstanding	25,443,601	21,782,383	23,101,832	21,727,540

See accompanying notes to condensed consolidated financial statements.

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Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net income	\$ 22,229	\$ 23,849
Adjustments to reconcile net income to net cash used in operating activities:		
Gain attributable to fair value of future servicing rights, net of guaranty obligation	(52,091)	(37,328)
Gain on sale of MSR, less prepayment of MSR	(9)	235
Provision for risk-sharing obligations	1,126	3,447
Amortization and depreciation	31,002	16,258
Originations of loans held for sale	(2,594,190)	(2,007,164)
Sales of loans to third parties	1,691,226	2,213,038
Stock compensation	3,384	1,724
Tax benefit from vesting of equity awards	7	
Cash paid to settle risk-sharing obligations	(2,030)	(680)
Amortization of leasehold inducement	(58)	
Cash allowance received from landlord	1,301	
Cash received from sale of assets acquired	2,244	
Changes in:		
Restricted cash and pledged securities	(3,291)	(3,999)
Servicing fees and other receivables	498	(7,595)
Derivative fair value adjustments	(9,701)	319
Other assets	(5,536)	(1,061)
Accounts payable and other accruals	9,850	8,956
Performance deposits from borrowers	1,763	3,588
Net cash (used in) provided by operating activities	\$ (902,276)	\$ 213,587
Cash flows from investing activities:		
Capital expenditures	\$ (4,668)	\$ (1,686)
Acquisition of CWCapital LLC, net of cash acquired and other assets	(208,109)	
Net increase in loans held for investment	(16,368)	
Net cash used in investing activities	\$ (229,145)	\$ (1,686)
Cash flows from financing activities:		
Borrowings (repayments) of warehouse notes payable, net	\$ 951,670	\$ (158,300)
Borrowings (repayments) of notes payable, net	59,131	(2,853)
Debt issuance costs	(1,108)	
Proceeds from issuance of common stock	150,698	2,053
Repurchase of common stock	(167)	
Tax benefit from vesting of equity awards	(7)	
Net cash provided by (used in) financing activities	\$ 1,160,217	\$ (159,100)
Net increase in cash and cash equivalents	\$ 28,796	\$ 52,801
Cash and cash equivalents at beginning of period	53,817	33,285
Cash and cash equivalents at end of period	\$ 82,613	\$ 86,086

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Supplemental Disclosure of Cash Flow Information:

Cash paid to third parties for interest	\$	4,296	\$	2,869
Cash paid for taxes	\$	8,256	\$	10,956

See accompanying notes to condensed consolidated financial statements.

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NOTE 1 ORGANIZATION AND BASIS OF PRESENTATION

These financial statements represent the condensed consolidated financial position and results of operations of Walker & Dunlop, Inc. and its subsidiaries. Unless the context otherwise requires, references to we, us, our, Walker & Dunlop and the Company mean the Walker & Dunlop consolidated companies. The statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. Because the accompanying condensed consolidated financial statements do not include all of the information and footnotes required by GAAP, they should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011. In the opinion of management, all adjustments (consisting only of normal recurring accruals except as otherwise noted herein) considered necessary for a fair presentation of the results for the Company in the interim periods presented have been included. Results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012, or thereafter.

Walker & Dunlop is one of the leading commercial real estate finance companies in the United States, with a primary focus on multifamily lending. The Company originates, sells and services a range of multifamily and other commercial real estate financing products. The Company s clients are owners and developers of commercial real estate across the country. The Company originates and sells loans pursuant to the programs of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac, and together with Fannie Mae, the government-sponsored enterprises, or the GSEs), the Government National Mortgage Association (Ginnie Mae) and the Federal Housing Administration, a division of the U.S. Department of Housing and Urban Development (together with Ginnie Mae, HUD), with which Walker & Dunlop has long-established relationships. The Company retains servicing rights and asset management responsibilities on nearly all loans that it sells to GSEs and HUD. Walker & Dunlop is approved as a Fannie Mae Delegated Underwriting and Servicing (DUS TM) lender nationally, a Freddie Mac Program Plus lender in 22 states and the District of Columbia, a HUD Multifamily Accelerated Processing (MAP) lender nationally, and a Ginnie Mae issuer. The Company also originates and services loans for a number of life insurance companies and other institutional investors, in which cases it does not fund the loan but rather acts as a loan broker.

The Company offers its borrowers an interim loan program offering floating-rate debt, for terms of up to two years, to experienced borrowers seeking to acquire or reposition multifamily properties that do not currently qualify for permanent financing. The Company closed its first loans under this program in 2012. The Company underwrites all loans originated through the program. During the time they are outstanding, the Company assumes the full risk of loss on the loans. In addition, the Company services and asset-manages loans originated through the program, with the ultimate goal of providing permanent financing on the properties. These loans are classified as held for investment on the Company s balance sheet during such time that they are outstanding.

On June 7, 2012, the Company entered into a purchase agreement (the Purchase Agreement), by and among the Company, its indirect wholly owned subsidiary, Walker & Dunlop, LLC, CWCcapital LLC (CWCcapital) and CW Financial Services LLC (CW Financial), pursuant to which Walker & Dunlop, LLC agreed to acquire all of CW Financial s interests in CWCcapital (the Acquisition), for approximately \$220 million, consisting of a cash payment to CW Financial of \$80 million and the Company s issuance in a private placement to CW Financial of approximately 11.6 million shares of common stock. The Acquisition closed, pursuant to the terms of the Purchase Agreement, on September 4, 2012, at which time the total consideration transferred was valued at approximately \$231 million. The increase in the fair value of the consideration transferred is the result of an increase in the fair value of the Company s common stock from execution of the Purchase Agreement to the closing date. Upon closing of the Acquisition, CWCcapital became an indirect wholly owned subsidiary of the Company. By virtue of the Company s ownership of CWCcapital, the Company also acquired a 50% ownership in ARA Finance LLC, a joint venture with ARA Finco LLC, in which ARA Finco LLC owns the remaining 50% of ARA Finance LLC. The Company accounts for its investment in ARA Finance LLC under the equity method of accounting.

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W&D Balanced Real Estate Fund I GP, LLC, a wholly owned subsidiary, has a general partnership interest in a partnership that invests in commercial real estate. The Company can be removed as general partner at the sole discretion of one of the limited partners. Walker & Dunlop Real Estate Opportunity Fund I Manager, LLC, a wholly owned subsidiary, is the managing member of a limited liability company that invests in commercial real estate. The Company can be removed as the managing member at the sole discretion of one of the members. In their respective capacities as general partner and managing member, the wholly owned subsidiaries of the Company earn fees pursuant to corporate services agreements under which they provide consulting and overhead services to the partnership and limited liability company.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation The condensed consolidated financial statements include the accounts of the Company as defined in Note 1. All material intercompany transactions have been eliminated. The Company has evaluated all subsequent events.

