

Ares Commercial Real Estate Corp  
Form 10-Q  
May 05, 2016  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2016**

**OR**

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

**For the transition period                      to**

**Commission File No. 001-35517**

**ARES COMMERCIAL REAL ESTATE CORPORATION**

# Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

(Exact name of Registrant as specified in its charter)

**Maryland**  
(State or other jurisdiction of  
incorporation or organization)

**45-3148087**  
(I.R.S. Employer  
Identification Number)

**245 Park Avenue, 42nd Floor, New York, NY 10167**

(Address of principal executive offices) (Zip Code)

**(212) 750-7300**

(Registrant's telephone number, including area code)

**N/A**

(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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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 ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

# Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

Class
Common stock, \$0.01 par value

Outstanding at May 3, 2016
28,478,457

Table of Contents

**ARES COMMERCIAL REAL ESTATE CORPORATION**

**INDEX**

**Part I.      Financial Information**

<u>Item 1.</u>	<u>Consolidated Financial Statements</u>	
	<u>Consolidated Balance Sheets as of March 31, 2016 (unaudited) and December 31, 2015</u>	2
	<u>Consolidated Statements of Operations for the three months ended March 31, 2016 and 2015 (unaudited)</u>	3
	<u>Consolidated Statement of Equity for the three months ended March 31, 2016 (unaudited)</u>	4
	<u>Consolidated Statements of Cash Flows for the three months ended March 31, 2016 and 2015 (unaudited)</u>	5
	<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	36
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	47
<u>Item 4.</u>	<u>Controls and Procedures</u>	49
<b><u>Part II.</u></b>	<b><u>Other Information</u></b>	
<u>Item 1.</u>	<u>Legal Proceedings</u>	49
<u>Item 1A.</u>	<u>Risk Factors</u>	49
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	50
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>	50
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	50
<u>Item 5.</u>	<u>Other Information</u>	50
<u>Item 6.</u>	<u>Exhibits</u>	50

---

[Table of Contents](#)**PART I FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements****ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(in thousands, except share and per share data)**

	March 31, 2016 (unaudited)	As of December 31, 2015
<b>ASSETS</b>		
Cash and cash equivalents (\$2 and \$8 related to consolidated VIEs, respectively)	\$ 6,164	\$ 8,995
Restricted cash	25,632	30,380
Loans held for investment (\$424,555 and \$483,572 related to consolidated VIEs, respectively)	1,209,800	1,174,391
Loans held for sale, at fair value	58,171	30,612
Mortgage servicing rights, at fair value	60,978	61,800
Other assets (\$2,256 and \$2,695 of interest receivable related to consolidated VIEs, respectively; \$25,411 and \$35,607 of other receivables related to consolidated VIEs, respectively)	61,370	72,804
Total assets	\$ 1,422,115	\$ 1,378,982
<b>LIABILITIES AND EQUITY</b>		
<b>LIABILITIES</b>		
Secured funding agreements	\$ 615,397	\$ 522,775
Warehouse lines of credit	49,578	24,806
Secured term loan	69,978	69,762
Commercial mortgage-backed securitization debt (consolidated VIE)	28,406	61,815
Collateralized loan obligation securitization debt (consolidated VIE)	156,959	192,528
Allowance for loss sharing	8,741	8,969
Due to affiliate	2,671	2,658
Dividends payable	7,429	7,152
Other liabilities (\$232 and \$299 of interest payable related to consolidated VIEs, respectively)	28,955	32,029
Total liabilities	968,114	922,494
<b>EQUITY</b>		
Common stock, par value \$0.01 per share, 450,000,000 shares authorized at March 31, 2016 and December 31, 2015, 28,573,519 and 28,609,650 shares issued and outstanding at March 31, 2016 and December 31, 2015, respectively	284	284
Additional paid-in capital	420,983	421,179
Accumulated deficit	(14,285)	(11,992)
Total stockholders' equity	406,982	409,471
Non-controlling interests in consolidated VIEs	47,019	47,017
Total equity	454,001	456,488
Total liabilities and equity	\$ 1,422,115	\$ 1,378,982

See accompanying notes to consolidated financial statements.

Table of Contents

## ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except share and per share data)

	For the three months ended March 31,	
	2016	2015
	(unaudited)	(unaudited)
<b>Net interest margin:</b>		
Interest income from loans held for investment	\$ 18,750	\$ 23,170
Interest expense	(8,525)	(10,178)
Net interest margin	10,225	12,992
<b>Mortgage banking revenue:</b>		
Servicing fees, net	4,042	3,916
Gains from mortgage banking activities	2,359	4,144
Provision for loss sharing	228	566
Change in fair value of mortgage servicing rights	(1,848)	(3,181)
Mortgage banking revenue	4,781	5,445
Total revenue	15,006	18,437
<b>Expenses:</b>		
Management fees to affiliate	1,499	1,476
Professional fees	699	775
Compensation and benefits	4,284	4,637
General and administrative expenses	1,819	1,831
General and administrative expenses reimbursed to affiliate	1,028	1,065
Total expenses	9,329	9,784
<b>Income before income taxes</b>	<b>5,677</b>	<b>8,653</b>
Income tax expense (benefit)	(748)	(642)
<b>Net income attributable to ACRE</b>	<b>6,425</b>	<b>9,295</b>
Less: Net income attributable to non-controlling interests	(1,289)	(2,233)
<b>Net income attributable to common stockholders</b>	<b>\$ 5,136</b>	<b>\$ 7,062</b>
<b>Net income per common share:</b>		
Basic earnings per common share	\$ 0.18	\$ 0.25
Diluted earnings per common share	\$ 0.18	\$ 0.25
<b>Weighted average number of common shares outstanding:</b>		
Basic weighted average shares of common stock outstanding	28,529,328	28,484,293
Diluted weighted average shares of common stock outstanding	28,602,054	28,584,784
Dividends declared per share of common stock	\$ 0.26	\$ 0.25

See accompanying notes to consolidated financial statements.

Table of Contents

**ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF EQUITY**

(in thousands, except share and per share data)

(unaudited)

	Common Stock		Additional		Accumulated		Total		Non-		Total	
	Shares	Amount		Paid-in		Deficit		Stockholders		Controlling		Equity
				Capital				Equity		Interests		
<b>Balance at December 31, 2015</b>	28,609,650	\$ 284	\$	421,179	\$	(11,992)	\$	409,471	\$	47,017	\$	456,488
Stock-based compensation	(1,277)			162				162				162
Repurchase and retirement of common stock	(34,854)			(358)				(358)				(358)
Net income						5,136		5,136		1,289		6,425
Dividends declared						(7,429)		(7,429)				(7,429)
Contributions from non-controlling interests										2		2
Distributions to non-controlling interests										(1,289)		(1,289)
<b>Balance at March 31, 2016</b>	28,573,519	\$ 284	\$	420,983	\$	(14,285)	\$	406,982	\$	47,019	\$	454,001

See accompanying notes to consolidated financial statements.



Table of Contents**ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

	<b>For the three months ended March 31,</b>	
	<b>2016</b>	<b>2015</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
Operating activities:		
Net income	\$ 6,425	\$ 9,295
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of deferred financing costs	1,534	3,158
Change in mortgage banking activities	277	(1,194)
Change in fair value of mortgage servicing rights	1,848	3,181
Accretion of deferred loan origination fees and costs	(953)	(1,525)
Provision for loss sharing	(228)	(566)
Originations of mortgage loans held for sale	(169,886)	(162,175)
Sale of mortgage loans held for sale to third parties	145,114	216,394
Stock-based compensation	162	199
Depreciation expense	55	54
Deferred tax benefit	(477)	(15)
Changes in operating assets and liabilities:		
Restricted cash	2,687	38,680
Other assets	36,696	18,217
Due to affiliate	13	28
Other liabilities	(5,459)	1,823
Net cash provided by (used in) operating activities	17,808	125,554
Investing activities:		
Issuance of and fundings on loans held for investment	(108,054)	(58,669)
Principal repayment of loans held for investment	47,850	218,094
Receipt of origination fees	680	398
Purchases of other assets	(339)	(56)
Net cash provided by (used in) investing activities	(59,863)	159,767
Financing activities:		
Proceeds from secured funding agreements	204,190	20,870
Repayments of secured funding agreements	(111,568)	(69,324)
Payment of secured funding costs	(161)	(248)
Repayments of debt of consolidated VIEs	(69,212)	(187,463)
Proceeds from warehouse lines of credit	191,226	175,689
Repayments of warehouse lines of credit	(166,454)	(229,165)
Repurchase of common stock	(358)	
Dividends paid	(7,152)	(7,147)
Contributions from non-controlling interests	2	5,685
Distributions to non-controlling interests	(1,289)	(1,764)
Net cash provided by (used in) financing activities	39,224	(292,867)
Change in cash and cash equivalents	(2,831)	(7,546)
Cash and cash equivalents, beginning of period	8,995	16,551
Cash and cash equivalents, end of period	\$ 6,164	\$ 9,005

See accompanying notes to consolidated financial statements.



Table of Contents

**ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**As of March 31, 2016**

**(in thousands, except share and per share data, percentages and as otherwise indicated)**

**(unaudited)**

**1. ORGANIZATION**

Ares Commercial Real Estate Corporation (together with its consolidated subsidiaries, the Company or ACRE) is a specialty finance company that operates both as a principal lender and a mortgage banker (with respect to loans collateralized by multifamily and senior-living properties). Through Ares Commercial Real Estate Management LLC (ACREM or the Company's Manager), a Securities and Exchange Commission (SEC) registered investment adviser and a subsidiary of Ares Management L.P. (NYSE: ARES) (Ares Management), a publicly traded, leading global alternative asset manager, it has investment professionals strategically located across the United States and Europe who directly source new loan opportunities for the Company with owners, operators and sponsors of commercial real estate (CRE) properties. The Company was formed and commenced operations in late 2011. The Company is a Maryland corporation and completed its initial public offering (the IPO) in May 2012. The Company is externally managed by its Manager, pursuant to the terms of a management agreement (the Management Agreement).

In the Company's principal lending business, it is primarily focused on directly originating, managing and servicing a diversified portfolio of CRE debt-related investments for the Company's own account. The Company's target investments in its principal lending business include senior mortgage loans, subordinated debt, preferred equity, mezzanine loans and other CRE investments. These investments, which are referred to as the Company's principal lending target investments, are generally held for investment and are secured, directly or indirectly, by office, multifamily, retail, industrial, lodging, senior-living and other commercial real estate properties, or by ownership interests therein.

The Company is also engaged in the mortgage banking business through its wholly owned subsidiary, ACRE Capital LLC (ACRE Capital), which the Company believes is complementary to its principal lending business. In this business segment, the Company primarily originates, sells and services multifamily and senior-living related loans under programs offered by government-sponsored enterprises (GSEs), such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and by government agencies, such as 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). ACRE Capital is approved as a Fannie Mae Delegated Underwriting and Servicing (DUS) lender, a Freddie Mac Program Plus® Seller/Servicer, a Multifamily Accelerated Processing and Section 232 LEAN lender for HUD, and a Ginnie Mae issuer. While the Company earns little interest income from these activities as it generally only holds loans for short periods, the Company receives origination fees when it closes loans and sale premiums when it sells loans. The Company also retains the rights to service the loans, which are known as mortgage servicing rights (MSRs) and receives fees for such servicing during the life of the loans, which generally last ten years or more.

The Company has elected and qualified to be taxed as a real estate investment trust (REIT) for U.S. federal income tax purposes under the Internal Revenue Code of 1986, as amended, commencing with its taxable year ended December 31, 2012. The Company generally will not be subject to U.S. federal income taxes on its REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, to the extent that it annually distributes all of its REIT taxable income to stockholders and complies with various other

requirements as a REIT.

## **2. SIGNIFICANT ACCOUNTING POLICIES**

The accompanying unaudited consolidated interim financial statements should be read in conjunction with the audited consolidated financial statements and the related management's discussion and analysis of financial condition and results of operations included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015 filed with the SEC.

Refer to the Company's Annual Report on Form 10-K for a description of the Company's recurring accounting policies. The Company has included disclosure below regarding basis of presentation and other accounting policies that (i) are required to be disclosed quarterly or (ii) the Company views as critical as of the date of this report.

Table of Contents

***Basis of Presentation***

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting in conformity with United States generally accepted accounting principles ( GAAP ) and include the accounts of the Company, the consolidated variable interest entities ( VIEs ) that the Company controls and of which the Company is the primary beneficiary, and the Company's wholly owned subsidiaries. The consolidated financial statements reflect all adjustments and reclassifications that, in the opinion of management, are necessary for the fair presentation of the Company's results of operations and financial condition as of and for the periods presented. All intercompany balances and transactions have been eliminated.

Interim financial statements are prepared in accordance with GAAP and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X. The current period's results of operations will not necessarily be indicative of results that ultimately may be achieved for the year ending December 31, 2016.

***Variable Interest Entities***

The Company evaluates all of its interests in VIEs for consolidation. When the Company's interests are determined to be variable interests, the Company assesses whether it is deemed to be the primary beneficiary of the VIE. The primary beneficiary of a VIE is required to consolidate the VIE. Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) Topic 810, *Consolidation*, defines the primary beneficiary as the party that has both (i) the power to direct the activities of the VIE that most significantly impact its economic performance, and (ii) the obligation to absorb losses and the right to receive benefits from the VIE which could be potentially significant. The Company considers its variable interests, as well as any variable interests of its related parties in making this determination. Where both of these factors are present, the Company is deemed to be the primary beneficiary and it consolidates the VIE. Where either one of these factors is not present, the Company is not the primary beneficiary and it does not consolidate the VIE.

To assess whether the Company has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, the Company considers all facts and circumstances, including its role in establishing the VIE and its ongoing rights and responsibilities. This assessment includes first, identifying the activities that most significantly impact the VIE's economic performance; and second, identifying which party, if any, has power over those activities. In general, the parties that make the most significant decisions affecting the VIE or have the right to unilaterally remove those decision makers are deemed to have the power to direct the activities of a VIE.

To assess whether the Company has the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE, the Company considers all of its economic interests, including debt and equity investments, servicing fees, and other arrangements deemed to be variable interests in the VIE. This assessment requires that the Company applies judgment in determining whether these interests, in the aggregate, are considered potentially significant to the VIE. Factors considered in assessing significance include: the design of the VIE, including its capitalization structure; subordination of interests; payment priority; relative share of interests held across various classes within the VIE's capital structure; and the reasons why the interests are held by the Company.

For VIEs of which the Company is determined to be the primary beneficiary, all of the underlying assets, liabilities, equity, revenue and expenses of the structures are consolidated into the Company's consolidated financial statements.

The Company performs an ongoing reassessment of: (1) whether any entities previously evaluated under the majority voting interest framework have become VIEs, based on certain events, and therefore are subject to the VIE consolidation framework, and (2) whether changes in the facts and circumstances regarding its involvement with a VIE cause the Company's consolidation conclusion regarding the VIE to change. See Note 15 included in these consolidated financial statements for further discussion of the Company's VIEs.

### ***Segment Reporting***

The Company has two reportable business segments: Principal Lending and Mortgage Banking. See Note 16 included in these consolidated financial statements for further discussion of the Company's reportable business segments.

### ***Reclassifications***

Certain prior period amounts have been reclassified to conform to the current period presentation. Amortization of convertible notes issuance costs and accretion of convertible notes have been reclassified into amortization of deferred financing costs in the consolidated statements of cash flows. As of March 31, 2016 and December 31, 2015, the Company no

Table of Contents

longer presents amortization of convertible notes issuance costs and accretion of convertible notes in its consolidated statements of cash flows.

***Loans Held for Investment***

The Company originates CRE debt and related instruments generally to be held for investment. Loans that are held for investment are carried at cost, net of unamortized loan fees and origination costs, unless the loans are deemed impaired. Impairment occurs when it is deemed probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan. If a loan is considered to be impaired, the Company will record an allowance to reduce the carrying value of the loan to the present value of expected future cash flows discounted at the loan's contractual effective rate.

Each loan classified as held for investment is evaluated for impairment on a quarterly basis. Loans are collateralized by real estate. The extent of any credit deterioration associated with the performance and/or value of the underlying collateral property and the financial and operating capability of the borrower could impact the expected amounts received. The Company monitors performance of its investment portfolio under the following methodology: (1) borrower review, which analyzes the borrower's ability to execute on its original business plan, reviews its financial condition, assesses pending litigation and considers its general level of responsiveness and cooperation; (2) economic review, which considers underlying collateral (i.e. leasing performance, unit sales and cash flow of the collateral and its ability to cover debt service, as well as the residual loan balance at maturity); (3) property review, which considers current environmental risks, changes in insurance costs or coverage, current site visibility, capital expenditures and market perception; and (4) market review, which analyzes the collateral from a supply and demand perspective of similar property types, as well as from a capital markets perspective. Such impairment analyses are completed and reviewed by asset management and finance personnel who utilize various data sources, including periodic financial data such as property occupancy, tenant profile, rental rates, operating expenses, and the borrower's exit plan, among other factors.

In addition, the Company evaluates the entire portfolio to determine whether the portfolio has any impairment that requires a valuation allowance on the remainder of the loan portfolio. As of March 31, 2016 and December 31, 2015, the Company did not recognize any impairment charges with respect to its loans held for investment.

Loans are generally placed on non-accrual status when principal or interest payments are past due 30 days or more or when there is reasonable doubt that principal or interest will be collected in full. Accrued and unpaid interest is generally reversed against interest income in the period the loan is placed on non-accrual status. Interest payments received on non-accrual loans may be recognized as income or applied to principal depending upon management's judgment regarding the borrower's ability to make pending principal and interest payments. Non-accrual loans are restored to accrual status when past due principal and interest are paid and, in management's judgment, are likely to remain current. The Company may make exceptions to placing a loan on non-accrual status if the loan has sufficient collateral value and is in the process of collection.

Preferred equity investments, which are subordinate to any loans but senior to common equity, are accounted for as loans held for investment and are carried at cost, net of unamortized loan fees and origination costs, unless the loans are deemed impaired, and are included within loans held for investment in the Company's consolidated balance sheets. The Company accretes or amortizes any discounts or premiums over the life of the related loan held for investment utilizing the effective interest method.

***Loans Held for Sale***

Through its subsidiaries, including ACRE Capital, ACRC Lender W TRS LLC ( ACRC W TRS ) and ACRC Lender U TRS LLC ( ACRC U TRS ), the Company originates mortgage loans held for sale, which are recorded at fair value and accounted for under FASB ASC Topic 860, *Transfers and Servicing*. The holding period for loans originated by ACRE Capital is approximately 30 days. The carrying value of the mortgage loans sold is reduced by the value allocated to the associated retained MSRs based on relative fair value at the time of the sale. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the adjusted value of the related mortgage loans sold.

Although the Company generally holds its target investments as long-term investments within its principal lending business, the Company may occasionally classify some of its investments as held for sale. Investments held for sale will be carried at fair value within loans held for sale in the Company's consolidated balance sheets, with changes in fair value recorded through earnings. The fees received are deferred and recognized as part of the gain or loss on sale. As of March 31, 2016 and December 31, 2015, the Company did not have any loans held for sale in its principal lending business.



Table of Contents

***Mortgage Servicing Rights***

When a mortgage loan is sold, ACRE Capital retains the right to service the loan and recognizes the MSR at fair value. The initial fair value represents expected net cash flows from servicing, as well as interest earnings on escrows and interim cash balances, borrower prepayment penalties, delinquency rates, late charges along with ancillary fees that are discounted at a rate that reflects the credit and liquidity risk of the MSR over the estimated life of the underlying loan. After initial recognition, changes in the MSR fair value are included within change in fair value of mortgage servicing rights in the Company's consolidated statements of operations for the period in which the change occurs.

***Allowance for Loss Sharing***

When a loan is sold under the Fannie Mae DUS program, ACRE Capital undertakes an obligation to partially guarantee the performance of the loan. The date ACRE Capital commits to make a loan to a borrower, a liability for the fair value of the obligation undertaken in issuing the guarantee is recognized. Subsequent to the initial commitment date, the Company monitors the performance of each loan for events or circumstances which may signal an additional liability to be recognized if there is a probable and estimable loss. The initial fair value of the guarantee is estimated by examining historical loss share experienced in the ACRE Capital Fannie Mae DUS portfolio over the most recent ten-year period. The initial fair value of the guarantee is included within the provision for loss sharing in the Company's consolidated statements of operations. These historical loss shares serve as a basis to derive a loss share rate which is then applied to the current ACRE Capital DUS portfolio (net of specifically identified impaired loans that are subject to a separate loss share reserve analysis).

***Revenue Recognition***

*Interest income from loans held for investment* is accrued based on the outstanding principal amount and the contractual terms of each loan. For loans held for investment, origination fees, contractual exit fees and direct loan origination costs are also recognized in interest income from loans held for investment over the initial loan term as a yield adjustment using the effective interest method.

A reconciliation of the Company's interest income from loans held for investment, excluding non-controlling interests, to the Company's interest income from loans held for investment as included within its consolidated statements of operations is as follows (\$ in thousands):

	<b>For the three months ended March 31,</b>	
	<b>2016</b>	<b>2015</b>
Interest income from loans held for investment, excluding non-controlling interests	\$ 17,461	\$ 20,927
Interest income from non-controlling interest investment held by third parties	1,289	2,243
Interest income from loans held for investment	\$ 18,750	\$ 23,170

*Servicing fees* are earned for servicing mortgage loans, including all activities related to servicing the loans, and are recognized as services are provided over the life of the related mortgage loan. Also included in servicing fees are the

net fees earned on borrower prepayment penalties and interest earned on borrowers' escrow payments and interim cash balances, along with other ancillary fees and reduced by write-offs of MSR for loans that are prepaid, changes in the fair value of the servicing fee payable (defined below) and interest expense related to escrow accounts. ACRE Capital provides additional payments to certain personnel by providing them with a percentage of the servicing fee revenue that is earned by ACRE Capital, which is initially recorded as a liability when ACRE Capital commits to make a loan to a borrower (the servicing fee payable).

*Gains from mortgage banking activities* includes the initial fair value of MSRs, loan origination fees, gain on the sale of loans originated, interest income and fees earned on loans held for sale, changes to the fair value of derivative financial instruments attributable to the loan commitments and forward sale commitments and reduced by the expense related to the initial fair value of the servicing fee payable and the interest expense related to the Warehouse Lines of Credit (as defined in Note 5 included in these consolidated financial statements). The initial fair value of MSRs, loan origination fees, gain on the sale of loans originated, certain direct loan origination costs for loans held for sale and the expenses related to the initial fair value of the servicing fee payable are recognized when ACRE Capital commits to make a loan to a borrower. When the Company settles a sale agreement and transfers the mortgage loan to the buyer, the Company recognizes a MSR asset equal to the present value of the expected net cash flows associated with the servicing of loans sold.

***Net Interest Margin and Interest Expense***

Net interest margin within the consolidated statements of operations is a measure that is specific to the Company's principal lending business and serves to measure the performance of the Principal Lending segment's loans held for investment as compared to its use of debt leverage. The Company includes interest income from its loans held for investment and interest

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

### Table of Contents

expense related to its Secured Funding Agreements, securitizations debt, the Secured Term Loan and the 2015 Convertible Notes (individually defined in Note 5 included in these consolidated financial statements) in net interest margin. For the three months ended March 31, 2016 and 2015, interest expense is comprised of the following (\$ in thousands):

	For the three months ended March 31,			
	2016		2015	
Secured funding agreements and securitizations debt	\$	6,768	\$	8,589
Secured term loan		1,757		
Convertible notes				1,589
Interest expense	\$	8,525	\$	10,178

### ***Comprehensive Income***

For the three months ended March 31, 2016 and 2015, comprehensive income equaled net income; therefore, a separate consolidated statement of comprehensive income is not included in the accompanying consolidated financial statements.

### ***Recent Accounting Pronouncements***

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606). The guidance in this ASU supersedes the revenue recognition requirements in Topic 605, Revenue Recognition. Under the new guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments in ASU No. 2014-09 are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. In March 2016, the FASB issued ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal Versus Agent Considerations, which clarifies the guidance in ASU No. 2014-09 and has the same effective date as the original standard. Early application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company is currently evaluating the impact of adopting this ASU on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The guidance in this ASU supersedes the leasing guidance in Topic 840, Leases. Under the new guidance, lessees are required to recognize lease assets and lease liabilities on the balance sheet for those leases previously classified as operating leases. The amendments in ASU No. 2016-02 are effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period, with early adoption permitted. The Company is currently evaluating the impact of adopting this ASU on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The standard is intended to simplify several areas of accounting for share-based compensation arrangements, including the income tax impact, classification on the statement of cash flows and forfeitures. ASU No. 2016-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, with early adoption permitted. The Company is currently evaluating the impact of adopting this ASU on its consolidated financial statements.

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

In February 2015, the FASB issued ASU No. 2015-02, Consolidation: Amendments to the Consolidation Analysis (Topic 810). The guidance in this ASU includes amendments to Topic 810, Consolidation. The new guidance modified the consolidation analysis for limited and general partnerships and similar type entities, as well as variable interests in a VIE, particularly those that have fee arrangements and related party relationships. Additionally, it provides a scope exception to the consolidation guidance for certain entities. The amendments in ASU No. 2015-02 are effective for annual reporting periods beginning after December 15, 2015. There was no impact of adopting this ASU on the Company's consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The new guidance modified the requirements for reporting debt issuance costs. Under the amendments in ASU No. 2015-03, debt issuance costs related to a recognized debt liability are no longer recorded as a separate asset, but are presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by ASU No. 2015-03. In addition, in August 2015, the FASB issued ASU No. 2015-15, Interest-Imputation of Interest (Subtopic 835-30). The

Table of Contents

additional guidance reiterates that the SEC would not object to an entity deferring and presenting debt issuance costs related to a line of credit arrangement as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line of credit arrangement, regardless of whether there are any outstanding borrowings. ASU No. 2015-03 and ASU No. 2015-15 are required to be applied retrospectively for periods beginning after December 15, 2015. The Company early adopted this guidance retrospectively during the fourth quarter of 2015.

### 3. LOANS HELD FOR INVESTMENT

As of March 31, 2016, the Company had originated or co-originated 38 loans held for investment, excluding 27 loans that were repaid or sold since inception. The aggregate originated commitment under these loans at closing was approximately \$1.3 billion and outstanding principal was \$1.2 billion, excluding non-controlling interests held by third parties, as of March 31, 2016. During the three months ended March 31, 2016, the Company funded approximately \$109.2 million of outstanding principal and received repayments of \$73.3 million of outstanding principal, excluding non-controlling interests held by third parties, as described in more detail in the tables below. Such investments are referred to herein as the Company's investment portfolio. As of March 31, 2016, 66.7% of the Company's loans have London Interbank Offered Rates (LIBOR) floors, with a weighted average floor of 0.23%, calculated based on loans with LIBOR floors. References to LIBOR or L are to 30-day LIBOR (unless otherwise specifically stated).

The Company's investments in mortgages and loans held for investment are accounted for at amortized cost. The following tables summarize the Company's loans held for investment as of March 31, 2016 and December 31, 2015 (\$ in thousands):

As of March 31, 2016					
	Carrying Amount (1)	Outstanding Principal (1)	Weighted Average Interest Rate	Weighted Average Unleveraged Effective Yield (2)	Weighted Average Remaining Life (Years)
Senior mortgage loans	\$ 992,166	\$ 996,308	4.4%	5.1%	1.3
Subordinated debt and preferred equity investments	171,055	173,441	10.7%	11.3%	5.3
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,163,221	\$ 1,169,749	5.3%	6.0%	1.9

  

As of December 31, 2015					
	Carrying Amount (1)	Outstanding Principal (1)	Weighted Average Interest Rate	Weighted Average Unleveraged Effective Yield (2)	Weighted Average Remaining Life (Years)
Senior mortgage loans	\$ 961,395	\$ 965,578	4.4%	5.1%	1.4
Subordinated debt and preferred equity investments	166,417	168,264	10.6%	11.2%	5.1
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,127,812	\$ 1,133,842	5.3%	6.0%	1.9

(1) The difference between the Carrying Amount and the Outstanding Principal face amount of the loans held for investment consists of unamortized purchase discount, deferred loan fees and loan origination costs. The

tables above exclude non-controlling interests held by third parties. A reconciliation of the Carrying Amount of loans held for investment portfolio, excluding non-controlling interests, to the Carrying Amount of loans held for investment, as included within the Company's consolidated balance sheets, is presented below.

(2) Unleveraged Effective Yield is the compounded effective rate of return that would be earned over the life of the investment based on the contractual interest rate (adjusted for any deferred loan fees, costs, premium or discount) and assumes no dispositions, early prepayments or defaults. The Total Weighted Average Unleveraged Effective Yield is calculated based on the average of Unleveraged Effective Yield of all loans held by the Company as of March 31, 2016 and December 31, 2015 as weighted by the Outstanding Principal balance of each loan.

Table of Contents

A reconciliation of the Company's loans held for investment portfolio, excluding non-controlling interests held by third parties, to the Company's loans held for investment as included within its consolidated balance sheets is as follows (\$ in thousands):

	<b>As of March 31, 2016</b>	
	<b>Carrying Amount</b>	<b>Outstanding Principal</b>
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,163,221	\$ 1,169,749
Non-controlling interest investment held by third parties	46,579	46,579
Loans held for investment	\$ 1,209,800	\$ 1,216,328

	<b>As of December 31, 2015</b>	
	<b>Carrying Amount</b>	<b>Outstanding Principal</b>
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,127,812	\$ 1,133,842
Non-controlling interest investment held by third parties	46,579	46,579
Loans held for investment	\$ 1,174,391	\$ 1,180,421

A more detailed listing of the Company's investment portfolio, excluding non-controlling interests, based on information available as of March 31, 2016 is as follows (\$ in millions, except percentages):

# Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

## Table of Contents

Loan Type	Location	Outstanding Principal (1)	Carrying Amount (1)	Interest Rate	Unleveraged Effective Yield (2)	Maturity Date (3)	Payment Terms (4)
<b>Senior Mortgage Loans:</b>							
Office	TX	\$ 81.8	\$ 81.4	L+5.00%	6.3%	Jan 2017	I/O
Retail	IL	75.9	75.6	L+4.00%	4.8%	Aug 2017	I/O
Hotel	CA	56.0	55.5	L+4.75%	5.9%	Feb 2019	I/O
Mixed-use	IL	56.9	56.4	L+3.60%	4.4%	Oct 2018	I/O
Office	FL	47.3	47.3	L+5.25%	5.6%	Apr 2016	I/O
Multifamily	TX	44.7	44.7	L+3.75%	4.7%	July 2016	I/O
Healthcare	NY	41.6	41.4	L+5.00%	5.9%	Dec 2016	I/O
Industrial	MO/KS	37.2	37.2	L+4.30%	5.3%	Jan 2017	P/I (5)
Hotel	NY	36.5	36.2	L+4.75%	5.6%	June 2018	I/O
Hotel	MI	35.2	35.1	L+4.15%	4.8%	July 2017	I/O
Multifamily	TX	35.0	35.0	L+3.75%	4.7%	July 2016	I/O
Office	FL	34.0	33.9	L+3.65%	4.3%	Oct 2017	I/O
Industrial	OH	32.5	32.4	L+4.20%	5.0%	May 2018	I/O (5)
Retail	IL	30.4	30.2	L+3.25%	4.1%	Sep 2018	I/O
Multifamily	NY	28.7	28.5	L+3.75%	4.7%	Oct 2017	I/O
Multifamily	TX	27.5	27.5	L+3.65%	4.6%	Jan 2017	I/O
Office	OR	28.6	28.4	L+3.75%	4.6%	Oct 2018	I/O
Mixed-use	NY	28.3	28.2	L+4.25%	5.0%	Aug 2017	I/O
Office	KS	25.5	25.4	L+5.00%	6.1%	Oct 2017	I/O
Multifamily	TX	25.0	24.9	L+3.65%	4.6%	Jan 2017	I/O
Multifamily	TX	23.9	23.8	L+3.80%	4.4%	Jan 2019	I/O
Multifamily	GA	23.1	23.0	L+3.85%	5.0%	May 2017	I/O
Multifamily	AZ	22.1	22.1	L+4.25%	5.5%	Sep 2016	I/O
Office	CO	19.5	19.4	L+3.95%	4.9%	Dec 2017	I/O
Office	CA	15.9	15.9	L+3.75%	4.6%	July 2016	I/O
Multifamily	NC	16.3	16.3	L+4.00%	5.0%	Apr 2017	I/O
Office	CA	14.9	14.9	L+4.50%	5.5%	July 2016	I/O
Multifamily	NY	15.0	15.0	L+3.85%	4.7%	Nov 2017	I/O
Mixed-use	NY	14.4	14.3	L+3.95%	5.0%	Sep 2017	I/O
Multifamily	FL	12.4	12.3	L+3.75%	4.8%	Apr 2017	I/O
Industrial	CA	10.1	10.0	L+5.25%	6.5%	May 2017	I/O
<b>Subordinated Debt and Preferred Equity Investments:</b>							
Multifamily	GA/FL	38.8	38.4	L+11.85% (6)	12.5%	June 2021	I/O
Multifamily	NY	33.3	33.2	L+8.07%	8.8%	Jan 2019	I/O
Office	NJ	17.0	16.2	12.00%	12.8%	Jan 2026	I/O (5)
Office	GA	14.3	14.3	9.50%	9.5%	Aug 2017	I/O
Mixed-use	NY	16.7	16.7	11.50% (7)	12.1%	Nov 2016	I/O
Multifamily	TX	4.9	4.8	L+11.00% (8)	11.8%	Oct 2016	I/O
Various	Diversified (9)	48.5	47.4	10.95%	11.7%	Dec 2024	I/O
Total/Weighted Average		\$ 1,169.7	\$ 1,163.2		6.0%		

(1) The difference between the Carrying Amount and the Outstanding Principal amount of the loans held for investment consists of unamortized purchase discount, deferred loan fees and loan origination costs.