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Use of Estimates The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, including guaranty obligations, capitalized mortgage servicing rights, derivative instruments and hedging relationships, and the disclosure of contingent assets and liabilities. Actual results may vary from these estimates.

Comprehensive Income For the three and nine months ended September 30, 2012 and 2011, comprehensive income equaled net income; therefore, a separate statement of comprehensive income is not included in the accompanying condensed consolidated financial statements.

Concentrations of Credit Risk Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash and cash equivalents, loans held for sale and derivative financial instruments.

The Company places cash and temporary investments with high-credit-quality financial institutions and believes no significant credit risk exists. The counterparties to the loans held for sale and funding commitments are owners of multifamily properties located throughout the United States. Mortgage loans are generally transferred or sold within 60 days from the date that a mortgage loan is funded.

There is no material counterparty risk with respect to the Company's funding commitments as each potential borrower must make a non-refundable good faith deposit when the funding commitment is executed. The counterparty to the forward sale is generally an investment bank. There is a risk that the purchase price agreed to by the investor will be reduced in the event of a late delivery. The risk for non-delivery of a loan primarily results from the risk that a borrower does not close on the funding commitment in a timely manner. This risk is generally a risk mitigated by the non-refundable good faith deposit.

Goodwill and Other Intangible Assets The Company accounts for business combinations using the acquisition method of accounting, under which the purchase price of the acquisition is allocated to the assets acquired and liabilities assumed using the fair values determined by management as of the acquisition date. The Company recognizes identifiable assets acquired and liabilities (both specific and contingent) assumed at their fair values at the acquisition date. Furthermore, acquisition-related costs, such as due diligence, legal and accounting fees, are not capitalized or applied in determining the fair value of the acquired assets.

We do not amortize goodwill; instead, we evaluate goodwill for impairment at least annually. In addition to our annual impairment evaluation, we evaluate whether events or circumstances have occurred in the period subsequent to our annual impairment testing which indicate that it is more likely than not an impairment loss has occurred. We evaluate our identified intangibles for impairment annually or if other events or circumstances indicate that the carrying value may be impaired.

See Notes 3 and 4 for additional information on goodwill and other intangible assets.

Loans Held for Sale Loans held for sale represent originated loans that are generally transferred or sold within 60 days from the date that a mortgage loan is funded. The Company initially measures all originated loans at fair value. Subsequent to initial measurement, the Company measures all mortgage loans at fair value, unless the Company documents at the time the loan is originated that it will measure the specific loan

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at the lower of cost or fair market value for the life of the loan. Electing to use fair value allows a better offset of the change in fair value of the loan and the change in fair value of the derivative instruments used as economic hedges. During the period prior to its sale, interest income on a loan held for sale is calculated in accordance with the terms of the individual loan. There were no loans held for sale that were valued at the lower of cost or market or on a non-accrual status at September 30, 2012 and December 31, 2011.

Gains from Mortgage Banking Activities Mortgage banking activity income is recognized when the Company records a derivative asset upon the commitment to originate a loan with a borrower and sell the loan to an investor. This commitment asset is recognized at fair value, which reflects the fair value of the contractual loan origination related fees and sale premiums, net of co-broker fees, and the estimated fair value of the expected net future cash flows associated with the servicing of the loan net of the estimated net future cash flows associated with any risk-sharing obligations. Loans originated in a brokerage capacity tend to have lower origination fees because they often require less time to execute, there is more competition for brokerage assignments and because the borrower will also have to pay an origination fee to the ultimate institutional lender. Also included in gains from mortgage banking activities are changes to the fair value of loan commitments, forward sale commitments, and loans held for sale that occur during their respective holding periods. Upon sale of the loans, no gains or losses are recognized as such loans are recorded at fair value during their holding periods. Mortgage servicing rights and guaranty obligations are recognized as assets or liabilities, respectively, upon the sale of the loans.

The co-broker fees for the three and nine months ended September 30, 2012 were \$5.2 million and \$13.6 million; and were \$3.6 million and \$17.4 million for the three and nine months ended September 30, 2011, respectively.

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Transfer of financial assets is reported as a sale when (a) the transferor surrenders control over those assets and (b) consideration other than beneficial interests in the transferred assets is received in exchange. The transferor is considered to have surrendered control over transferred assets if, and only if, certain conditions are met. The Company has determined that all loans sold have met these specific conditions and accounts for all transfers of mortgage loans and mortgage participations as completed sales.

When a mortgage loan is sold, the Company retains the right to service the loan and initially recognizes the mortgage servicing right (MSR) at fair value. Subsequent to the initial measurement date, mortgage servicing assets are amortized using the effective interest method.

Guaranty obligation and allowance for risk-sharing obligations When a loan is sold under the Fannie Mae DUS program, the Company undertakes an obligation to partially guarantee the performance of the loan. At inception, a liability for the fair value of the obligation undertaken in issuing the guaranty is recognized. The fair value includes the Company's obligation to stand ready to perform over the term of the guaranty (the non-contingent guaranty), and the Company's obligation to make future payments should those triggering events or conditions occur (contingent guaranty).

Historically, the contingent guaranty recognized at inception has been de minimis. In determining the fair value of the guaranty obligation, we consider the risk profile of the collateral, historical loss experience, and various market indicators. Generally, the estimated fair value of the guaranty obligation is based on the present value of the future cash flows expected to be paid under the guaranty over the estimated life of the loan (historically three to five basis points per year) discounted using a 12-15 percent discount rate. The discount rate and estimated life used are consistent with those used for the calculation of the MSR for each loan.

Subsequent to the initial measurement date, the liability is amortized over the life of the guaranty period using the straight-line method. We evaluate the allowance for risk-sharing obligations by monitoring the performance of each loan for events or conditions which may signal a potential default. In instances where payment under the guaranty on a specific loan is determined to be probable and estimable, we record an additional liability for the estimated allowance for risk-sharing through a charge to the provision for risk-sharing obligations, along with a write-off of the associated loan-specific MSR (Note 6).

Loans Held for Investment Loans held for investment are interim loans originated by the Company for properties that currently do not qualify for permanent GSE or HUD financing. These loans have a maximum term of two years. The loans are carried at their unpaid principal balances adjusted for net unamortized loan fees and costs, and net of any allowance for loan losses. Interest income is accrued based on the actual coupon rate and is recognized as revenue when earned and deemed collectible.