(2) Unleveraged Effective Yield is the compounded effective rate of return that would be earned over the life of the investment based on the contractual interest rate (adjusted for any deferred loan fees, costs, premium or discount) and assumes no dispositions, early prepayments or defaults. Unleveraged Effective Yield for each loan is calculated based on LIBOR as of March 31, 2016 or the LIBOR floor, as applicable. The Weighted Average Unleveraged Effective Yield is calculated based on the average of Unleveraged Effective Yield of all loans held by the Company as of March 31, 2016 as weighted by the Outstanding Principal balance of each loan.

(3) Certain loans are subject to contractual extension options that vary between one and two 12-month extensions and may be subject to performance based or other conditions as stipulated in the loan agreement. Actual maturities may differ from contractual maturities stated herein as certain borrowers may have the right to prepay with or without paying a prepayment penalty. The Company may also extend contractual maturities in connection with loan modifications.



## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

(4) I/O = interest only, P/I = principal and interest.

(5) In January 2015, amortization began on the senior Missouri/Kansas loan, which had an outstanding principal balance of \$37.2 million as of March 31, 2016. In May 2017, amortization will begin on the senior Ohio loan, which had an

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

### Table of Contents

outstanding principal balance of \$32.5 million as of March 31, 2016. In February 2021, amortization will begin on the subordinated New Jersey loan, which had an outstanding principal balance of \$17.0 million as of March 31, 2016. The remainder of the loans in the Company's principal lending portfolio are non-amortizing through their primary terms.

(6) The preferred return is L+11.85% with 2.00% as payment-in-kind (PIK), to the extent cash flow is not available. There is no capped dollar amount on accrued PIK.

(7) The interest rate is 11.50% with a 9.00% current pay and up to a capped dollar amount as PIK based on the borrower's election. In July 2015, the Company entered into an amendment to increase the loan commitment and outstanding principal by \$650 thousand at an interest rate of 15.00% on the increased commitment and outstanding principal only.

(8) The preferred return is L+11.00% with a L+9.00% current pay and up to a capped dollar amount as PIK.

(9) The preferred equity investment is in an entity whose assets are comprised of multifamily, student housing and medical office properties.

For the three months ended March 31, 2016, the activity in the Company's loan portfolio was as follows (\$ in thousands):

<b>Balance at December 31, 2015</b>	<b>\$ 1,174,391</b>
Initial funding	98,500
Origination fees and discounts, net of costs	(1,452)
Additional funding	10,669
Amortizing payments	(156)
Loan payoffs	(73,105)
Origination fee accretion	953
<b>Balance at March 31, 2016</b>	<b>\$ 1,209,800</b>

No impairment charges have been recognized during the three months ended March 31, 2016 and 2015.

#### **4. MORTGAGE SERVICING RIGHTS**

MSRs represent servicing rights retained by ACRE Capital for loans it originates and sells. The servicing fees are collected from the monthly payments made by the borrowers. ACRE Capital generally receives other remuneration including rights to various loan fees such as late charges, collateral re-conveyance charges, loan prepayment penalties, and other ancillary fees. In addition, ACRE Capital is also generally entitled to retain the interest earned on funds held pending remittance related to its collection of loan principal and escrow balances. As of March 31, 2016, ACRE Capital had a servicing portfolio (excluding ACRE's loans held for investment portfolio; see Note 13 included in these consolidated financial statements) consisting of 971 loans with an unpaid principal balance of \$5.0 billion, which includes 950 GSE / HUD loans with an unpaid principal balance of \$4.4 billion and 21 other loans (managed by an affiliate of the manager of ACRE) with an unpaid principal balance of \$567.6 million. As of December 31, 2015, ACRE Capital had a servicing portfolio (excluding ACRE's loans held for investment portfolio; see Note 13 included in these consolidated financial statements) consisting of 973 loans with an unpaid principal balance of \$4.9 billion, which includes 953 GSE / HUD loans with an unpaid principal balance of \$4.3 billion and 20 other loans (managed by an affiliate of the manager of ACRE) with an unpaid principal balance of \$554.8 million. As

Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

of March 31, 2016 and December 31, 2015, the carrying value of ACRE Capital's MSR's for the GSE and HUD loan portfolio was approximately \$61.0 million and \$61.8 million, respectively.

Activity related to MSR's as of and for the three months ended March 31, 2016 and 2015 was as follows (\$ in thousands):

<b>Balance at December 31, 2015</b>	\$	61,800
MSR's purchased		323
Additions, following sale of loan		1,490
Changes in fair value		(1,848)
Prepayments and write-offs		(787)
<b>Balance at March 31, 2016</b>	\$	60,978

# Table of Contents

<b>Balance at December 31, 2014</b>	\$	58,889
Additions, following sale of loan		3,144
Changes in fair value		(3,181)
Prepayments and write-offs		(327)
<b>Balance at March 31, 2015</b>	\$	58,525

As discussed in Note 2 included in these consolidated financial statements, the Company determines the fair values of the MSR's based on discounted cash flow models that calculate the present value of estimated future net servicing income. The fair values of ACRE Capital's MSR's are subject to changes in discount rates. For example, a 100 basis point increase or decrease in the weighted average discount rate would decrease or increase, respectively, the fair value of ACRE Capital's MSR's outstanding as of March 31, 2016 and December 31, 2015 by approximately \$1.9 million and \$2.0 million, respectively.

## 5. DEBT

### Financing Agreements

The Company, through its subsidiary ACRE Capital, borrows funds under the ASAP Line of Credit and the BAML Line of Credit (individually defined below and together, the Warehouse Lines of Credit). The Company also borrows funds under the Wells Fargo Facility, the Citibank Facility, the BAML Facility, the CNB Facilities, the MetLife Facility and the UBS Facilities (individually defined below and collectively, the Secured Funding Agreements) and the Secured Term Loan (defined below). The Company refers to the Warehouse Lines of Credit, the Secured Funding Agreements and the Secured Term Loan as the Financing Agreements. As of March 31, 2016 and December 31, 2015, the outstanding balances and total commitments under the Financing Agreements consisted of the following (\$ in thousands):

	March 31, 2016		December 31, 2015	
	Outstanding Balance	Total Commitment	Outstanding Balance	Total Commitment
Wells Fargo Facility	\$ 124,958	\$ 225,000	\$ 101,473	\$ 225,000
Citibank Facility	152,643	250,000	112,827	250,000
BAML Facility		50,000		50,000
March 2014 CNB Facility	50,000	50,000		50,000
July 2014 CNB Facility	37,900	75,000	66,200	75,000
MetLife Facility	110,359	180,000	109,474	180,000
April 2014 UBS Facility	82,294	140,000	75,558	140,000
December 2014 UBS Facility	57,243	57,243	57,243	57,243
Secured Term Loan	75,000	155,000	75,000	155,000
ASAP Line of Credit		80,000 (1)		80,000 (1)
BAML Line of Credit	49,578	135,000	24,806	135,000
Total	\$ 739,975	\$ 1,397,243	\$ 622,581	\$ 1,397,243

(1) The commitment amount is subject to change at any time at Fannie Mae's discretion.

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

Some of the Company's Financing Agreements are collateralized by (i) assignments of specific loans, preferred equity or a pool of loans held for investment or loans held for sale owned by the Company, (ii) interests in the subordinated portion of the Company's securitization debt, or (iii) interests in wholly owned entity subsidiaries that hold the Company's loans held for investment. The Company is the borrower or guarantor under each of the Financing Agreements (excluding the Warehouse Lines of Credit, where ACRE Capital is the borrower). Generally, the Company partially offsets interest rate risk by matching the interest index of loans held for investment with the Secured Funding Agreements used to fund them. The Company's Financing Agreements contain various affirmative and negative covenants, including negative pledges, and provisions regarding events of default that are normal and customary for similar financing arrangements.

Table of Contents

***Wells Fargo Facility***

The Company is party to a master repurchase funding facility arranged by Wells Fargo Bank, National Association ( "Wells Fargo" ) (as amended and restated, the "Wells Fargo Facility" ), which allows the Company to borrow up to \$225.0 million. The maturity date of the Wells Fargo Facility is December 14, 2016, subject to two 12-month extensions at the Company's option assuming no existing defaults under the Wells Fargo Facility and applicable extension fees are paid. Under the Wells Fargo Facility, the Company is permitted to sell, and later repurchase, certain qualifying senior commercial mortgage loans, A-Notes, pari passu participations in commercial mortgage loans and mezzanine loans under certain circumstances, subject to available collateral approved by Wells Fargo in its sole discretion. Beginning on December 14, 2015, new advances under the Wells Fargo Facility accrue interest at a per annum rate equal to the sum of (i) 30 day LIBOR plus (ii) a pricing margin range of 1.75% to 2.35%. Advances on loans made prior to December 14, 2015 under the Wells Fargo Facility continue to accrue interest at a per annum rate equal to the sum of (i) 30 day LIBOR plus (ii) a pricing margin range of 2.00% to 2.50%. The Company incurs a non-utilization fee of 25 basis points on the daily available balance of the Wells Fargo Facility to the extent less than 75% of the Wells Fargo Facility is utilized. For the three months ended March 31, 2016, the Company incurred a non-utilization fee of \$66 thousand. For the three months ended March 31, 2015, the Company did not incur a non-utilization fee.

***Citibank Facility***

The Company is party to a \$250.0 million master repurchase facility (the "Citibank Facility" ) with Citibank, N.A. Under the Citibank Facility, the Company is permitted to sell and later repurchase certain qualifying senior commercial mortgage loans and A-Notes approved by Citibank, N.A. in its sole discretion. Advances under the Citibank Facility accrue interest at a per annum rate equal to 30 day LIBOR plus a pricing margin of 2.00% to 2.50%, subject to certain exceptions. The maturity date of the Citibank Facility is December 8, 2016, subject to three 12-month extensions at the Company's option assuming no existing defaults under the Citibank Facility and applicable extension fees are paid. The Company incurs a non-utilization fee of 25 basis points on the daily available balance of the Citibank Facility. For the three months ended March 31, 2016 and 2015, the Company incurred a non-utilization fee of \$68 thousand and \$97 thousand, respectively.

***BAML Facility***

The Company is party to a \$50.0 million Bridge Loan Warehousing Credit and Security Agreement (the "BAML Facility" ) with Bank of America, N.A. Under the BAML Facility, the Company may obtain advances secured by eligible commercial mortgage loans collateralized by healthcare facilities and other multifamily properties. In February 2016, the Company amended the BAML Facility to expand the eligible assets to include loans secured by general and affordable multifamily properties. Bank of America, N.A. may approve the loans on which advances are made under the BAML Facility in its sole discretion. The Company may request individual loans under the BAML Facility through May 26, 2016. Individual advances under the BAML Facility generally have a two-year maturity, subject to one 12-month extension at the Company's option upon the satisfaction of certain conditions and applicable extension fees being paid. The final maturity date of individual loans under the BAML Facility is May 26, 2019. Advances under the BAML Facility accrue interest at a per annum rate equal to one-month LIBOR plus a spread ranging from 2.25% to 2.75% depending upon the type of asset securing such advance. The Company incurs a non-utilization fee of 12.5 basis points on the average daily available balance of the BAML Facility. For the three months ended March 31, 2016, the Company incurred a non-utilization fee of \$16 thousand.

***City National Bank Facilities***

***March 2014 CNB Facility***

The Company is party to a \$50.0 million secured revolving funding facility with City National Bank (the *March 2014 CNB Facility*). The Company is permitted to borrow funds under the March 2014 CNB Facility to finance investments and for other working capital and general corporate needs. In February 2016, the Company amended the March 2014 CNB Facility to extend the maturity date to March 11, 2017. The Company has one 12-month extension at its option provided that certain conditions are met and applicable extension fees are paid, which, if exercised, would extend the final maturity of the March 2014 CNB Facility to March 10, 2018. Advances under the March 2014 CNB Facility accrue interest at a per annum rate equal to the sum of, at the Company's option, either (a) LIBOR for a one, two, three, six or, if available to all lenders, 12-month interest period plus 3.00% or (b) a base rate (which is the highest of a prime rate, the federal funds rate plus 0.50%, or one month LIBOR plus 1.00%) plus 1.25%; provided that in no event shall the interest rate be less than 3.00%. Unless at least 75% of the March 2014 CNB Facility is used on average, unused commitments under the March 2014 CNB Facility accrue unused line fees at the rate of 0.375% per annum. For the three months ended March 31, 2016 and 2015, the Company incurred a non-utilization fee of \$43 thousand and \$37 thousand, respectively.

Table of Contents

***July 2014 CNB Facility***

The Company and certain of its subsidiaries are party to a \$75.0 million revolving funding facility (the July 2014 CNB Facility) and together with the March 2014 CNB Facility, the CNB Facilities) with City National Bank. The Company is permitted to borrow funds under the July 2014 CNB Facility to finance investments and for other working capital and general corporate needs. The maturity date of the July 2014 CNB Facility is July 31, 2016. Advances under the July 2014 CNB Facility accrue interest at a per annum rate equal, at the Company's option, to either (a) LIBOR for a one, two, three, six or, if available to all lenders, 12-month interest period plus 1.50% or (b) a base rate (which is the highest of a prime rate, the federal funds rate plus 0.50%, or one month LIBOR plus 1.00%) plus 0.25%; provided that in no event shall the interest rate be less than 1.50%. Unless at least 75% of the July 2014 CNB Facility is used on average, unused commitments under the July 2014 CNB Facility accrue unused line fees at the rate of 0.125% per annum. For the three months ended March 31, 2016, the Company incurred a non-utilization fee of \$7 thousand. For the three months ended March 31, 2015, the Company did not incur a non-utilization fee. See Note 13 included in these consolidated financial statements for more information on a credit support fee agreement with respect to the July 2014 CNB Facility.

***MetLife Facility***

The Company and certain of its subsidiaries are party to a \$180.0 million revolving master repurchase facility (the MetLife Facility) with Metropolitan Life Insurance Company (MetLife), pursuant to which the Company may sell, and later repurchase, commercial mortgage loans meeting defined eligibility criteria which are approved by MetLife in its sole discretion. The maturity date of the MetLife Facility is August 12, 2017, subject to two 12-month extensions at the Company's option provided that certain conditions are met and applicable extension fees are paid. Advances under the MetLife Facility accrue interest at a per annum rate of 30 day LIBOR plus 2.35%. The Company will pay MetLife, if applicable, an annual make-whole fee equal to the amount by which the aggregate price differential paid over the term of the MetLife Facility is less than the defined minimum price differential, unless certain conditions are met.

***UBS Facilities***

***April 2014 UBS Facility***

The Company is party to a \$140.0 million revolving master repurchase facility (the April 2014 UBS Facility) with UBS Real Estate Securities Inc. (UBS), pursuant to which the Company may sell, and later repurchase, commercial mortgage loans and, under certain circumstances, other assets meeting defined eligibility criteria that are approved by UBS in its sole discretion. The maturity date of the April 2014 UBS Facility is October 21, 2018, subject to annual extensions in UBS's sole discretion. The price differential (or interest rate) on the April 2014 UBS Facility is one-month LIBOR plus (a) 1.88% per annum, for assets that are subject to an advance for one year or less, (b) 2.08% per annum, for assets that are subject to an advance in excess of one year but less than two years, and (c) 2.28% per annum, for assets that are subject to an advance for greater than two years; in each case, excluding amortization of commitment and exit fees. Upon termination of the April 2014 UBS Facility, the Company will pay UBS, if applicable, the amount by which the aggregate price differential paid over the term of the April 2014 UBS Facility is less than the defined minimum price differential and an exit fee, in each case, unless certain conditions are met.

***December 2014 UBS Facility***



The Company is party to a global master repurchase agreement (the December 2014 UBS Facility, and together with the April 2014 UBS Facility, the UBS Facilities ) with UBS AG, pursuant to which the Company will sell, and later repurchase, certain retained subordinate notes in the Company's commercial mortgage-backed securities ( CMBS ) securitization (the Purchased Securities ) for an aggregate purchase price equal to \$57.2 million. The scheduled repurchase date of the December 2014 UBS Facility is July 6, 2016 (the Repurchase Date ). The transaction fee (or interest rate), which is payable monthly on the December 2014 UBS Facility, is equal to one-month LIBOR plus 2.74% per annum on the outstanding amount. The Purchased Securities may be purchased by the Company in whole, but not in part, prior to the Repurchase Date. If the outstanding amount of the Purchased Securities subject to the December 2014 UBS Facility is reduced or repaid prior to the Repurchase Date, UBS AG shall be entitled to a termination fee.

Table of Contents

**Warehouse Lines of Credit**

***ASAP Line of Credit***

ACRE Capital is party to a multifamily as soon as pooled ( ASAP ) sale agreement with Fannie Mae (the ASAP Line of Credit ) to finance installments received from Fannie Mae. To the extent the ASAP Line of Credit remains active through utilization, there is no expiration date. The commitment amount is subject to change at any time at Fannie Mae's discretion. Fannie Mae advances payment to ACRE Capital in two separate installments according to the terms as set forth in the ASAP sale agreement. The first installment is considered an advance to ACRE Capital from Fannie Mae and not a sale until the second advance and settlement is made.

***BAML Line of Credit***

ACRE Capital is party to a \$135.0 million line of credit agreement with Bank of America, N.A. (as amended and restated, the BAML Line of Credit ), which is used to finance mortgage loans originated by ACRE Capital. The stated interest rate on the BAML Line of Credit is LIBOR Daily Floating Rate plus 1.60%. The BAML Line of Credit has a maturity date of June 30, 2016. ACRE Capital incurs a non-utilization fee of 12.5 basis points on the daily available balance of the BAML Line of Credit to the extent less than 40% of the BAML Line of Credit is utilized. For the three months ended March 31, 2016 and 2015, the Company incurred a non-utilization fee of \$23 thousand and \$15 thousand, respectively.

**Secured Term Loan**

The Company and certain of its subsidiaries are party to a \$155.0 million Credit and Guaranty Agreement (the Secured Term Loan ) with Highbridge Principal Strategies, LLC, as administrative agent, and DBD Credit Funding LLC, as collateral agent. The Company made an initial draw of \$75.0 million on December 9, 2015, the closing date. The remaining \$80.0 million of the Secured Term Loan may be borrowed during the nine-month commitment period following the closing date, subject to the satisfaction of certain conditions. The Secured Term Loan carries a coupon of LIBOR + 6.0% with a LIBOR floor of 1.0% on drawn amounts. The Secured Term Loan has a maturity date of December 9, 2018. The Company is subject to a monthly non-utilization fee equal to 1.0% per annum on the unused commitment amount during the nine month commitment period following the closing date. For the three months ended March 31, 2016, the Company incurred a non-utilization fee of \$202 thousand. The original issue discount on the initial draw was \$1.1 million, which represented a discount to the debt cost to be amortized into interest expense using the effective interest method over the term of the Secured Term Loan. The estimated effective interest rate of the Secured Term Loan, which is equal to LIBOR (subject to a floor of 1.0%) plus the stated rate of 6.0% plus the accretion of the original issue discount and associated costs, was 8.5% for the three months ended March 31, 2016.

**2015 Convertible Notes**

In December 2012, the Company issued \$69.0 million aggregate principal amount of unsecured 7.000% Convertible Senior Notes due 2015 (the 2015 Convertible Notes ). The 2015 Convertible Notes bore interest at a rate of 7.00% per year, payable semiannually in arrears on June 15 and

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

December 15 of each year, beginning on June 15, 2013. The effective interest rate of the 2015 Convertible Notes, which was equal to the stated rate of 7.00% plus the accretion of the original issue discount and associated costs, was 9.4% for the three months ended March 31, 2015. For the three months ended March 31, 2015, the interest expense incurred on this indebtedness was \$1.6 million. The 2015 Convertible Notes matured on December 15, 2015 and were fully repaid at par.

### 6. ALLOWANCE FOR LOSS SHARING

Loans originated and sold by ACRE Capital to Fannie Mae under the Fannie Mae DUS program are subject to the terms and conditions of a Master Loss Sharing Agreement, which was amended and restated during 2012. Under the Master Loss Sharing Agreement, ACRE Capital is responsible for absorbing certain losses incurred by Fannie Mae with respect to loans originated under the DUS program, as described below in more detail. The compensation for this risk of loss is a component of servicing fees on the loan.

The losses incurred with respect to individual loans are allocated between ACRE Capital and Fannie Mae based on the loss level designation ( Loss Level ) for the particular loan. Loans are designated as Loss Level I, Loss Level II or Loss Level III. All loans are designated Loss Level I unless Fannie Mae and ACRE Capital agree upon a different Loss Level for a particular loan at the time of the loan commitment, or if Fannie Mae determines that the loan was not underwritten, processed or serviced according to Fannie Mae guidelines.

Losses on Loss Level I loans are shared 33.33% by ACRE Capital and 66.67% by Fannie Mae. The maximum amount of ACRE Capital's risk-sharing obligation with respect to any Loss Level I loan is 33.33% of the original principal amount of the loan. Losses incurred in connection with Loss Level II and Loss Level III loans are allocated disproportionately to ACRE

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

### Table of Contents

Capital until ACRE Capital has absorbed the maximum level of its risk-sharing obligation with respect to the particular loan. The maximum loss allocable to ACRE Capital for Loss Level II loans is 30% of the original principal amount of the loan, and for Loss Level III loans is 40% of the original principal amount of the loan.

According to the Master Loss Sharing Agreement, Fannie Mae may unilaterally increase the amount of the risk-sharing obligation of ACRE Capital with respect to individual loans without regard to a particular Loss Level if (a) the loan does not meet specific underwriting criteria, (b) the loan is defaulted within twelve (12) months after it is purchased by Fannie Mae, or (c) Fannie Mae determines that there was fraud, material misrepresentation or gross negligence by ACRE Capital in its underwriting, closing, delivery or servicing of the loan. Under certain limited circumstances, Fannie Mae may require ACRE Capital to absorb 100% of the losses incurred on a loan by requiring ACRE Capital to repurchase the loan.

The amount of loss incurred on a particular loan is determined at the time the loss is incurred, for example, at the time a property is foreclosed by Fannie Mae (whether acquired by Fannie Mae or a third party) or at the time a loan is modified in connection with a default. Losses may be determined by reference to the price paid by a third party at a foreclosure sale or by reference to an appraisal obtained by Fannie Mae in connection with the default on the loan.

In connection with the Company's acquisition of ACRE Capital, Alliant, Inc., a Florida corporation, and The Alliant Company, LLC, a Florida limited liability company (the "Sellers"), are jointly and severally obligated to fund directly (if permitted) or to reimburse ACRE Capital for amounts due and owing after the closing date to Fannie Mae pursuant to ACRE Capital's allowance for loss sharing with respect to settlement of certain DUS program mortgage loans originated and serviced by ACRE Capital, subject to certain limitations. In addition, the Sellers are jointly and severally obligated to indemnify ACRE Capital for, among other things, certain losses arising from Sellers' failure to fulfill the funding or reimbursement obligations described above. As of both March 31, 2016 and December 31, 2015, the preliminary estimate of the portion of such contributions towards such losses relating to the allowance for loss sharing of ACRE Capital was \$377 thousand and is included within other assets in the consolidated balance sheets. Additionally, with respect to the settlement of certain non-designated DUS program mortgage loans originated and serviced by ACRE Capital, the Sellers are jointly and severally obligated to fund directly (if permitted) or to reimburse ACRE Capital in each of the three 12 month periods following the closing date for eighty percent (80%) of amounts due and owing after the closing date to Fannie Mae pursuant to ACRE Capital's allowance for loss sharing in excess of \$2.0 million during such 12 month period; provided that in no event shall Sellers obligations exceed in the aggregate \$3.0 million for the entire three year period.

ACRE Capital uses several tools to manage its risk-sharing obligation, including maintenance of disciplined underwriting and approval processes and procedures, and periodic review and evaluation of underwriting criteria based on underlying multifamily housing market data and limitation of exposure to particular geographic markets and submarkets and to individual borrowers. In situations where payment under the guarantee is probable and estimable on a specific loan, the Company records an additional liability through a charge to the provision for loss sharing in the consolidated statements of operations. The amount of the provision reflects the Company's assessment of the likelihood of payment by the borrower, the estimated disposition value of the underlying collateral and the level of risk-sharing. Historically, among other factors, the loss recognition occurs at or before the loan becoming 60 days delinquent.

A summary of the Company's allowance for loss sharing as of and for the three months ended March 31, 2016 and 2015 is as follows (\$ in thousands):

<b>Balance at December 31, 2015</b>	<b>\$</b>	<b>8,969</b>
Current period provision for loss sharing		(228)

Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

Settlements/Writeoffs		
<b>Balance at March 31, 2016</b>	\$	8,741
<b>Balance at December 31, 2014</b>	\$	12,349
Current period provision for loss sharing		(566)
Settlements/Writeoffs		(38)
<b>Balance at March 31, 2015</b>	\$	11,745

As of both March 31, 2016 and December 31, 2015, the maximum quantifiable allowance for loss sharing associated with the Company's guarantees under the Fannie Mae DUS agreement was \$1.1 billion, from a total recourse at risk pool of

## Table of Contents

\$3.1 billion. Additionally, as of March 31, 2016 and December 31, 2015, the non-at risk pool was \$64.5 million and \$64.8 million, respectively. The at risk pool is subject to Fannie Mae's Master Loss Sharing Agreement and the non-at risk pool is not subject to such agreement. The maximum quantifiable allowance for loss sharing is not representative of the actual loss the Company would incur. The Company would be liable for this amount only if all of the loans it services for Fannie Mae, for which the Company retains 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.

## 7. COMMITMENTS AND CONTINGENCIES

As of March 31, 2016 and December 31, 2015, the Company had the following commitments to fund various senior mortgage loans, subordinated debt investments, as well as preferred equity investments accounted for as loans held for investment (\$ in thousands):

		As of	
	March 31, 2016	December 31, 2015	
Total commitments	\$ 1,256,250	\$ 1,232,163	
Less: funded commitments	(1,169,749)	(1,133,842)	
Total unfunded commitments	\$ 86,501	\$ 98,321	

Commitments to extend credit by ACRE Capital are generally agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Occasionally, the commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements. As of March 31, 2016 and December 31, 2015, ACRE Capital had the following commitments to sell and fund loans (\$ in thousands):

		As of	
	March 31, 2016	December 31, 2015	
Commitments to sell loans	\$ 131,205	\$ 237,372	
Commitments to fund loans	\$ 76,627	\$ 207,566	

The Company from time to time may be party to litigation relating to claims arising in the normal course of business. As of March 31, 2016, the Company is not aware of any legal claims that could materially impact its business, financial condition or results of operations.

## 8. DERIVATIVES

### Non-designated Hedges

Derivatives not designated as hedges are derivatives that do not meet the criteria for hedge accounting under GAAP or for which the Company has not elected to designate as hedges. Changes in the fair value of derivatives related to the loan commitments and forward sale commitments

are recorded directly in gains from mortgage banking activities in the consolidated statements of operations.

*Loan commitments and forward sale commitments*

Through its subsidiary, ACRE Capital, the Company enters into loan commitments with borrowers on loan originations whereby the interest rate on the prospective loan is determined prior to funding. In general, ACRE Capital simultaneously enters into forward sale commitments with investors in order to hedge against the interest rate exposure on loan commitments. The forward sale commitment with the investor locks in an interest rate and price for the sale of the loan. The terms of the loan commitment with the borrower and the forward sale commitment with the investor are matched with the objective of hedging interest rate risk. Loan commitments and forward sale commitments are considered undesignated derivative instruments. Accordingly, such commitments, along with any related fees received from potential borrowers, are recorded at fair value, with changes in fair value recorded in earnings. For the three months ended March 31, 2016, the Company entered into six loan commitments and six forward sale commitments. For the three months ended March 31, 2015, the Company entered into 16 loan commitments and 16 forward sale commitments.

## Table of Contents

As of March 31, 2016, the Company had five loan commitments with a total notional amount of \$76.6 million and 17 forward sale commitments with a total notional amount of \$131.2 million, with maturities ranging from 15 days to 14 months that were not designated as hedges in qualifying hedging relationships. As of December 31, 2015, the Company had 16 loan commitments with a total notional amount of \$207.6 million and 24 forward sale commitments with a total notional amount of \$237.4 million, with maturities ranging from 25 days to 17 months that were not designated as hedges in qualifying hedging relationships.

### MSR purchase commitments

In July 2015, ACRE Capital entered into a purchase agreement with a third party to purchase the servicing rights for a HUD loan (the July 2015 HUD Loan). Under the purchase agreement, the purchase price for the servicing rights was \$325 thousand and ACRE Capital assumed the rights to service the loan in March 2016. The derivative asset associated with the rights to service the July 2015 HUD Loan is included within other assets in the consolidated balance sheet as of December 31, 2015.

The table below presents the fair value of the Company's derivative financial instruments as well as their classification within the Company's consolidated balance sheets as of March 31, 2016 and December 31, 2015 (\$ in thousands):

	March 31, 2016		As of December 31, 2015	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
<b>Derivatives not designated as hedging instruments</b>				
Loan commitments	Other assets	\$ 9,554	Other assets	\$ 8,450
Forward sale commitments	Other assets		Other assets	25
MSR purchase commitment	Other assets		Other assets	330
Forward sale commitments	Other liabilities	(6,725)	Other liabilities	(1,868)
<b>Total derivatives not designated as hedging instruments</b>		\$ 2,829		\$ 6,937

## 9. EQUITY

### Stock Buyback Program

In May 2015, the Company announced that the Company's board of directors authorized the Company to repurchase up to \$20 million of the Company's outstanding common stock over a period of one year (the Stock Buyback Program). In February 2016, the Company's board of directors increased the size of the existing \$20 million Stock Buyback Program to \$30 million and extended the Stock Buyback Program through March 31, 2017. Purchases made pursuant to the Stock Buyback Program will be made in either the open market or in privately negotiated transactions, from time to time and as permitted by federal securities laws and other legal requirements. Repurchases may be suspended or discontinued at any time. In connection with this Stock Buyback Program, in March 2016, the Company entered into a Rule 10b5-1 plan to repurchase shares of the Company's common stock in accordance with certain parameters set forth in the Stock Buyback Program. During the three months ended March 31, 2016, the Company repurchased a total of 34,854 shares of the Company's common stock in the open market for an aggregate purchase price of approximately \$358 thousand, including expenses paid. The shares were repurchased at an average price of



## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

\$10.28 per share, including expenses paid. See Note 17 included in these consolidated financial statements for a subsequent event related to the Stock Buyback Program.

### *Common Stock*

There were no shares issued in public or private offerings for the three months ended March 31, 2016 and for the year ended December 31, 2015. See *Equity Incentive Plan* below for shares issued under the plan.

### *Equity Incentive Plan*

On April 23, 2012, the Company adopted an equity incentive plan (the *2012 Equity Incentive Plan*). Pursuant to the 2012 Equity Incentive Plan, the Company may grant awards consisting of restricted shares of the Company's common stock,

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

### Table of Contents

restricted stock units and/or other equity-based awards to the Company's outside directors, employees, officers, ACREM and other eligible awardees under the plan, subject to an aggregate limitation of 690,000 shares of common stock (7.5% of the issued and outstanding shares of the Company's common stock immediately after giving effect to the issuance of the shares sold in the IPO). Any restricted shares of the Company's common stock and restricted stock units will be accounted for under FASB ASC Topic 718, *Compensation - Stock Compensation*, resulting in share-based compensation expense equal to the grant date fair value of the underlying restricted shares of common stock or restricted stock units.