The Company uses the interest method to determine an effective yield to amortize the loan fees and costs on real estate loans held for investment. The Company uses the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments, if any, to determine periodic amortization.

The Company will reclassify loans held-for-investment as loans held-for-sale if it determines that the loans will be sold or transferred to third parties.

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Share-Based Payment The Company recognizes compensation costs for all share-based payment awards made to employees and directors, including restricted stock, employee stock options and other forms of equity compensation based on the grant date fair value.

Under the Walker & Dunlop, Inc. 2010 Equity Incentive Plan, the Company has granted restricted stock, unrestricted stock and stock option awards. Restricted stock awards have been granted without cost to the Company's officers, employees and non-employee directors, for which the fair value of the award was calculated as the difference between the market value of the Company's common stock on the date of grant and the purchase price to be paid by the grantee. The Company's stock option and restricted stock awards for its officers and employees vest, predicated on continued employment, satisfaction of performance conditions, or a combination of both. Restricted stock awards for non-employee directors fully vest after one year.

Stock option awards have been granted to officers and certain other employees, with an exercise price equal to the closing price of the Company's common stock on the date of the grant, and were granted for a ten-year term, vesting ratably over three years dependent solely on continued employment. To estimate the grant-date fair value of stock options, the Company uses the Black-Scholes pricing model. The Black-Scholes model estimates the per share fair value of an option on its date of grant based on the following inputs: the option's exercise price, the price of the underlying stock on the date of the grant, the expected option term, the estimated dividend yield, a risk-free interest rate and the expected volatility. For the risk-free rate, the Company uses a U.S. Treasury strip due in a number of years equal to the option's expected term. To determine the expected volatility, the Company has calculated the volatility of the common stock price of a group of peer companies, as the Company has insufficient historical data for its common stock at this time to develop an expectation of volatility over the expected term of the options granted solely based on the historical volatility of its own common stock.

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Compensation expense is adjusted for estimated forfeitures and is recognized on a straight-line basis, for the entire award, over the requisite service period of the award. Forfeiture assumptions are evaluated on a quarterly basis and updated as necessary. Compensation is recognized within the income statement as Personnel expense, the same expense line as the cash compensation paid to the respective employees.

Income Taxes The Company files income tax returns in the applicable U.S. federal, state and local jurisdictions and generally is subject to examination by the respective jurisdictions for three years from the filing of a tax return. The Company accounts for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in earnings in the period when the new rate is enacted.

Deferred tax assets are recognized only to the extent that it is more likely than not that they will be realizable based on consideration of available evidence, including future reversals of existing taxable temporary differences, projected future taxable income and tax planning strategies. Net deferred tax liabilities are included in Accounts payable and other accrued expenses in the accompanying condensed consolidated balance sheets.

We had no accruals for tax uncertainties as of September 30, 2012 or December 31, 2011.

Net Warehouse Interest Income The Company presents warehouse interest income net of warehouse interest expense. Warehouse interest income is the interest earned from loans that are held for sale and those held for investment. Substantially all loans that are held for sale are financed with matched borrowings under our warehouse facilities incurred to fund a specific loan held for sale. Warehouse interest expense is incurred on borrowings used to fund loans solely while they are held for sale or for investment. Warehouse interest income and expense are earned or incurred on loans held for sale after a loan is closed and before a loan is sold. Warehouse interest income and expense are earned or incurred on loans held for investment after a loan is closed and before a loan is repaid. Included in net warehouse interest income for the three and nine months ended September 30, 2012 and 2011 are the following components (in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Warehouse interest income	\$ 4,169	\$ 2,654	\$ 9,722	\$ 6,755
Warehouse interest expense	2,921	1,602	6,463	3,927
Net warehouse interest income	\$ 1,248	\$ 1,052	\$ 3,259	\$ 2,828

Recently Issued Accounting Pronouncements In May 2011, the FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*. ASU No. 2011-04 was issued to achieve common fair value measurement and disclosure requirements between U.S. GAAP and International Financial Reporting Standards. ASU No. 2011-04 amends current fair value measurement and disclosure guidance to include increased transparency around valuation inputs and investment categorization. The adoption of ASU No. 2011-04 expanded our disclosures regarding fair value measurements but did not have a material impact on our financial statement disclosures.

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In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*. ASU No. 2011-05 allows an entity to have the option to present the components of net income and comprehensive income in either one or two consecutive financial statements. ASU No. 2011-05 eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. While the new guidance changes the presentation of comprehensive income, there are no changes to the components that are recognized in net income or other comprehensive income under current accounting guidance. The adoption of ASU No. 2011-05 did not have a material impact on our financial statements.

NOTE 3 ACQUISITION OF CWCAPITAL LLC

On June 7, 2012, the Company entered into a Purchase Agreement, by and among the Company, its indirect wholly owned subsidiary, Walker & Dunlop, LLC, CWCapital and CW Financial, pursuant to which Walker & Dunlop, LLC agreed to acquire all of CW Financial's interests in CWCapital, for approximately \$220 million (comprising a cash payment to CW Financial of \$80 million and the balance consisting of the Company's issuance in a private placement to CW Financial of approximately 11.6 million shares of common stock).

CWCapital, a Massachusetts limited liability company, was one of the leading commercial real estate finance companies in the United States, with a primary focus on multifamily lending, originating and selling mortgage loans pursuant to the programs of

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Fannie Mae, Freddie Mac, Ginnie Mae and HUD. CWCcapital had approximately 180 employees in 14 offices nationwide. In reaching its decision to recommend and approve the transaction, the Company's management and board of directors considered a variety of factors weighing positively in favor of the Acquisition, including but not limited to, strategic benefits, CWCcapital's businesses, operating results, financial condition and management, the consideration and terms of the Purchase Agreement, financing and closing agreements.

The Acquisition closed on September 4, 2012, pursuant to the terms of the Purchase Agreement. Upon closing of the Acquisition, CWCcapital became an indirect wholly owned subsidiary of the Company and was renamed Walker & Dunlop Capital, LLC. The consideration transferred at the close of the Acquisition totaled approximately \$231 million, consisting of \$80 million in cash and 11,647,255 shares of the Company's common stock at a closing date fair value of \$151 million.