Restricted stock grants generally vest ratably over a one to four year period from the vesting start date. The grantee receives additional compensation for each outstanding restricted stock grant, classified as dividends paid, equal to the per-share dividends received by common stockholders.

The following table details the restricted stock grants awarded as of March 31, 2016:

Grant Date	Vesting Start Date	Shares Granted
May 1, 2012	July 1, 2012	35,135
June 18, 2012	July 1, 2012	7,027
July 9, 2012	October 1, 2012	25,000
June 26, 2013	July 1, 2013	22,526
November 25, 2013	November 25, 2016	30,381
January 31, 2014	August 31, 2015	48,273
February 26, 2014	February 26, 2014	12,030
February 27, 2014	August 27, 2014	22,354
June 24, 2014	June 24, 2014	17,658
June 24, 2015	July 1, 2015	25,555
Total		245,939

The following tables summarize the non-vested shares of restricted stock and the vesting schedule of shares of restricted stock for the Company's directors and officers and employees of ACRE Capital as of March 31, 2016:

### *Schedule of Non-Vested Share and Share Equivalents*

	Restricted Stock Grants Directors	Restricted Stock Grants Officer	Restricted Stock Grants Employees	Total
<b>Balance as of December 31, 2015</b>	16,945	4,686	62,563	84,194
Granted				
Vested	(7,224)	(1,562)	(7,646)	(16,432)
Forfeited	(1,277)			(1,277)
<b>Balance as of March 31, 2016</b>	8,444	3,124	54,917	66,485

### *Future Anticipated Vesting Schedule*

Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

	Restricted Stock Grants Directors	Restricted Stock Grants Officer	Restricted Stock Grants Employees (1)	Total
2016	7,610	3,124	30,381	41,115
2017	834			834
2018				
2019				
2020				
Total	8,444	3,124	30,381	41,949

## Table of Contents

(1) Future anticipated vesting related to an employee of ACRE Capital that was granted restricted stock that vests in proportion to certain financial performance targets being met over a specified period of time is not included due to uncertainty in actual vesting date.

## Non-Controlling Interests

The non-controlling interests held by third parties in the Company's consolidated balance sheets represent the equity interests in a limited liability company, ACRC KA Investor LLC ( "ACRC KA" ) that are not owned by the Company. A portion of ACRC KA's consolidated equity and net income are allocated to these non-controlling interests held by third parties based on their pro-rata ownership of ACRC KA. As of March 31, 2016 and December 31, 2015, ACRC KA's total equity was \$96.0 million, of which \$49.0 million was owned by the Company and \$47.0 million was allocated to non-controlling interests held by third parties. See Note 15 included in these consolidated financial statements for more information on ACRC KA.

## 10. EARNINGS PER SHARE

The following information sets forth the computations of basic and diluted earnings per common share for the three months ended March 31, 2016 and 2015 (\$ in thousands, except share and per share data):

	For the three months ended March 31,	
	2016	2015
Net income attributable to common stockholders:	\$ 5,136	\$ 7,062
Divided by:		
Basic weighted average shares of common stock outstanding:	28,529,328	28,484,293
Non-vested restricted stock	72,726	100,491
Diluted weighted average shares of common stock outstanding:	28,602,054	28,584,784
Basic earnings per common share:	\$ 0.18	\$ 0.25
Diluted earnings per common share:	\$ 0.18	\$ 0.25

## 11. INCOME TAX

The Company established a taxable REIT subsidiary ( "TRS" ), ACRE Capital Holdings LLC ( "TRSHoldings" ), in connection with the acquisition of ACRE Capital. In addition, in December 2013 and March 2014, the Company formed ACRC W TRS and ACRC U TRS, respectively, in order to issue and hold certain loans intended for sale. The TRS' income tax provision consisted of the following for the three months ended March 31, 2016 and 2015 (\$ in thousands):

	For the three months ended March 31,	
	2016	2015
Current	\$ (271)	\$ (627)

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

Deferred		(477)		(15)
Total income tax benefit	\$	(748)	\$	(642)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of the assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Deferred tax assets and liabilities are presented net by tax jurisdiction and are included within other assets and other liabilities in the consolidated balance sheets, respectively. As of March 31, 2016 and December 31, 2015, the TRS U.S. tax jurisdiction was in a net deferred tax liability position. The TRS are not currently subject to tax in any foreign tax jurisdictions.

As of March 31, 2016, TRS Holdings had a net operating loss carryforward of \$7.8 million, which may be carried back to 2013 and forward 20 years. The following table presents the U.S. tax jurisdiction and the tax effects of temporary differences on the TRS respective net deferred tax assets and liabilities (\$ in thousands):

# Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

## Table of Contents

	March 31, 2016	As of December 31, 2015
<b>Deferred tax assets</b>		
Mortgage servicing rights	\$ 4,632	\$ 4,083
Net operating loss carryforward	2,906	2,906
Other temporary differences	2,066	1,762
Sub-total-deferred tax assets	9,604	8,751
<b>Deferred tax liabilities</b>		
Basis difference in assets from acquisition of ACRE Capital	(2,709)	(2,709)
Components of gains from mortgage banking activities	(9,689)	(9,344)
Amortization of intangible assets	(328)	(297)
Sub-total-deferred tax liabilities	(12,726)	(12,350)
<b>Net deferred tax liability</b>	\$ (3,122)	\$ (3,599)

Based on the TRS assessment, it is more likely than not that the deferred tax assets will be realized through future taxable income. The TRS recognize interest and penalties related to unrecognized tax benefits within income tax expense in the consolidated statements of operations. Accrued interest and penalties, if any, are included within other liabilities in the consolidated balance sheets.

The following table is a reconciliation of the TRS statutory U.S. federal income tax rate to the TRS effective tax rate for the three months ended March 31, 2016 and 2015:

	For the three months ended March 31, 2016	2015
Federal statutory rate	35.0%	35.0%
State income taxes	3.6%	2.4%
Federal benefit of state tax deduction	(1.3)%	(0.8)%
Effective tax rate	37.3%	36.6%

As of March 31, 2016, tax years 2012 through 2015 remain subject to examination by taxing authorities. The Company does not have any unrecognized tax benefits and the Company does not expect that to change in the next twelve months.

## Intercompany Notes

In connection with the acquisition of ACRE Capital, the Company partially capitalized TRS Holdings with a \$44.0 million note. In October 2014, the Company entered into an \$8.0 million revolving promissory note with TRS Holdings (collectively, the two intercompany notes described above are referred to as, the Intercompany Notes). As of both March 31, 2016 and December 31, 2015, the outstanding principal balance of the Intercompany Notes was \$51.9 million. The income statement effects of the Intercompany Notes are eliminated in consolidation for financial reporting purposes, but the interest income and expense from the Intercompany Notes will affect the taxable income of the Company and TRS Holdings.

## 12. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company follows FASB ASC Topic 820-10, *Fair Value Measurement* ( ASC 820-10 ), which expands the application of fair value accounting. ASC 820-10 defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosure requirements for fair value measurements. ASC 820-10 determines fair value to be the price that would be received for a financial instrument in a current sale, which assumes an orderly transaction between market participants on the measurement date. The financial instruments recorded at fair value on a recurring basis in the Company's consolidated financial statements are derivative instruments, MSRs and loans held for sale. ASC 820-10 specifies a hierarchy of valuation techniques based on the inputs used in measuring fair value.

In accordance with ASC 820-10, the inputs used to measure fair value are summarized in the three broad levels listed below:

# Table of Contents

- Level I-Quoted prices in active markets for identical assets or liabilities.
- Level II-Prices are determined using other significant observable inputs. Observable inputs are inputs that other market participants would use in pricing a security. These may include quoted prices for similar securities, interest rates, prepayment speeds, credit risk and others.
- Level III-Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

GAAP requires disclosure of fair value information about financial instruments, whether or not recognized in the financial statements, for which it is practical to estimate the value. In cases where quoted market prices are not available, fair values are based upon the application of discount rates to estimated future cash flows using market yields, or other valuation methodologies. Any changes to the valuation methodology will be reviewed by the Company's management to ensure the changes are appropriate. The methods used may produce a fair value calculation that is not indicative of net realizable value or reflective of future fair values. Furthermore, while the Company anticipates that the valuation methods are appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. The Company uses inputs that are current as of the measurement date, which may fall within periods of market dislocation, during which price transparency may be reduced.

## Financial Instruments Reported at Fair Value

The Company has certain assets and liabilities that are required to be recorded at fair value on a recurring basis in accordance with GAAP. Financial instruments reported at fair value in the Company's consolidated financial statements include MSRs, MSR purchase commitments, loan commitments, forward sale commitments and loans held for sale.

The following table summarizes the levels in the fair value hierarchy into which the Company's financial instruments were categorized as of March 31, 2016 and December 31, 2015 (\$ in thousands):

	Fair Value as of March 31, 2016			
	Level I	Level II	Level III	Total
Loans held for sale	\$	\$ 58,171	\$	\$ 58,171
Mortgage servicing rights			60,978	60,978
Derivative assets:				
Loan commitments			9,554	9,554
Derivative liabilities:				
Forward sale commitments			(6,725)	(6,725)



# Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

	Level I	Fair Value as of December 31, 2015		Total
		Level II	Level III	
Loans held for sale	\$	\$ 30,612	\$	\$ 30,612
Mortgage servicing rights			61,800	61,800
Derivative assets:				
Loan commitments			8,450	8,450
Forward sale commitments			25	25
MSR purchase commitment			330	330
Derivative liabilities:				
Forward sale commitments			(1,868)	(1,868)

There were no transfers between the levels as of March 31, 2016 and December 31, 2015. Transfers between levels are recognized based on the fair value of the financial instrument at the beginning of the period.

# Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

## Table of Contents

Loan commitments and forward sale commitments are valued based on a discounted cash flow model that incorporates changes in interest rates during the period. The MSRs and the MSR purchase commitment are valued based on 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 loans held for sale are valued based on discounted cash flow models that incorporate quoted observable prices from market participants. The valuation of derivative instruments are determined using widely accepted valuation techniques, including market yield analyses and discounted cash flow analysis on the expected cash flows of each derivative.

The following table summarizes the significant unobservable inputs the Company used to value financial instruments categorized within Level III as of March 31, 2016 (\$ in thousands):

Asset Category	Fair Value	Primary Valuation Technique	Input	Unobservable Input	Weighted Average
				Range	
Mortgage servicing rights	\$ 60,978	Discounted cash flow	Discount rate	8 - 14%	11.0%
Loan commitments and forward sale commitments	2,829	Discounted cash flow	Discount rate	8%	8.0%

The following table summarizes the significant unobservable inputs the Company used to value financial instruments categorized within Level III as of December 31, 2015 (\$ in thousands):

Asset Category	Fair Value	Primary Valuation Technique	Input	Unobservable Input	Weighted Average
				Range	
Mortgage servicing rights	\$ 61,800	Discounted cash flow	Discount rate	8 - 14%	11.1%
Loan commitments and forward sale commitments	6,607	Discounted cash flow	Discount rate	8 - 12%	8.2%
MSR purchase commitment	330	Discounted cash flow	Discount rate	8%	8.0%

The tables above are not intended to be all-inclusive, but instead are intended to capture the significant unobservable inputs relevant to the Company's determination of fair values. Changes in market yields, discount rates or EBITDA multiples, each in isolation, may have changed the fair value of the financial instruments. Generally, an increase in market yields or discount rates or a decrease in EBITDA multiples may have resulted in a decrease in the fair value of the financial instruments.

The Company's management is responsible for the Company's fair value valuation policies, processes and procedures related to Level III financial instruments. The Company's management reports to the Company's Chief Financial Officer, who has final authority over the valuation of the Company's Level III financial instruments.

The following table summarizes the change in derivative assets and liabilities classified as Level III related to mortgage banking activities as of and for the three months ended March 31, 2016 and 2015 (\$ in thousands):

Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

<b>Balance as of December 31, 2015</b>	\$	6,937
Settlements		(9,438)
Realized gains (losses) recorded in net income (1)		2,501
Unrealized gains (losses) recorded in net income (1)		2,829
<b>Balance as of March 31, 2016</b>	\$	2,829

<b>Balance as of December 31, 2014</b>	\$	1,670
Settlements		(4,337)
Realized gains (losses) recorded in net income (1)		2,667
Unrealized gains (losses) recorded in net income (1)		4,719
<b>Balance as of March 31, 2015</b>	\$	4,719

## Table of Contents

(1) Realized and unrealized gains (losses) from derivatives are included within gains from mortgage banking activities in the consolidated statements of operations.

See Note 4 included in these consolidated financial statements for the changes in MSRs that are classified as Level III.

As of March 31, 2016 and December 31, 2015, the carrying values and fair values of the Company's financial assets and liabilities recorded at cost are as follows (\$ in thousands):

		March 31, 2016		As of December 31, 2015	
	Level in Fair Value Hierarchy	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Financial assets:</b>					
Loans held for investment	3	\$ 1,209,800	\$ 1,216,328	\$ 1,174,391	\$ 1,180,421
<b>Financial liabilities:</b>					
Secured funding agreements	2	\$ 615,397	\$ 615,397	\$ 522,775	\$ 522,775
Warehouse lines of credit	2	49,578	49,578	24,806	24,806
Secured term loan	2	69,978	75,000	69,762	75,000
Commercial mortgage-backed securitization debt (consolidated VIE)	3	28,406	28,406	61,815	61,856
Collateralized loan obligation securitization debt (consolidated VIE)	3	156,959	157,656	192,528	193,419

The carrying values of cash and cash equivalents, restricted cash, interest receivable, due to affiliate liability and accrued expenses approximate their fair values due to their short-term nature.

Loans held for investment are recorded at cost, net of unamortized loan fees and origination costs and net of an allowance for loan losses. The Company may record fair value adjustments on a nonrecurring basis when it has determined that it is necessary to record a specific reserve against a loan and the Company measures such specific reserve using the fair value of the loan's collateral. To determine the fair value of the collateral, the Company may employ different approaches depending on the type of collateral. The Financing Agreements, CMBS debt and collateralized loan obligation (CLO) debt are recorded at outstanding principal, which is the Company's best estimate of the fair value.

## 13. RELATED PARTY TRANSACTIONS

### Management Agreement

The Company is party to a Management Agreement under which ACREM, subject to the supervision and oversight of the Company's board of directors, is responsible for, among other duties, (a) performing all of the Company's day-to-day functions, (b) determining the Company's

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

investment strategy and guidelines in conjunction with the Company's board of directors, (c) sourcing, analyzing and executing investments, asset sales and financing, and (d) performing portfolio management duties. In addition, ACREM has an Investment Committee that oversees compliance with the Company's investment strategy and guidelines, investment portfolio holdings and financing strategy.

In exchange for its services, ACREM is entitled to receive a base management fee, an incentive fee, expense reimbursements, grants of equity-based awards pursuant to the Company's 2012 Equity Incentive Plan and a termination fee, if applicable.

The base management fee is equal to 1.5% of the Company's stockholders' equity per annum, which is calculated and payable quarterly in arrears in cash. For purposes of calculating the base management fee, stockholders' equity means: (a) the sum of (i) the net proceeds from all issuances of the Company's equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus (ii) the Company's retained earnings at the end of the most recently completed fiscal quarter determined in accordance with GAAP (without taking into account any non-cash equity compensation expense incurred in current or prior periods); less (b) (x) any amount that the Company has paid to repurchase the Company's common stock since inception, (y) any unrealized gains and losses and other non-cash items that have impacted stockholders' equity as reported in the Company's consolidated financial statements prepared in accordance with GAAP, and (z) one-time events pursuant to changes in GAAP, and certain non-cash items not otherwise described above, in

Table of Contents

each case after discussions between ACREM and the Company's independent directors and approval by a majority of the Company's independent directors. As a result, the Company's stockholders' equity, for purposes of calculating the management fee, could be greater or less than the amount of stockholders' equity shown in the Company's consolidated financial statements.

The incentive fee is an amount, not less than zero, equal to the difference between: (a) the product of (i) 20% and (ii) the difference between (A) the Company's Core Earnings (as defined below) for the previous 12-month period, and (B) the product of (1) the weighted average of the issue price per share of the Company's common stock of all of the Company's public offerings of common stock multiplied by the weighted average number of all shares of common stock outstanding including any restricted shares of the Company's common stock, restricted stock units or any shares of the Company's common stock not yet issued, but underlying other awards granted under the Company's 2012 Equity Incentive Plan (see Note 9 included in these consolidated financial statements) in the previous 12-month period, and (2) 8%; and (b) the sum of any incentive fees earned by ACREM with respect to the first three fiscal quarters of such previous 12-month period; *provided, however*, that no incentive fee is payable with respect to any fiscal quarter unless cumulative Core Earnings for the 12 most recently completed fiscal quarters is greater than zero. Core Earnings is a non-GAAP measure and is defined as GAAP net income (loss) computed in accordance with GAAP, excluding non-cash equity compensation expense, the incentive fee, depreciation and amortization (to the extent that any of the Company's target investments are structured as debt and the Company forecloses on any properties underlying such debt), any unrealized gains, losses or other non-cash items recorded in net income (loss) for the period, regardless of whether such items are included in other comprehensive income or loss, or in net income (loss), and one-time events pursuant to changes in GAAP and certain non-cash charges after discussions between ACREM and the Company's independent directors and after approval by a majority of the Company's independent directors. No incentive fees were incurred for the three months ended March 31, 2016 and 2015.

The Company reimburses ACREM at cost for operating expenses that ACREM incurs on the Company's behalf, including expenses relating to legal, financial, accounting, servicing, due diligence and other services.

The Company will not reimburse ACREM for the salaries and other compensation of its personnel, except for the allocable share of the salaries and other compensation of the Company's (a) Chief Financial Officer, based on the percentage of his time spent on the Company's affairs and (b) other corporate finance, tax, accounting, internal audit, legal, risk management, operations, compliance and other non-investment professional personnel of ACREM or its affiliates who spend all or a portion of their time managing the Company's affairs based on the percentage of their time spent on the Company's affairs. The Company is also required to pay its pro rata portion of rent, telephone, utilities, office furniture, equipment, machinery and other office, internal and overhead expenses of ACREM and its affiliates that are required for the Company's operations. The term of the Management Agreement ends on May 1, 2016, with automatic one-year renewal terms thereafter. Except under limited circumstances, upon a termination of the Management Agreement, the Company will pay ACREM a termination fee equal to three times the average annual base management fee and incentive fee received by ACREM during the 24-month period immediately preceding the most recently completed fiscal quarter prior to the date of termination, each as described above.

Certain of the Company's subsidiaries, along with the Company's lenders under certain of the Company's Secured Funding Agreements, as well as under the CMBS and CLO have entered into various servicing agreements with ACREM's subsidiary servicer, Ares Commercial Real Estate Servicer LLC (ACRES), a Standard & Poor's-rated commercial special servicer that is included on Standard & Poor's Select Servicer List. Effective January 1, 2015, ACREM transferred primary servicing of the Company's loans held for investment to ACRE Capital. The Company's Manager will specially service, as needed, certain of the Company's investments. Effective May 1, 2012, ACRES agreed that no servicing fees pursuant to these servicing agreements would be charged to the Company or its subsidiaries by ACRES or the Manager for so long as the Management Agreement remains in effect, but that ACRES will continue to receive reimbursement for overhead related to servicing and operational activities pursuant to the terms of the Management Agreement.

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

Summarized below are the related party costs incurred by the Company, including ACRE Capital, for the three months ended March 31, 2016 and 2015 and amounts payable to the Company's Manager as of March 31, 2016 and December 31, 2015 (\$ in thousands):

# Table of Contents

	Incurred		Payable	
	For the three months ended March 31,		As of	
	2016	2015	March 31, 2016	December 31, 2015
<b>Affiliate Payments</b>				
Management fees	\$ 1,499	\$ 1,476	\$ 1,499	\$ 1,501
General and administrative expenses	1,028	1,065	1,028	919
Direct costs	375	407	144	238
Total	\$ 2,902	\$ 2,948	\$ 2,671	\$ 2,658

## Credit Support Fee Agreement

In July 2014, the Company and certain of its subsidiaries entered into a Credit Support Fee Agreement with Ares Management under which the Company agreed to pay Ares Management a credit support fee in an amount equal to 1.50% per annum times the average amount of the loans outstanding under the July 2014 CNB Facility and to reimburse Ares Management for its out-of-pocket costs and expenses in connection with the transaction. During the three months ended March 31, 2016 and 2015, the Company incurred a credit support fee of \$193 thousand and \$275 thousand, respectively, under the July 2014 CNB Facility which is included within interest expense in the Company's consolidated statements of operations. See Note 5 included in these consolidated financial statements for more information on the July 2014 CNB Facility.

## 14. DIVIDENDS AND DISTRIBUTIONS

The following table summarizes the Company's dividends declared during the three months ended March 31, 2016 and 2015 (\$ in thousands, except per share data):

Date declared	Record date	Payment date	Per share amount	Total amount
March 1, 2016	March 31, 2016	April 15, 2016	\$ 0.26	\$ 7,429
Total cash dividends declared for the three months ended March 31, 2016			\$ 0.26	\$ 7,429
March 5, 2015	March 31, 2015	April 15, 2015	\$ 0.25	\$ 7,146
Total cash dividends declared for the three months ended March 31, 2015			\$ 0.25	\$ 7,146

## 15. VARIABLE INTEREST ENTITIES

### Consolidated VIEs

As discussed in Note 2, the Company evaluates all of its investments and other interests in entities for consolidation, including its investments in: (a) the CMBS transaction and the Company's retained interests in the subordinated classes of the certificates issued by the Trust (as defined below) it initiated and (b) the CLO transaction and the Company's retained interests in the subordinated notes and preferred equity of the Issuer



## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

(as defined below) and (c) a preferred equity investment in an LLC entity (discussed below), all of which are generally considered to be variable interests in a VIE. The Trust and Issuer together are referred herein as the Company's Securitization VIEs.

### *CMBS Securitization*

In connection with forming ACRE Commercial Mortgage Trust 2013-FL1 (the Trust), ACRC 2013-FL1 Depositor LLC (the Depositor), a wholly owned subsidiary of the Company, entered into a Pooling and Servicing Agreement dated as of November 1, 2013 (as amended on March 28, 2014, the Pooling and Servicing Agreement) with Wells Fargo as master servicer, ACRES as servicer, U.S. Bank National Association as trustee, and Trimont Real Estate Advisors Inc. as trust advisor. The Trust is treated for U.S. federal income tax purposes as a real estate mortgage investment conduit.

The Pooling and Servicing Agreement governs the issuance of approximately \$493.8 million aggregate principal balance commercial mortgage pass through certificates in a CMBS effected by the Depositor. In connection with the securitization, the Depositor contributed a pool of 18 adjustable rate participation interests in commercial mortgage loans to the Trust. The commercial mortgage loans were originated by the Company or its subsidiaries and are secured by 27 commercial

Table of Contents

properties. The certificates represent, in the aggregate, the entire beneficial ownership interest in, and the obligations of, the Trust.

In connection with the securitization, the Company offered and sold the following classes of certificates: Class A, Class B, Class C and Class D Certificates (collectively, the Offered Certificates) to third parties pursuant to an offering made privately in transactions exempt from the registration requirements of the Securities Act of 1933. As of March 31, 2016 and December 31, 2015, the aggregate principal balance of the Offered Certificates was approximately \$28.4 million and \$61.9 million, respectively. In addition, a wholly owned subsidiary of the Company retained approximately \$98.8 million of the certificates. The Company, as the holder of the subordinated classes of the Trust, has the obligation to absorb losses of the Trust, since the Company has a first loss position in the capital structure of the Trust.

***CLO Securitization***

On August 15, 2014, ACRE Commercial Mortgage 2014-FL2 Ltd. (the Issuer) and ACRE Commercial Mortgage 2014-FL2 LLC (Co-Issuer), both wholly owned indirect subsidiaries of the Company, entered into an indenture with Wells Fargo as advancing agent and note administrator and Wilmington Trust, National Association as trustee, which governs the issuance of approximately \$346.1 million principal balance secured floating rate notes (the Notes) and \$32.7 million of preferred equity in the Issuer. For U.S. federal income tax purposes, the Issuer and Co-Issuer are disregarded entities.

The Notes are collateralized by interests in a pool of 15 mortgage assets having a total principal balance of \$378.8 million (the Mortgage Assets) originated by a subsidiary of the Company. The sale of the Mortgage Assets to the Issuer is governed by a Mortgage Asset Purchase Agreement dated as of August 15, 2014, between ACRC Lender LLC and the Issuer. In connection with the securitization, the Issuer and Co-Issuer offered and sold the following classes of Notes: Class A, Class A-S, Class B, Class C and Class D Notes to third parties. A wholly owned subsidiary of the Company retained approximately \$37.4 million of the most subordinate Notes and all of the preferred equity in the Issuer. The Company, as the holder of the subordinated Notes and all of the preferred equity in the Issuer, has the obligation to absorb losses of the CLO, since the Company has a first loss position in the capital structure of the CLO. As of March 31, 2016 and December 31, 2015, the aggregate principal balance of the Offered Notes was approximately \$157.7 million and \$193.4 million, respectively.

***Summary of Securitization VIEs***

As the directing holder of the CMBS and the CLO, the Company has the ability to direct activities that could significantly impact the Securitization VIEs' economic performance. If an unrelated third party had the right to unilaterally remove the special servicer, then the Company would not have the power to direct activities that most significantly impact the Securitization VIEs' economic performance. In addition, there are no substantive kick-out rights of any unrelated third party to remove the special servicer without cause. The Company's subsidiaries, as directing holders, have the ability to remove the special servicer without cause. Based on these factors, the Company is determined to be the primary beneficiary of these Securitization VIEs; thus, the Securitization VIEs are consolidated into the Company's consolidated financial statements.

ACRE Capital is designated as primary servicer and ACRES as special servicer of the CMBS and the CLO. ACRES has the power to direct activities during the loan workout process on defaulted and delinquent loans, which is the activity that most significantly impacts the Securitization VIEs' economic performance. ACRE Capital and ACRES waive the servicing and special servicing fees and the Company pays its

overhead costs, as with other servicing agreements.

The Securitization VIEs consolidated in accordance with FASB ASC Topic 810 are structured as pass through entities that receive principal and interest on the underlying collateral and distribute those payments to the certificate and note holders, as applicable. The assets and other instruments held by the Securitization VIEs are restricted and can only be used to fulfill the obligations of the Securitization VIEs. Additionally, the obligations of the Securitization VIEs do not have any recourse to the general credit of any other consolidated entities, nor to the Company as the primary beneficiary.

The inclusion of the assets and liabilities of Securitization VIEs of which the Company is deemed the primary beneficiary has no economic effect on the Company. The Company's exposure to the obligations of Securitization VIEs is generally limited to its investment in these entities. The Company is not obligated to provide, nor has it provided, any financial support for any of these consolidated structures. As such, the risk associated with the Company's involvement in these Securitization VIEs is limited to the carrying value of its investment in the entity. As of March 31, 2016 and December 31, 2015, the Company's maximum risk of loss was \$168.8 million, which represents the carrying value of its investment in the Securitization VIEs. For the three months ended March 31, 2016 and 2015, the Company incurred interest expense related to

Table of Contents

the Securitization VIEs of \$1.4 million and \$2.4 million, respectively, which is included within interest expense in the Company's consolidated statements of operations.

***Investment in VIE***

On December 19, 2014, the Company and third party institutional investors formed a limited liability company, ACRC KA, which acquired \$170.0 million of preferred equity in a REIT whose assets were comprised of a portfolio of 22 multifamily, student housing, medical office and self-storage properties managed by its sponsor. The Company's investment in ACRC KA is considered to be an investment in a VIE. As of both March 31, 2016 and December 31, 2015, the Company owned a controlling financial interest of 51.0% of the equity shares in the VIE and the third party institutional investors owned the remaining 49.0%, a minority financial interest. The preferred equity shares are entitled to a preferred monthly return over the term of the investment at a fixed rate of 10.95% per annum.

ACREM is the non-member manager of the VIE. Based on the terms of the ACRC KA LLC agreement, ACREM has the ability to direct activities that could significantly impact the VIE's economic performance. There are no substantive kick-out rights held by the third party institutional investors to remove ACREM as the non-member manager without cause. As ACREM serves as the manager of the Company, the Company has the right to receive benefits from the VIE that could potentially be significant. As such, the Company is deemed to be the primary beneficiary of the VIE and the party that is most closely associated with the VIE. Thus, the VIE is consolidated into the Company's consolidated financial statements and the preferred equity interests owned by the third party institutional investors are reflected as a non-controlling interest held by third parties within the Company's consolidated balance sheets.

As of March 31, 2016 and December 31, 2015, the carrying value of the preferred equity investment, which is net of unamortized fees and origination costs, was \$94.0 million and \$93.9 million, respectively, and is included within loans held for investment in the consolidated balance sheets. The risk associated solely with respect to the Company's investment in this VIE is limited to the outstanding principal of its investment in the entity. As of both March 31, 2016 and December 31, 2015, the Company's maximum risk of loss solely with respect to this investment was \$48.5 million.

***Unconsolidated VIEs***

The Company also holds variable interests in VIEs structured as preferred equity investments, where the Company does not have a controlling financial interest. For these structures, the Company is not deemed to be the primary beneficiary of the VIE, and the Company does not consolidate these VIEs. These preferred equity investments are accounted for as loans held for investment and are carried at cost, net of unamortized loan fees and origination costs, unless the loans are deemed impaired, and are included within loans held for investment in the Company's consolidated balance sheets.

The Company is not obligated to provide, nor has it provided, any financial support for any of the Company's unconsolidated VIEs. As such, the risks associated with the Company's involvement in these unconsolidated VIEs are limited to the outstanding principal of the Company's investment in the entity.

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

The following table presents the carrying value and the maximum exposure to loss of unconsolidated VIEs as of March 31, 2016 and December 31, 2015 (\$ in thousands):

	March 31, 2016		As of	December 31, 2015	
Carrying value	\$	43,261	\$	55,144	
Maximum exposure to loss	\$	43,677	\$	55,704	

### 16. SEGMENTS

The Company's reportable segments reflect the significant components of the Company's operations that are evaluated separately by the Company's chief operating decision makers, the Company's Co-Chief Executive Officers, and have discrete financial information available. The Company organizes its segments based primarily upon the nature of the underlying products and services. The Company's Co-Chief Executive Officers and management review certain financial information, including segmented internal profit and loss statements, which are presented below on that basis. The amounts in the reportable segments included in the tables below are in conformity with GAAP and the Company's significant accounting policies as described in Note 2 included in these consolidated financial statements.

# Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

## Table of Contents

The Company operates in two reportable business segments:

- **Principal Lending** includes all business activities of the Company, excluding the ACRE Capital business, which generally represents investments in real estate related loans and securities that are held for investment.
- **Mortgage Banking** includes all business activities of the acquired ACRE Capital business.

The Company is primarily focused on two business segments involving CRE loans. First, in its principal lending business, the Company originates, invests in, manages and services middle-market CRE loans and other CRE related investments for its own account. These loans and other CRE related investments are generally held for investment and are secured, directly or indirectly, by office, multifamily, retail, industrial and other commercial real estate properties, or by ownership interests therein. Second, in its mortgage banking business, conducted through a wholly owned subsidiary, ACRE Capital, the Company originates, sells and retains servicing of primarily multifamily and other senior-living related CRE loans. These loans are generally held for sale.

Allocated costs between the segments include management fees and general and administrative expenses payable to the Company's Manager, both of which represent shared costs. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated.