The Company recorded the fair value of the assets acquired and liabilities assumed as of August 31, 2012, the date which the Company obtained control pursuant to the Closing Side Letter by and among the Company, Walker & Dunlop, LLC, CWCcapital and CW Financial, whereby the closing of the Acquisition was deemed to have occurred and become effective at 11:59 p.m. on August 31, 2012. The Company has also included CWCcapital's results of operations and cash flows in its financial statements from August 31, 2012 forward. Amounts recorded upon the closing of the acquisition of CWCcapital, are as follows (in thousands):

	August 31, 2012	
Assets acquired and liabilities assumed		
Cash	\$	22,955
Pledged securities		9,657
Servicing fees and other accounts receivable		11,777
Loans held for sale		332,841
Derivative assets		19,852
Mortgage servicing rights		130,543
Other assets		3,905
Mortgage pipeline intangible asset		18,700
Accounts payable		(22,921)
Derivative liabilities		(16,107)
Guaranty obligation		(8,254)
Allowance for risk-sharing obligation		(4,063)
Notes payable		(321,222)
Goodwill		53,401
Consideration paid	\$	231,064

The fair value of consideration transferred was allocated to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values at the acquisition date, with the remaining unallocated amount recognized as goodwill. The fair values assigned to identifiable intangible assets acquired and liabilities assumed were determined using the following approaches:

- Mortgage servicing rights: market and income approaches
- Mortgage pipeline: market and income approaches

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The recognized goodwill of \$53.4 million, all of which is expected to be tax deductible over 15 years, is attributed to the value of the assembled workforce, the broader scale of operations of the combined company's national platform and the long-term expected synergies associated with the combination.

Any changes in the estimated fair values of the assets acquired and liabilities assumed as a result of the completion of the allocation of the purchase price could change the amount of the purchase price allocable to goodwill.

The total revenues and income from operations of CWCapital, since the acquisition date and included in the accompanying consolidated statements of income for both the three and nine months ended September 30, 2012, were \$27.0 million and \$3.9 million, respectively.

The revenues and earnings of the combined entity, as though the Acquisition had occurred as of January 1, 2011, for the nine months ended September 30, 2012 and 2011, are as follows (in thousands):

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Supplementary pro forma information (in thousands, except per share data)	For the nine months ended September 30,	
	2012	2011
Revenues	\$ 256,839	\$ 194,172
Income from operations (1)	\$ 67,370	\$ 47,493
Net income	\$ 53,218	\$ 33,682
Diluted earnings per share	\$ 2.30	\$ 1.55
Diluted shares outstanding	23,101,832	21,727,540

(1) Income from operations includes pro forma adjustments related to interest expense for additional term debt financing obtained to close the Acquisition as well as the additional tax expense as a result of the increased combined earnings. Pro forma adjustments increasing interest expense by \$0.8 million and \$1.1 million and tax expense by \$12.1 million and \$3.8 million are included in the supplementary pro forma information presented for 2012 and 2011, respectively.

NOTE 4 GOODWILL AND OTHER INTANGIBLE ASSETS

The following summarizes the Company's goodwill activity for the nine months ended September 30, 2012 (in thousands):

	For the nine months ended, September 30, 2012	
Beginning balance	\$	
Goodwill related to the CWCapital acquisition		53,401
Impairment		
Ending balance	\$	53,401

The following summarizes the Company's other intangible assets, related to acquisition activity, as of September 30, 2012 (in thousands):

	As of September 30, 2012		
	Gross carrying value	Accumulated amortization	Net carrying value
Mortgage pipeline intangible asset	18,700	(7,353)	11,347
Mortgage servicing rights	130,543	(2,104)	128,439
	\$ 149,243	\$ (9,457)	\$ 139,786

The weighted average remaining lives of the Company's intangible assets are as follows:

- Mortgage pipeline: the mortgage pipeline will be amortized ratably over the lives of the underlying mortgage application contracts, a term that is expected to be between 18 and 24 months but is expected to fluctuate based on customer needs and/or mortgage application cancellations.

- Mortgage servicing rights: mortgage servicing rights acquired through the Acquisition are amortized using the effective yield method. The estimated lives of the mortgage servicing rights are derived based upon the stated yield maintenance and/or prepayment protection term of the underlying loans. The weighted average remaining life of the portfolio acquired is 7.5 years.

NOTE 5 GAINS FROM MORTGAGE BANKING ACTIVITIES

The gains from mortgage banking activities consist of the following activity for the three and nine months ended September 30, 2012 and 2011 (in thousands):

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	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Contractual loan origination related fees, net	\$ 27,674	\$ 9,657	\$ 55,045	\$ 32,350
Fair value of expected future cash flows from servicing recognized at commitment	27,237	12,664	55,404	39,214
Fair value of expected guaranty obligation	(1,511)	(759)	(3,313)	(1,886)
Total gains from mortgage banking activities	\$ 53,400	\$ 21,562	\$ 107,136	\$ 69,678

NOTE 6 MORTGAGE SERVICING RIGHTS

Mortgage servicing rights (MSRs) represent the fair value of the servicing rights retained by the Company for mortgage loans originated and sold. The capitalized amount is equal to the estimated fair value of the future expected net cash flows associated with the servicing rights. The following describes the key assumptions used in calculating each loan's MSR:

Discount rate Depending upon loan type, the discount rate used is management's best estimate of market discount rates. The rates used for loans originated were 10% to 15% for each of the three and nine month periods presented.

Estimated Life The estimated life of the MSRs is derived based upon the stated yield maintenance and/or prepayment protection term of the underlying loan and may be reduced by 6 to 12 months based upon the expiration of various types of prepayment penalty and/or lockout provisions prior to that stated maturity date.

Servicing Cost The estimated future cost to service the loan for the estimated life of the MSR is subtracted from the estimated future cash flows.

The fair value of the MSRs was \$320.0 million and \$158.5 million at September 30, 2012 and December 31, 2011, respectively.

The Company uses a discounted static cash flow valuation approach and the key economic assumption is the discount rate. For example see the following sensitivities:

The impact of a 100 basis point increase in the discount rate at September 30, 2012, is a decrease in the fair value of \$9.4 million.

The impact of a 200 basis point increase in the discount rate at September 30, 2012, is a decrease in the fair value of \$18.1 million.