The table below presents the Company's total assets as of March 31, 2016 by business segment (\$ in thousands):

	<b>Principal Lending</b>	<b>Mortgage Banking</b>	<b>Total</b>
Cash and cash equivalents	\$ 4,311	\$ 1,853	\$ 6,164
Restricted cash	9,962	15,670	25,632
Loans held for investment	1,209,800		1,209,800
Loans held for sale, at fair value		58,171	58,171
Mortgage servicing rights, at fair value		60,978	60,978
Other assets	40,475	20,895	61,370
<b>Total Assets</b>	<b>\$ 1,264,548</b>	<b>\$ 157,567</b>	<b>\$ 1,422,115</b>

The table below presents the Company's total assets as of December 31, 2015 by business segment (\$ in thousands):

	<b>Principal Lending</b>	<b>Mortgage Banking</b>	<b>Total</b>
Cash and cash equivalents	\$ 5,066	\$ 3,929	\$ 8,995
Restricted cash	13,083	17,297	30,380
Loans held for investment	1,174,391		1,174,391
Loans held for sale, at fair value		30,612	30,612

# Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

Mortgage servicing rights, at fair value			61,800		61,800
Other assets		53,191		19,613	72,804
<b>Total Assets</b>	\$	1,245,731	\$	133,251	\$ 1,378,982

The table below presents the Company's consolidated net income for the three months ended March 31, 2016 by business segment (\$ in thousands):

Table of Contents

	Principal Lending	Mortgage Banking	Total
<b>Net interest margin:</b>			
Interest income from loans held for investment	\$ 18,750	\$	\$ 18,750
Interest expense	(8,525)	(2)	(8,525)
Net interest margin	10,225 (1)		10,225
<b>Mortgage banking revenue:</b>			
Servicing fees, net		4,042 (2)	4,042
Gains from mortgage banking activities		2,359	2,359
Provision for loss sharing		228	228
Change in fair value of mortgage servicing rights		(1,848)	(1,848)
Mortgage banking revenue		4,781	4,781
Total revenue	10,225	4,781	15,006
<b>Expenses:</b>			
Management fees to affiliate	1,352	147	1,499
Professional fees	490	209	699
Compensation and benefits		4,284	4,284
General and administrative expenses	723	1,096	1,819
General and administrative expenses reimbursed to affiliate	897	131	1,028
Total expenses	3,462	5,867	9,329
<b>Income (loss) before income taxes</b>	<b>6,763</b>	<b>(1,086)</b>	<b>5,677</b>
Income tax expense (benefit)	4	(752)	(748)
<b>Net income (loss) attributable to ACRE</b>	<b>6,759</b>	<b>(334)</b>	<b>6,425</b>
Less: Net income attributable to non-controlling interests	(1,289)		(1,289)
<b>Net income (loss) attributable to common stockholders</b>	<b>\$ 5,470</b>	<b>\$ (334)</b>	<b>\$ 5,136</b>

(1) Revenues from two of the Company's borrowers in the Principal Lending segment represented approximately 26.0% of the Company's consolidated revenues for the three months ended March 31, 2016.

(2) Interest expense does not include interest expense related to the Intercompany Notes, as described in Note 11 included in these consolidated financial statements. Additionally, servicing fees, net does not include servicing fee revenue related to the primary servicing by ACRE Capital of the Company's loans held for investment, as described in Note 13 included in these consolidated financial statements. The intercompany interest expense and servicing fee revenue are eliminated from the consolidated financial statements of the Company. If intercompany interest expense and servicing fee revenue were included in the consolidated financial statements, interest expense, servicing fees, net and net loss for the three months ended March 31, 2016 would have been \$1.0 million, \$4.1 million and \$1.3 million, respectively, for Mortgage Banking.

The table below presents the Company's consolidated net income for the three months ended March 31, 2015 by business segment (\$ in thousands):



Table of Contents

	Principal Lending	Mortgage Banking	Total
<b>Net interest margin:</b>			
Interest income from loans held for investment	\$ 23,170	\$	23,170
Interest expense	(10,178)	(2)	(10,178)
Net interest margin	12,992 (1)		12,992
<b>Mortgage banking revenue:</b>			
Servicing fees, net		3,916 (2)	3,916
Gains from mortgage banking activities		4,144	4,144
Provision for loss sharing		566	566
Change in fair value of mortgage servicing rights		(3,181)	(3,181)
Mortgage banking revenue		5,445	5,445
Total revenue	12,992	5,445	18,437
<b>Expenses:</b>			
Management fees to affiliate	1,343	133	1,476
Professional fees	506	269	775
Compensation and benefits		4,637	4,637
General and administrative expenses	799	1,032	1,831
General and administrative expenses reimbursed to affiliate	930	135	1,065
Total expenses	3,578	6,206	9,784
<b>Income (loss) before income taxes</b>	<b>9,414</b>	<b>(761)</b>	<b>8,653</b>
Income tax expense (benefit)	(21)	(621)	(642)
<b>Net income (loss) attributable to ACRE</b>	<b>9,435</b>	<b>(140)</b>	<b>9,295</b>
Less: Net income attributable to non-controlling interests	(2,233)		(2,233)
<b>Net income (loss) attributable to common stockholders</b>	<b>\$ 7,202</b>	<b>\$ (140)</b>	<b>\$ 7,062</b>

(1) Revenues from one of the Company's borrowers in the Principal Lending segment represented approximately 17.6% of the Company's consolidated revenues for the three months ended March 31, 2015.

(2) Interest expense does not include interest expense related to the Intercompany Notes, as described in Note 11 included in these consolidated financial statements. Additionally, servicing fees, net does not include servicing fee revenue related to the primary servicing by ACRE Capital of the Company's loans held for investment, as described in Note 13 included in these consolidated financial statements. The intercompany interest expense and servicing fee revenue are eliminated from the consolidated financial statements of the Company. If intercompany interest expense and servicing fee revenue were included in the consolidated financial statements, interest expense, servicing fees, net and net loss for the three months ended March 31, 2015 would have been \$1.0 million, \$4.0 million and \$1.1 million, respectively, for Mortgage Banking.

## 17. SUBSEQUENT EVENTS

The Company's management has evaluated subsequent events through the date of issuance of the consolidated financial statements included herein. There have been no subsequent events that occurred during such period that would require disclosure in this Form 10-Q or would be required to be recognized in the consolidated financial statements as of and for the three months ended March 31, 2016, except as disclosed below.

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

On April 25, 2016, the Company appointed Rand S. April and James E. Skinner to its board of directors as independent directors.

On April 27, 2016, the Company originated a \$76.0 million first mortgage loan on a mixed-use property located in New York. At closing, the outstanding principal balance was approximately \$65.6 million. The loan has an interest rate of LIBOR + 4.16% (plus fees) and an initial term of three years.

Table of Contents

From April 1, 2016 through May 3, 2016, the Company repurchased a total of 95,062 shares of the Company's common stock in the open market for an aggregate purchase price of \$1.1 million, including expenses paid, under the Stock Buyback Program. The shares were repurchased at an average price of \$11.34 per share, including expenses paid.

From April 1, 2016 through May 3, 2016, ACRE Capital originated \$38.3 million in Fannie Mae, Freddie Mac or HUD loan commitments.

On May 5, 2016, the Company declared a cash dividend of \$0.26 per common share for the second quarter of 2016. The second quarter 2016 dividend is payable on July 15, 2016 to common stockholders of record as of June 30, 2016.

Table of Contents

**Item 2. Management's Discussion And Analysis Of Financial Condition And Results Of Operations**

Some of the statements contained in this quarterly report constitute forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995 and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and we intend such statements to be covered by the safe harbor provisions contained therein. The information contained in this section should be read in conjunction with our consolidated financial statements and notes thereto appearing elsewhere in this quarterly report on Form 10-Q. This description contains forward-looking statements that involve risks and uncertainties. Actual results could differ significantly from the results discussed in the forward-looking statements due to the factors set forth in Risk Factors and elsewhere in this quarterly report on Form 10-Q and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. In addition, some of the statements in this quarterly report (including in the following discussion) constitute forward-looking statements, which relate to future events or the future performance or financial condition of Ares Commercial Real Estate Corporation (ACRE) and, together with its consolidated subsidiaries, the Company, we, us and our. The forward-looking statements contained in this report involve a number of risks and uncertainties, including statements concerning:

- our business and investment strategy;
- our projected operating results;
- the return or impact of current and future investments;
- the timing of cash flows, if any, from our investments;
- estimates relating to our ability to make distributions to our stockholders in the future;
- defaults by borrowers in paying debt service on outstanding indebtedness;
- our ability to obtain and maintain financing arrangements, including securitizations;
- market conditions and our ability to access alternative debt markets and additional debt and equity capital;

Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

- the amount of commercial mortgage loans requiring refinancing;
- our expected investment capacity and available capital;
- financing and advance rates for our target investments;
- our expected leverage;
- changes in interest rates and the market value of our investments;
- effects of hedging instruments on our target investments;
- rates of default or decreased recovery rates on our target investments;
- rates of prepayments on our mortgage loans and the effect on our business of such prepayments;
- the degree to which our hedging strategies may or may not protect us from interest rate volatility;
- the impact of committed loans failing to close;
- availability of investment opportunities in mortgage-related and real estate-related investments and securities;
- the ability of Ares Commercial Real Estate Management LLC ( "ACREM" or our "Manager" ) to locate suitable investments for us, monitor, service and administer our investments and execute our investment strategy;
- allocation of investment opportunities to us by our Manager;



Table of Contents

- the ability of our wholly owned subsidiary, ACRE Capital LLC ( ACRE Capital ), to originate and sell mortgage loans;
- our ability to successfully complete and integrate any acquisitions;
- our ability to maintain our qualification as a real estate investment trust ( REIT ) for U.S. federal income tax purposes;
- our ability to maintain our exemption from registration under the Investment Company Act of 1940 (the 1940 Act );
- our understanding of our competition;
- general volatility of the securities markets in which we may invest;
- adverse changes in the real estate, real estate capital and credit markets and the impact of a protracted decline in the liquidity of credit markets on our business;
- changes in governmental regulations, tax law and rates, and similar matters (including interpretation thereof);
- actions and initiatives of the U.S. Government and changes to U.S. Government policies;
- the state of the U.S. economy generally or in specific geographic regions;
- uncertainty surrounding the financial stability of the United States, European Union and China;

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

- global economic trends and economic recoveries;
- market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy; and
- the future of U.S. government-sponsored enterprises ( GSEs ).

We use words such as anticipates, believes, expects, intends, will, should, may and similar expressions to identify forward-looking statements. Our actual results could differ materially from those expressed in the forward-looking statements for any reason, including the factors set forth under Risk Factors and elsewhere in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 and elsewhere in this quarterly report on Form 10-Q.

We have based the forward-looking statements included in this quarterly report on information available to us on the date of this quarterly report, and we assume no obligation to update any such forward-looking statements.

### Overview

We are a specialty finance company that operates both as a principal lender and a mortgage banker (with respect to loans collateralized by multifamily and senior-living properties). We are externally managed by our Manager, a subsidiary of Ares Management, L.P. (NYSE: ARES) ( Ares Management ), a publicly traded, leading global alternative asset manager, pursuant to the terms of the management agreement dated April 25, 2012, as amended, between us and our Manager (the Management Agreement ). From the commencement of our operations in late 2011, we have been primarily focused on our principal lending business, where we directly originate, manage and service a diversified portfolio of commercial real estate ( CRE ) debt-related investments for our own account.

We are also engaged in the mortgage banking business through our wholly owned subsidiary, ACRE Capital, which we believe is complementary to our principal lending business. In this business segment, we primarily originate, sell and service multifamily and other senior-living related loans under programs offered by GSEs, such as the Federal National Mortgage Association ( Fannie Mae ) and the Federal Home Loan Mortgage Corporation ( Freddie Mac ) and by government agencies, such as 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 ). ACRE Capital is approved as a Fannie Mae Delegated Underwriting and Servicing ( DUS ) lender, a Freddie Mac Program Plus® Seller/Servicer, a Multifamily Accelerated Processing and Section 232 LEAN lender for HUD, and a Ginnie Mae issuer. While we



Table of Contents

earn little interest income from these activities as we generally only hold loans for short periods, we receive origination fees when we close loans and sale premiums when we sell loans. We also retain the rights to service the loans, which are known as mortgage servicing rights ( MSRs ) and receive fees for providing such servicing during the life of the loans, which generally last ten years or more.

We were formed and commenced operations in late 2011. We are a Maryland corporation and completed our initial public offering in May 2012. We have elected and qualified to be taxed as a REIT for U.S. federal income tax purposes under the Internal Revenue Code of 1986, as amended, commencing with our taxable year ended December 31, 2012. We generally will not be subject to U.S. federal income taxes on our REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, to the extent that we annually distribute all of our REIT taxable income to stockholders and comply with various other requirements as a REIT. We also operate our business in a manner that will permit us to maintain our exemption from registration under the 1940 Act.

We are an emerging growth company, as defined in the Jumpstart Our Business Startups Act of 2012, or the JOBS Act, and we are eligible to take advantage of certain exemptions from various reporting requirements that are applicable to other public companies that are not emerging growth companies. In addition, Section 107 of the JOBS Act also provides that an emerging growth company can take advantage of the extended transition period provided in Section 7(a)(2)(B) of the Securities Act of 1933, as amended, for complying with new or revised accounting standards. However, we chose to opt out of such extended transition period, and as a result, we will comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for non-emerging growth companies. Section 107 of the JOBS Act provides that our decision to opt out of the extended transition period for complying with new or revised accounting standards is irrevocable.

We could remain an emerging growth company for up to five years, or until the earliest of (i) the last day of the first fiscal year in which our annual gross revenues exceed \$1.0 billion, (ii) the date that we become a large accelerated filer as defined in Rule 12b-2 under the Exchange Act which would occur if the market value of our common stock that is held by non-affiliates exceeds \$700 million as of the last business day of our most recently completed second fiscal quarter, or (iii) the date on which we have issued more than \$1.0 billion in non-convertible debt during the preceding three-year period.

**Developments During the First Quarter of 2016:**

- ACRE originated a \$56.0 million first mortgage loan on a hotel portfolio located in California.
- ACRE originated a \$25.5 million first mortgage loan on an office property located in Kansas.
- ACRE originated a \$17.0 million mezzanine loan on an office property located in New Jersey.
- ACRE Capital rate locked \$38.9 million in loan commitments.

- ACRE amended its \$50.0 million Bridge Loan Warehousing Credit and Security Agreement (the BAML Facility ) with Bank of America, N.A. to expand the eligible assets to include loans secured by general and affordable multifamily properties.
- ACRE amended its \$50.0 million secured revolving funding facility (the March 2014 CNB Facility ) with City National Bank to extend the maturity date to March 11, 2017.

#### **Factors Impacting Our Operating Results**

The results of our operations are affected by a number of factors and primarily depend on, among other things, the level of our net interest income, the market value of our assets and the supply of, and demand for, commercial mortgage loans, CRE debt and other financial assets in the marketplace. Our net interest income, which reflects the amortization of origination fees and direct costs, is recognized based on the contractual rate and the outstanding principal balance of the loans we originate. Interest rates will vary according to the type of investment, conditions in the financial markets, credit worthiness of our borrowers, competition and other factors, none of which can be predicted with any certainty. Our operating results may also be impacted by credit losses in excess of initial anticipations or unanticipated credit events experienced by borrowers.

Table of Contents**Stock Buyback Program**

In May 2015, we announced that the our board of directors authorized us to repurchase up to \$20.0 million of our outstanding common stock over a period of one year (the Stock Buyback Program). In February 2016, we announced that our board of directors increased the size of the existing \$20.0 million Stock Buyback Program to \$30.0 million and extended the Stock Buyback Program through March 31, 2017. Purchases made pursuant to the Stock Buyback Program will be made in either the open market or in privately negotiated transactions, from time to time and as permitted by federal securities laws and other legal requirements. Repurchases may be suspended or discontinued at any time. In connection with this Stock Buyback Program, in March 2016, we entered into a Rule 10b5-1 plan to repurchase shares of our common stock in accordance with certain parameters set forth in the Stock Buyback Program. During the three months ended March 31, 2016, we repurchased a total of 34,854 shares of our common stock in the open market for an aggregate purchase price of approximately \$358 thousand, including expenses paid. The shares were repurchased at an average price of \$10.28 per share, including expenses paid. See Recent Developments, as well as Note 17 to our consolidated financial statements for a subsequent event related to the Stock Buyback Program.

**Investment Portfolio**

As of March 31, 2016, we have originated or co-originated 38 loans held for investment, excluding 27 loans that were repaid or sold since inception. Such investments are referred to herein as our investment portfolio. As of March 31, 2016, the aggregate originated commitment under these loans at closing was approximately \$1.3 billion and outstanding principal was \$1.2 billion, excluding non-controlling interests held by third parties. During the three months ended March 31, 2016, we funded approximately \$109.2 million of outstanding principal and received repayments of \$73.3 million of outstanding principal, excluding non-controlling interests held by third parties. As of March 31, 2016, 66.7% of our loans have London Interbank Offered Rates (LIBOR) floors, with a weighted average floor of 0.23%, calculated based on loans with LIBOR floors. References to LIBOR or L are to 30-day LIBOR (unless otherwise specifically stated).

As of March 31, 2016, all loans were paying in accordance with their contractual terms. During the three months ended March 31, 2016, there were no impairments with respect to our loans held for investment.