Activity related to capitalized MSRs for the three and nine months ended September 30, 2012 and 2011 was as follows (in thousands):

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	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Beginning balance	\$ 149,533	\$ 118,597	\$ 137,079	\$ 106,189
Additions, following the sale of loan	24,585	18,187	51,449	41,319
Additions, CWCapital acquisition	130,543		130,543	
Amortization	(9,228)	(5,768)	(22,279)	(15,937)
Pre-payments and write-offs	(729)	(641)	(2,088)	(1,196)
Ending balance	\$ 294,704	\$ 130,375	\$ 294,704	\$ 130,375

The MSR's are being amortized in proportion to, and over the period, that net servicing income is expected to be received using the effective interest method. The Company reported write downs of MSR's related to loans that were repaid prior to the expected maturity or the servicing rights being sold. These write-offs are included with the amortization and depreciation expense in the accompanying condensed consolidated statements of income.

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Management reviews the capitalized MSR for impairment quarterly. MSRs are measured for impairment on an asset-by-asset basis, considering factors such as debt service coverage ratio, property location, loan-to-value ratio and property type. In addition, at each reporting period, we compare the aggregate carrying value of the MSR portfolio to the aggregate estimated fair value of the portfolio. No impairments other than write-offs discussed above have been recognized for the periods presented.

NOTE 7 GUARANTY OBLIGATION AND ALLOWANCE FOR RISK-SHARING OBLIGATIONS

When a loan is sold under the Fannie Mae DUS program, the Company typically agrees to guarantee a portion of the ultimate loss incurred on the loan should the borrower fail to perform. The compensation for this risk is a component of the servicing fee on the loan. No guaranty is provided for loans sold under the Freddie Mac or HUD loan programs.

A summary of our guaranty obligation for the three and nine months ended September 30, 2012 and 2011 is as follows (in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Beginning balance	\$ 10,746	\$ 9,398	\$ 9,921	\$ 8,928
Guaranty obligation recognized, following the sale of loan	1,778	740	3,565	2,019
Guaranty obligation recognized, CWCapital acquisition	8,254		8,254	
Amortization of guaranty obligation	(664)	(470)	(1,626)	(1,279)
Ending Balance	\$ 20,114	\$ 9,668	\$ 20,114	\$ 9,668

We evaluate the allowance for risk-sharing obligations by monitoring the performance of each loan for triggering events or conditions that may signal a potential default. In situations where payment under the guaranty is probable and estimable on a specific loan, we record an additional liability for the estimated allowance for risk-sharing through a charge to the provision for risk-sharing obligations in the income statement, along with a write-off of the loan-specific MSR. The amount of the provision reflects our assessment of the likelihood of payment by the borrower, the estimated disposition value of the underlying collateral and the level of risk-sharing. Historically, the loss recognition occurs at or before the loan becoming 60 days delinquent. A summary of our allowance for risk-sharing for the three and nine months ended September 30, 2012 and 2011 is as follows (in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Beginning balance	\$ 13,629	\$ 13,383	\$ 14,917	\$ 10,873
Provision for risk sharing obligations	(848)	937	1,126	3,447
Allowance for risk-sharing obligations, CWCapital acquisition	4,063		4,063	
Write-offs		(680)	(3,262)	(680)
Ending Balance	\$ 16,844	\$ 13,640	\$ 16,844	\$ 13,640

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As of September 30, 2012, the maximum quantifiable contingent liability associated with the Company's guarantees under the Fannie Mae DUS agreement was \$2.6 billion. The maximum quantifiable contingent liability is not representative of the actual loss we would incur. We would be liable for this amount only if all of the loans we service for Fannie Mae, for which we retain some risk of loss, were to default and all of the collateral underlying these loans was determined to be without value at the time of settlement.

NOTE 8 SERVICING

The total unpaid principal balance of loans the Company was servicing for various institutional investors was \$33.9 billion as of September 30, 2012, and reflects the addition of \$14.5 billion (unpaid principal balance) of loan servicing on September 4, 2012, through the completion of the Acquisition.

NOTE 9 NOTES PAYABLE

To provide financing to borrowers under GSE and HUD programs, and to assist in funding interim loans, the Company has

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arranged for committed warehouse lines of credit in the aggregate amount of \$885 million with certain national banks, a temporary increase commitment of \$640 million with a national bank and a \$450 million uncommitted facility with Fannie Mae. Consistent with industry practice, two of these facilities are revolving commitments the Company expects to renew annually, one is a revolving commitment the Company expects to renew every two years, and the last facility is provided on an uncommitted basis without a specific maturity date. The Company's ability to originate mortgage loans depends upon its ability to secure and maintain these types of short-term financings on acceptable terms.

The Company had a \$150 million committed warehouse line agreement that was scheduled to mature on November 26, 2012. On September 4, 2012, contemporaneously with the closing of the Acquisition, the Company entered into the Warehousing Credit and Security Agreement with a national bank to replace the existing \$150 million warehouse line with a \$500 million committed warehouse line that matures on September 3, 2013. The Warehousing Credit and Security Agreement provides the Company with the ability to fund its Fannie Mae, Freddie Mac, HUD and FHA loans. Advances are made at 100% of the loan balance and borrowings under this line bear interest at the average 30-day London Interbank Offered Rate (LIBOR) plus 185 basis points. On December 6, 2012, the warehousing commitment amount will automatically be reduced to \$425 million. On or before December 6, 2012, it is anticipated that an alternative lender will (but is not obligated to) become an assignee of up to at least \$75 million of committed capacity, and may provide a maximum total commitment of \$200 million. At no time will the maximum total commitment for all lenders under the Warehousing Credit and Security Agreement exceed \$625 million.

The Warehousing Credit and Security Agreement contains certain affirmative and negative covenants that are binding on the Company's operating subsidiary (which are in some cases subject to exceptions), including, but not limited to, restrictions on its ability to assume, guarantee or become contingently liable for the obligation of another person, to undertake certain fundamental changes such as reorganizations, mergers, amendments to our certificate of formation or operating agreement, liquidations, dissolutions or dispositions or acquisitions of assets or businesses, to cease to be directly or indirectly wholly owned by the Company, to pay any subordinated debt in advance of its stated maturity or to take any action that would cause the Company's operating subsidiary to lose all or any part of its status as an eligible lender, seller, servicer or issuer or any license or approval required for it to engage in the business of originating, acquiring or servicing mortgage loans.

In addition, the Warehousing Credit and Security Agreement requires compliance with certain financial covenants, which are measured for the Company and its subsidiaries on a consolidated basis, as follows:

- a tangible net worth covenant;
- an agency compliance covenant;
- a leverage ratio (as defined in the Warehousing Credit and Security Agreement) of not greater than 2.25;
- a liquid assets covenant;
- a servicing delinquencies covenant; and
- a total servicing portfolio covenant.

The Warehousing Credit and Security Agreement contains customary events of default (which are in some cases subject to certain exceptions, thresholds, notice requirements and grace periods).

On September 28, 2012, the Company amended this committed warehouse line agreement to provide for a temporary increase commitment (Temporary Increase Agreement) of \$640 million, temporarily increasing the warehouse commitment amount available to \$1.14 billion until the earliest of December 6, 2012, an event of default under the existing warehouse agreement or the termination of the warehousing commitment pursuant to the terms of the existing warehouse agreement. Borrowings under the Temporary Increase Agreement are only available when outstanding funding under the existing warehouse facility exceeds \$500 million and will accrue interest at a rate of the average 30-day LIBOR plus 185 basis points. In the event the aggregate interest accrued over the term of the Temporary Increase Agreement is less than \$1 million, the borrower is obligated to pay an amount equal to \$1 million minus the actual accrued interest. As of September 30, 2012, there were \$899.6 million of borrowings outstanding under this line and corresponding loans held for sale.

On September 4, 2012, contemporaneously with the closing of the Acquisition, the Company amended its \$350 million committed warehouse agreement that was scheduled to mature on February 28, 2013. The committed warehouse facility provides the Company with the ability to fund its Fannie Mae, Freddie Mac and HUD loans. The amendment, among other things extended the maturity date to September 3, 2013, reduced the rate for borrowing from the average 30-day LIBOR plus 185 basis points to the average 30-day LIBOR plus 175 basis points and amended the negative and financial covenants to conform to those of our \$500 million Warehousing Credit and Security Agreement, described above, with the exception of the leverage ratio covenant, which is not included in the amended facility. As of September 30, 2012, there were \$182.7 million of borrowings outstanding under this line and corresponding loans held for sale.

The Company has a \$450 million uncommitted facility with Fannie Mae under its ASAP funding program. After approval of

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certain loan documents, Fannie Mae will fund loans after closing and the advances are used to repay the primary warehouse line. Fannie Mae will advance 99% of the loan balance and borrowings under this program bear interest at the average 30-day LIBOR plus 115 basis points. As of September 30, 2012, there were \$74.9 million of borrowings outstanding under this program. There is no expiration date for this facility.

The Company had an unlimited master purchase and sale agreement which expired on March 16, 2012. In anticipation of the expiration of the master purchase and sale agreement, the Company amended one of our committed warehouse lines, and on March 16, 2012, the Company allowed the master purchase and sale agreement to expire.

The Company has a \$35 million committed warehouse line agreement that matures on July 21, 2013, subject to one year extensions at the lenders' discretion. The facility provides the Company with the ability to fund first mortgage loans (interim loans) on multifamily real estate properties for periods of up to two years, using available cash in combination with advances under the facility. All borrowings bear interest at the average 30-day LIBOR plus 250 basis points. Borrowings under the facility are full recourse to the Company. As of September 30, 2012, there were \$12.4 million of borrowings outstanding under this line and two corresponding loans held for investment.

Upon closing the Acquisition, the Company, Walker & Dunlop, LLC, CW Financial and Walker & Dunlop Capital, LLC (formerly CWC Capital) entered into agreements to amend the three outstanding warehouse lines of Walker & Dunlop Capital, LLC that existed immediately prior to the Acquisition (collectively, the "Old Warehouse Lines") to (i) freeze the Old Warehouse Lines on the closing date of the acquisition by eliminating the ability of Walker & Dunlop Capital, LLC, or any other entity, to request advances under the Old Warehouse Lines, (ii) provide for repayment in full of any outstanding borrowings under the Old Warehouse Lines, each within a period of not more than 75 days after the closing date, and (iii) substitute CW Financial's guarantees of the Old Warehouse Lines with guarantees by the Company. As of September 30, 2012, there were \$110.5 million of borrowings outstanding under these lines.

All of the notes payable, including the warehouse facilities, are senior obligations of the Company. The agreements above contain cross-default provisions, such that if a default occurs under any of our debt agreements, generally the lenders under the Company's other debt agreements could also declare a default. As of September 30, 2012, the Company was in compliance with all of its warehouse line covenants.

Debt Obligations

On October 31, 2006, the Company entered into a \$42.5 million term note agreement (the "Existing Term Loan Agreement") which, as amended, was scheduled to mature on October 31, 2015. On September 4, 2012, and substantially contemporaneously with the closing of the Acquisition, the Company entered into a senior secured term loan credit agreement (the "Credit Agreement") with a group of lenders that replaced the Company's \$42.5 million Existing Term Loan Agreement. The Credit Agreement provides for an \$83.0 million term loan (the "Term Loan"). At September 30, 2012, there were \$83.0 million of borrowings outstanding under the Credit Agreement.

On September 4, 2012 (the "Closing Date"), \$61.8 million of the Term Loan proceeds were used to pay cash consideration to CW Financial under the Purchase Agreement, \$20.7 million of the Term Loan proceeds were used to refinance the Existing Term Loan Agreement and the remaining \$0.5 million of the proceeds were used to repay certain existing indebtedness of the Company to former equity holders in our predecessor entities (during 2008, we purchased small amounts of subsidiary equity from certain existing employees and issued notes that were subordinated to the Existing Term Loan Agreement).

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The Term Loan amortizes in equal quarterly installments of \$2,075,000 commencing 90 days after the Closing Date, with a final maturity date for all remaining amounts due under the Term Loan of August 31, 2017. Other than the scheduled quarterly amortization installments, any payments of Term Loan principal during the first 18 months after the Closing Date (the Lockout Period) must be accompanied by a prepayment penalty fee equal to the amount of interest that would have accrued on the prepaid principal amount during the then remaining portion of the Lockout Period.

Borrowings under the Credit Agreement bear interest at a rate derived from LIBOR for a one-month interest period plus an applicable margin of 3.75%, subject to adjustment if an event of default is continuing.

The obligations of the Company under the Credit Agreement are guaranteed by Walker & Dunlop Multifamily, Inc., Walker & Dunlop, LLC and Walker & Dunlop Capital, LLC (upon closing of the Acquisition, CWCcapital became an indirect wholly-owned subsidiary of the Company and changed its name from CWCcapital LLC to Walker & Dunlop Capital, LLC), each of which is a direct or indirect wholly owned subsidiary of the Company (together with the Company, the Loan Parties), pursuant to a Guarantee and Collateral Agreement entered into on the Closing Date among the Loan Parties and the lender (the Guarantee and Collateral Agreement).

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The Credit Agreement contains certain affirmative and negative covenants that are binding on the Loan Parties, including, but not limited to, restrictions (subject to specified exceptions) on the ability of the Loan Parties to create liens on their respective property, assets or revenues, to make investments, to incur indebtedness, to merge, dissolve, liquidate or consolidate with or into another person, to make a material disposition, to pay certain dividends or related distributions, to prepay, redeem or defease prior to maturity certain indebtedness, to change the nature of their business, to enter into certain transactions with affiliates, to enter into certain burdensome agreements, to amend certain material documents or to change their respective names or fiscal years.

In addition, the Credit Agreement requires the Loan Parties to abide by certain financial covenants calculated for the Company and its subsidiaries on a consolidated basis. As of September 30, 2012, the Company was in compliance with all financial covenants of the Term Loan. The most significant financial covenants are summarized as follows:

- Four-Quarter EBITDA (as defined in the Credit Agreement and calculated to reflect the Acquisition on a pro forma basis) of not less than \$35,000,000;
- Debt Service Coverage Ratio (as defined in the Credit Agreement and calculated excluding interest expense on warehouse credit lines) of not less than 3.0 to 1.0; and
- Maximum ratio of Adjusted Funded Debt to Four-Quarter EBITDA (each as defined in the Credit Agreement) of (i) 4.0 to 1.0 for each of the fiscal quarters ending on September 30, 2012, December 31, 2012, March 31, 2013, and June 30, 2013 and (ii) 3.5 to 1.0 for the fiscal quarter ending September 30, 2013 and each fiscal quarter thereafter.

NOTE 10 FAIR VALUE MEASUREMENTS

The Company uses valuation techniques that are consistent with the market approach, the income approach and/or the cost approach to measure assets and liabilities that are measured at fair value. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, accounting standards establish a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1* Financial assets and liabilities whose values are based on unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.
- *Level 2* Financial assets and liabilities whose values are based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

- *Level 3* Financial assets and liabilities whose values are based on inputs that are both unobservable and significant to the overall valuation.

The Company's MSR's are measured at fair value on a nonrecurring basis. That is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The Company's MSR's do not trade in an active, open market with readily observable prices. While sales of MSR's do occur, precise terms and conditions vary with each transaction and are not readily available. Accordingly, the estimated fair value of MSR's was developed using discounted cash flow models that calculate the present value of estimated future net servicing income. The model considers contractually specified servicing fees, prepayment assumptions, delinquency rates, late charges, other ancillary revenue, costs to service and other economic factors. The Company reassesses and periodically adjusts the underlying inputs and assumptions used in the model to reflect observable market conditions and assumptions that a market participant would consider in valuing an MSR asset. MSR's are carried at the lower of amortized cost or estimated fair value.

A description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's assets and liabilities carried at fair value:

- *Derivative Instruments* The derivative positions consist of interest rate lock commitments and forward sale agreements. These instruments are valued using a discounted cash flow model developed based on changes in the U.S. Treasury rate and other observable market data. The value was determined after considering the potential impact of collateralization, adjusted to reflect nonperformance risk of both the counterparty and the Company and are classified within Level 3 of the valuation

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hierarchy.

- *Loans held for sale* The loans held for sale are reported at fair value. The Company determines the fair value of the loans held for sale using discounted cash flow models that incorporate quoted observable prices from market participants. Therefore, the Company classifies these loans held for sale as Level 2.
- *Pledged Securities* The pledged securities are valued using quoted market prices from recent trades. Therefore, the Company classifies pledged securities as Level 1.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of September 30, 2012, and December 31, 2011, segregated by the level of the valuation inputs within the fair value hierarchy used to measure fair value (in thousands):

	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Balance as of Period End
September 30, 2012				
Assets				
Loans held for sale	\$	\$ 1,293,320	\$	\$ 1,293,320
Pledged securities	32,080			32,080
Derivative assets			37,986	37,986
Total	\$ 32,080	\$ 1,293,320	\$ 37,986	\$ 1,363,386
Liabilities				
Derivative liabilities	\$	\$	\$ 17,881	\$ 17,881
Total	\$	\$	\$ 17,881	\$ 17,881
December 31, 2011				
Assets				
Loans held for sale	\$	\$ 268,167	\$	\$ 268,167
Pledged securities	18,959			18,959
Derivative assets			10,638	10,638
Total	\$ 18,959	\$ 268,167	\$ 10,638	\$ 297,764
Liabilities				
Derivative liabilities	\$	\$	\$ 5,223	\$ 5,223
Total	\$	\$	\$ 5,223	\$ 5,223

There were no transfers into or out of assets that are considered Level 1 or Level 2 fair value measurements.

Derivative instruments (Level 3) are outstanding for short periods of time (generally less than 60 days) and are not outstanding for more than one period. A roll forward of derivative instruments which require valuations based upon significant unobservable inputs, is presented below for

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the nine months ended September 30, 2012 and 2011 (in thousands):

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	Fair Value Measurements Using Significant Unobservable Inputs: Derivative Instruments September 30, 2012	
Derivative assets and liabilities, net		
Beginning balance, December 31, 2011	\$	5,415
Transfers in (out) of Level 3		
Purchases		
Sales		
Issuances		
Settlements		(92,446)
Realized gains (losses) recorded in earnings		87,031
Unrealized gains (losses) recorded in earnings		20,105
Ending balance, September 30, 2012	\$	20,105

	Derivative Instruments September 30, 2011	
Derivative assets and liabilities, net		
Beginning balance, December 31, 2010	\$	4,900
Transfers in (out) of Level 3		
Purchases		
Sales		
Issuances		
Settlements		(71,374)
Realized gains (losses) recorded in earnings		66,474
Unrealized gains (losses) recorded in earnings		3,204
Ending balance, September 30, 2011	\$	3,204

The following table presents information about significant unobservable inputs used in the measurement of the fair value of Company's Level 3 assets and liabilities (in thousands):

	Fair Value	Quantitative Information about Level 3 Measurements		Input Value (1)
		Valuation Technique	Unobservable Input (1)	
Derivative assets	\$ 37,986	Discounted cash flow	Counterparty credit risk	
Derivative liabilities	17,881	Discounted cash flow	Counterparty credit risk	

(1) Significant increases (decreases) in this input may lead to significantly lower (higher) fair value measurements.

The carrying amounts and the fair values of the Company's financial instruments as of September 30, 2012, and December 31, 2011, are presented below (in thousands):

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	September 30, 2012	
	Carrying Amount	Fair Value
Financial Assets:		
Cash and cash equivalents	\$ 82,613	\$ 82,613
Restricted cash	6,991	6,991
Pledged securities	32,080	32,080
Loans held for sale	1,293,320	1,293,320
Loans held for investment	16,426	16,500
Derivative assets	37,986	37,986
Total	\$ 1,469,416	\$ 1,469,490
Financial Liabilities:		
Derivative liabilities	\$ 17,881	\$ 17,881
Warehouse notes payable	1,279,947	1,279,947
Notes payable	83,000	83,000
Total	\$ 1,380,828	\$ 1,380,828

	December 31, 2011	
	Carrying Amount	Fair Value
Financial Assets:		
Cash and cash equivalents	\$ 53,817	\$ 53,817
Restricted cash	7,164	7,164
Pledged securities	18,959	18,959
Loans held for sale	268,167	268,167
Derivative assets	10,638	10,638
Total	\$ 358,745	\$ 358,745
Financial Liabilities:		
Derivative liabilities	\$ 5,223	\$ 5,223
Warehouse notes payable	218,426	218,426
Notes payable	23,869	23,869
Total	\$ 247,518	\$ 247,518

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents and Restricted Cash The carrying amounts, at face value or cost plus accrued interest, approximate fair value because of the short maturity of these instruments (Level 1).

Pledged Securities Consist of highly liquid investments in commercial paper of AAA rated entities and investments in money market accounts invested in government securities. Investments typically have maturities of 90 days or less, and are valued using quoted market prices from recent trades.

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Loans Held For Sale Consist of originated loans that are generally transferred or sold within 60 days from the date that a mortgage loan is funded, and are valued using discounted cash flow models that incorporate observable prices from market participants.

Loans Held For Investment Consist of originated interim loans which the Company expects to hold for investment for periods of up to two years, and are valued using discounted cash flow models that incorporate observable prices from market participants (Level 2).

Derivative Instruments Consist of interest rate lock commitments and forward sale agreements. These instruments are valued using discounted cash flow models developed based on changes in the U.S. Treasury rate and other observable market data. The value is determined after considering the potential impact of collateralization, adjusted to reflect nonperformance risk of both the counterparty and the Company.

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Warehouse Notes Payable Consist of borrowings outstanding under warehouse line agreements. The borrowing rates on the warehouse lines are based upon average 30-day LIBOR plus an applicable margin. The carrying amounts approximate fair value because of the short maturity of these instruments (Level 1).

Notes Payable Consist of borrowings outstanding under term note agreements. The borrowing rates on the notes payable are based upon average 30-day LIBOR plus an applicable margin. We estimate the fair value by discounting the future cash flows of each instrument at market rates (Level 2).

Fair Value of Derivative Instruments and Loans Held for Sale In the normal course of business, the Company enters into contractual commitments to originate (purchase) and sell multifamily mortgage loans at fixed prices with fixed expiration dates. The commitments become effective when the borrowers' lock-in a specified interest rate within time frames established by the Company. All mortgagors are evaluated for creditworthiness prior to the extension of the commitment. Market risk arises if interest rates move adversely between the time of the lock-in of rates by the borrower and the sale date of the loan to an investor.

To mitigate the effect of the interest rate risk inherent in providing rate lock commitments to borrowers, the Company's policy is to enter into a sale commitment with the investor simultaneously with the rate lock commitment with the borrower. The sale contract with the investor locks in an interest rate and price for the sale of the loan. The terms of the contract with the investor and the rate lock with the borrower are matched in substantially all respects, with the objective of eliminating interest rate risk to the extent practical. Sale commitments with the investors have an expiration date that is longer than our related commitments to the borrower to allow, among other things, for the closing of the loan and processing of paperwork to deliver the loan into the sale commitment.

Both the rate lock commitments to borrowers and the forward sale contracts to buyers are undesignated derivatives and, accordingly, are marked to fair value through other income and expenses. The fair value of the Company's rate lock commitments to borrowers and loans held for sale and the related input levels includes, as applicable:

- the assumed gain/loss of the expected resultant loan sale to the buyer;
- the expected net future cash flows associated with servicing the loan (Level 2);
- the effects of interest rate movements between the date of the rate lock and the balance sheet date (Level 2); and
- the nonperformance risk of both the counterparty and the Company (Level 3).

The fair value of the Company's forward sales contracts to investors considers effects of interest rate movements between the trade date and the balance sheet date (Level 2). The market price changes are multiplied by the notional amount of the forward sales contracts to measure the fair value.

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The assumed gain/loss considers the amount that the Company has discounted the price to the borrower from par for competitive reasons, if at all, and the expected net cash flows from servicing to be received upon securitization of the loan. The fair value of the expected net future cash flows associated with servicing the loan is calculated pursuant to the valuation techniques described previously for mortgage servicing rights.

To calculate the effects of interest rate movements, the Company uses applicable published U.S. Treasury prices, and multiplies the price movement between the rate lock date and the balance sheet date by the notional loan commitment amount.

The fair value of the Company's forward sales contracts to investors considers the market price movement of the same type of security between the trade date and the balance sheet date (Level 2). The market price changes are multiplied by the notional amount of the forward sales contracts to measure the fair value.

The fair value of the Company's interest rate lock commitments and forward sales contracts is adjusted to reflect the risk that the agreement will not be fulfilled. The Company's exposure to nonperformance in rate lock and forward sale contracts is represented by the contractual amount of those instruments. Given the credit quality of our counterparties, the short duration of interest rate lock commitments and forward sale contracts, and the Company's historical experience with the agreements, the risk of nonperformance by the Company's counterparties is not significant.

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(in thousands)	Fair Value Adjustment Components				Balance Sheet Location		Fair Value Adjustment To Loans Held for Sale
	Notional or Principal Amount	Assumed Gain (Loss) on Sale	Interest Rate Movement Effect	Total Fair Value Adjustment	Derivative Contract Assets	Derivative Contract Liabilities	
September 30, 2012							
Rate lock commitments	\$ 700,547	\$ 22,280	\$ 5,749	\$ 28,029	\$ 31,705	\$ (3,733)	\$
Forward sale contracts	1,970,266		(7,867)	(7,867)	6,281	(14,148)	
Loans held for sale	1,269,719	21,483	2,118	23,601			23,601
Total		\$ 43,763	\$	\$ 43,763	\$ 37,986	\$ (17,881)	\$ 23,601
December 31, 2011							
Rate lock commitments	\$ 226,455	\$ 7,781	\$ 2,785	\$ 10,566	\$ 10,566	\$	\$
Forward sale contracts	482,751		(5,151)	(5,151)	72	(5,223)	
Loans held for sale	256,296	9,505	2,366	11,871			11,871
Total		\$ 17,286	\$	\$ 17,286	\$		