Our loans held for investment are accounted for at amortized cost. The following table summarizes our loans held for investment as of March 31, 2016 (\$ in thousands):

	As of March 31, 2016				
	Carrying Amount (1)	Outstanding Principal (1)	Weighted Average Interest Rate	Weighted Average Unleveraged Effective Yield (2)	Weighted Average Remaining Life (Years)
Senior mortgage loans	\$ 992,166	\$ 996,308	4.4%	5.1%	1.3
Subordinated debt and preferred equity investments	171,055	173,441	10.7%	11.3%	5.3
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,163,221	\$ 1,169,749	5.3%	6.0%	1.9

(1) The difference between the Carrying Amount and the Outstanding Principal face amount of the loans held for investment consists of unamortized purchase discount, deferred loan fees and loan origination costs.

(2) Unleveraged Effective Yield is the compounded effective rate of return that would be earned over the life of the investment based on the contractual interest rate (adjusted for any deferred loan fees, costs, premium or discount) and assumes no dispositions, early prepayments or defaults. The Total Weighted Average Unleveraged Effective Yield is calculated based on the average of Unleveraged Effective Yield of all loans held by us as of March 31, 2016 as weighted by the Outstanding Principal balance of each loan.

#### **Non-Controlling Interests**

The non-controlling interests held by third parties in our consolidated financial statements represent the equity interests in ACRC KA Investor LLC ( ACRC KA ) that are not owned by us. See Note 15 to our consolidated financial statements included in this quarterly report on Form 10-Q for more information about ACRC KA.

# Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

## Table of Contents

A reconciliation of our loans held for investment portfolio, excluding non-controlling interests held by third parties, to our loans held for investment as included within our consolidated balance sheets is as follows (\$ in thousands):

	As of March 31, 2016	
	Carrying Amount	Outstanding Principal
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,163,221	\$ 1,169,749
Non-controlling interest investment held by third parties	46,579	46,579
Loans held for investment	\$ 1,209,800	\$ 1,216,328

For more information about our investment portfolio, see Note 3 to our consolidated financial statements included in this quarterly report on Form 10-Q.

A reconciliation of our interest income from loans held for investment, excluding non-controlling interests, to our interest income from loans held for investment as included within our consolidated statements of operations is as follows (\$ in thousands):

	For the three months ended March 31, 2016	
Interest income from loans held for investment, excluding non-controlling interests	\$	17,461
Interest income from non-controlling interest investment held by third parties		1,289
Interest income from loans held for investment	\$	18,750

## **Critical Accounting Policies**

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles ( GAAP ), which require management to make estimates and assumptions that affect reported amounts. The estimates and assumptions are based on historical experience and other factors management believes to be reasonable. Actual results may differ from those estimates and assumptions. There have been no significant changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. See Note 2 to our consolidated financial statements included in this quarterly report on Form 10-Q, which describes recently issued accounting pronouncements not yet required to be adopted by us.

## **RESULTS OF OPERATIONS**

The following table sets forth a summary of our consolidated results of operations for the three months ended March 31, 2016 and 2015 (\$ thousands):

Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

	For the three months ended March 31,			
		2016		2015
Net interest margin	\$	10,225	\$	12,992
Mortgage banking revenue		4,781		5,445
Total revenue		15,006		18,437
Total expenses		9,329		9,784
<b>Income before income taxes</b>		<b>5,677</b>		<b>8,653</b>
Income tax expense (benefit)		(748)		(642)
<b>Net income attributable to ACRE</b>		<b>6,425</b>		<b>9,295</b>
Less: Net income attributable to non-controlling interests		(1,289)		(2,233)
<b>Net income attributable to common stockholders</b>	\$	<b>5,136</b>	\$	<b>7,062</b>

## Table of Contents

The following tables set forth select details of our consolidated results of operations for the three months ended March 31, 2016 and 2015 (\$ thousands):

### Net Interest Margin

	For the three months ended March 31,		For the three months ended March 31,	
	2016		2015	
Interest income from loans held for investment	\$	18,750	\$	23,170
Interest expense		(8,525)		(10,178)
<b>Net interest margin</b>	<b>\$</b>	<b>10,225</b>	<b>\$</b>	<b>12,992</b>

For the three months ended March 31, 2016 and 2015, net interest margin was approximately \$10.2 million and \$13.0 million, respectively. For the three months ended March 31, 2016 and 2015, interest income from loans held for investment of \$18.8 million and \$23.2 million, respectively, was generated by weighted average earning assets of \$1.2 billion and \$1.3 billion, respectively, offset by \$8.5 million and \$10.2 million, respectively, of interest expense, unused fees and amortization of deferred loan costs. The weighted average borrowings under the Wells Fargo Facility, the Citibank Facility, the BAML Facility, the CNB Facilities, the MetLife Facility and the UBS Facilities (individually defined below and collectively, the Secured Funding Agreements ) and securitization debt, the Secured Term Loan (defined below) and convertible notes were \$845.0 million and \$1.0 billion for the three months ended March 31, 2016 and 2015, respectively. The decrease in net interest margin for the three months ended March 31, 2016 compared to the three months ended March 31, 2015 primarily relates to a decrease in our weighted average earning assets for the three months ended March 31, 2016.

### Mortgage Banking Revenue

	For the three months ended March 31,		For the three months ended March 31,	
	2016		2015	
Servicing fees, net (1)	\$	4,042	\$	3,916
Gains from mortgage banking activities (2)		2,359		4,144
Provision for loss sharing		228		566
Change in fair value of mortgage servicing rights		(1,848)		(3,181)
<b>Mortgage banking revenue</b>	<b>\$</b>	<b>4,781</b>	<b>\$</b>	<b>5,445</b>

(1) Servicing fees include fees earned for all activities related to servicing ACRE Capital's loans, the net fees earned on borrower prepayment penalties and interest earned on borrowers' escrow payments and interim cash balances, along with other ancillary fees and reduced by write-offs of MSR for loans that are prepaid, changes in the fair value of the servicing fee payable and interest expense related to escrow accounts.

(2) Gains from mortgage banking activities include the initial fair value of MSR, loan origination fees, gain on the sale of loans, interest income on loans held for sale, changes to the fair value of derivative financial instruments, including loan commitments and forward sale commitments, and reduced by the expense related to the initial fair value of the servicing fee payable and interest expense related to our multifamily as soon as pooled sale agreement with Fannie Mae (the ASAP Line of Credit ) and the BAML Line of Credit (together with the ASAP Line of Credit, the Warehouse Lines of Credit ).

For the three months ended March 31, 2016 and 2015, net servicing fees were approximately \$4.0 million and \$3.9 million, respectively. For the three months ended March 31, 2016 and 2015, net gains from mortgage banking activities were approximately \$2.4 million and \$4.1 million, respectively. The decrease in mortgage banking revenue for the three months ended March 31, 2016 compared to the three months ended March 31, 2015 primarily relates to a decrease in our loan originations for the three months ended March 31, 2016. ACRE Capital rate-locked six loans totaling \$38.9 million in commitments for the three months ended March 31, 2016 compared to 16 loans totaling \$202.0 million in commitments for the three months ended March 31, 2015.



Table of Contents

**Operating Expenses**

	For the three months ended March 31,			
	2016		2015	
Management fees to affiliate	\$	1,499	\$	1,476
Professional fees		699		775
Compensation and benefits		4,284		4,637
General and administrative expenses		1,819		1,831
General and administrative expenses reimbursed to affiliate		1,028		1,065
<b>Total expenses</b>	\$	9,329	\$	9,784

For the three months ended March 31, 2016 and 2015, we incurred operating expenses of \$9.3 million and \$9.8 million, respectively. The decrease in operating expenses for the three months ended March 31, 2016 compared to the three months ended March 31, 2015 primarily relates to a reduction in commission expense and other performance based compensation due to a decrease in our loan originations at ACRE Capital for the three months ended March 31, 2016.

***Related Party Expenses***

For the three months ended March 31, 2016, related party expenses included \$1.5 million in management fees due to our Manager and \$1.0 million for our share of allocable general and administrative expenses for which we were required to reimburse our Manager pursuant to the Management Agreement. For the three months ended March 31, 2015, related party expenses included \$1.5 million in management fees due to our Manager and \$1.1 million for our share of allocable general and administrative expenses for which we were required to reimburse our Manager pursuant to the Management Agreement.

***Other Expenses***

For the three months ended March 31, 2016 and 2015, professional fees were \$0.7 million and \$0.8 million, respectively. The decrease in professional fees for the three months ended March 31, 2016 compared to the three months ended March 31, 2015 primarily relates to a decrease in our use of third party professionals. For both the three months ended March 31, 2016 and 2015, general and administrative expenses were \$1.8 million.

***Compensation and Benefits***

For the three months ended March 31, 2016 and 2015, compensation and benefits were \$4.3 million and \$4.6 million, respectively, all of which related to ACRE Capital. The decrease in compensation and benefits for the three months ended March 31, 2016 compared to the three months ended March 31, 2015 primarily relates to a reduction in commission expense and other performance based compensation due to a decrease in our loan originations at ACRE Capital for the three months ended March 31, 2016.

## LIQUIDITY AND CAPITAL RESOURCES

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain our assets and operations, make distributions to our stockholders and other general business needs. We use significant cash to purchase our target investments, make principal and interest payments on our borrowings, make distributions to our stockholders and fund our operations. Our primary sources of cash generally consist of unused borrowing capacity under the Secured Funding Agreements, the Warehouse Lines of Credit and the Secured Term Loan (defined below) (collectively, the Financing Agreements), the net proceeds of future offerings, payments of principal and interest we receive on our portfolio of assets and cash generated from our operating activities. However, principal repayments from mortgage loans in the commercial mortgage-backed securitization ( CMBS ) and collateralized loan obligation ( CLO ) securitization are applied sequentially, first going to pay down the senior CMBS and CLO notes, and accordingly we will not receive any proceeds from repayment of loans in the CMBS or CLO until all senior notes are repaid in full. Subject to maintaining our qualification as a REIT and our exemption from the 1940 Act, we expect that our primary sources of financing will be, to the extent available to us, through (a) credit, secured funding and other lending facilities, (b) securitizations, (c) other sources of private financing, including warehouse and repurchase facilities, and (d) public or private offerings of our equity or debt securities. See Recent Developments included in this quarterly report on Form 10-Q for information on our available capital as of May 3, 2016. We may seek to sell certain of our investments in order to manage liquidity needs, interest rate risk, meet other operating objectives and adapt to market conditions.

## Table of Contents

### Cash Flows

The following table sets forth changes in cash and cash equivalents for the three months ended March 31, 2016 and 2015 (\$ in thousands):

	For the three months ended March 31,	
	2016	2015
Net income	\$ 6,425	\$ 9,295
Adjustments to reconcile net income to net cash provided by (used in) operating activities:	11,383	116,259
Net cash provided by (used in) operating activities	17,808	125,554
Net cash provided by (used in) investing activities	(59,863)	159,767
Net cash provided by (used in) financing activities	39,224	(292,867)
Change in cash and cash equivalents	\$ (2,831)	\$ (7,546)

During the three months ended March 31, 2016 and 2015, cash and cash equivalents decreased by \$2.8 million and \$7.5 million, respectively.

### Operating Activities

For the three months ended March 31, 2016 and 2015, net cash provided by operating activities totaled \$17.8 million and \$125.6 million, respectively. For the three months ended March 31, 2016, adjustments to net income related to operating activities primarily included originations of mortgage loans held for sale of \$169.9 million, sale of mortgage loans held for sale to third parties of \$145.1 million, change in the fair value of MSR of \$1.8 million, change in other liabilities of \$5.5 million, change in restricted cash of \$2.7 million and change in other assets of \$36.7 million. For the three months ended March 31, 2015, adjustments to net income related to operating activities primarily included originations of mortgage loans held for sale of \$162.2 million, sale of mortgage loans held for sale to third parties of \$216.4 million, change in the fair value of MSR of \$3.2 million, change in restricted cash of \$38.7 million and change in other assets of \$18.2 million.

### Investing Activities

For the three months ended March 31, 2016 and 2015, net cash provided by (used in) investing activities totaled \$(59.9) million and \$159.8 million, respectively. This change in net cash provided by (used in) investing activities was primarily related to cash used for the origination of new loans held for investment exceeding the cash received for the principal repayment of loans held for investment for the three months ended March 31, 2016.

### Financing Activities

For the three months ended March 31, 2016, net cash provided by financing activities totaled \$39.2 million and primarily related to proceeds from our Secured Funding Agreements of \$204.2 million and proceeds from our Warehouse Lines of Credit of \$191.2 million, partially offset by

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

repayments of our Secured Funding Agreements of \$111.6 million, repayments of debt of consolidated variable interest entities ( VIEs ) of \$69.2 million and repayments of our Warehouse Lines of Credit of \$166.5 million. For the three months ended March 31, 2015, net cash used in financing activities totaled \$292.9 million and related primarily to repayments of our Secured Funding Agreements of \$69.3 million, repayments of debt of consolidated VIEs of \$187.5 million and repayments of our Warehouse Lines of Credit of \$229.2 million, partially offset by proceeds from our Secured Funding Agreements of \$20.9 million and proceeds from our Warehouse Lines of Credit of \$175.7 million.

### Summary of Financing Agreements

The sources of financing under our Financing Agreements are described in the following table (\$ in thousands):

Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

Table of Contents

As of								
	Total	March 31, 2016		Maturity	Total	December 31, 2015		Maturity
	Commitment	Outstanding	Interest	Date	Commitment	Outstanding	Interest	Date
		Balance	Rate			Balance	Rate	
<b>Secured funding agreements:</b>								
Wells Fargo Facility	\$ 225,000	\$ 124,958	LIBOR+1.75 to 2.35%	December 14, 2016 (1)	\$ 225,000	\$ 101,473	LIBOR+1.75 to 2.35%	December 14, 2016 (1)
Citibank Facility	250,000	152,643	LIBOR+2.00 to 2.50%	December 8, 2016 (2)	250,000	112,827	LIBOR+2.00 to 2.50%	December 8, 2016 (2)
BAML Facility	50,000		LIBOR+2.25 to 2.75%	May 26, 2016 (3)	50,000		LIBOR+2.25 to 2.75%	May 26, 2016 (3)
March 2014 CNB Facility	50,000	50,000	LIBOR+3.00%	March 11, 2017 (4)	50,000		LIBOR+3.00%	March 11, 2016 (4)
July 2014 CNB Facility	75,000	37,900	LIBOR+3.00%(5)	July 31, 2016	75,000	66,200	LIBOR+3.00%(5)	July 31, 2016
MetLife Facility	180,000	110,359	LIBOR+2.35%	August 12, 2017 (6)	180,000	109,474	LIBOR+2.35%	August 12, 2017 (6)
April 2014 UBS Facility	140,000	82,294	LIBOR+1.88 to 2.28% (7)	October 21, 2018	140,000	75,558	LIBOR+1.88 to 2.28% (7)	October 21, 2018
December 2014 UBS Facility	57,243	57,243	LIBOR+2.74%	July 6, 2016	57,243	57,243	LIBOR+2.74%	July 6, 2016
Subtotal	\$ 1,027,243	\$ 615,397			\$ 1,027,243	\$ 522,775		
<b>Warehouse lines of credit:</b>								
ASAP Line of Credit	\$ 80,000 (8)		LIBOR+1.40 to 1.75%	No expiration (8)	\$ 80,000 (8)		LIBOR+1.40 to 1.75%	No expiration (8)
BAML Line of Credit	135,000	49,578	LIBOR+1.60%	June 30, 2016	135,000	24,806	LIBOR+1.60%	June 30, 2016
Subtotal	\$ 215,000	\$ 49,578			\$ 215,000	\$ 24,806		
<b>Secured Term Loan</b>								
	\$ 155,000	\$ 75,000	LIBOR+6.00%(9)	December 9, 2018	\$ 155,000	\$ 75,000	LIBOR+6.00%(9)	December 9, 2018
Total	\$ 1,397,243	\$ 739,975			\$ 1,397,243	\$ 622,581		

(1) The maturity date of the master repurchase funding facility with Wells Fargo Bank, National Association ( Wells Fargo ) (as amended and restated, the Wells Fargo Facility ) is subject to two 12-month extensions at our option provided that certain conditions are met and applicable extension fees are paid. Beginning on December 14, 2015, new advances under the Wells Fargo Facility accrue interest at a per annum rate equal to the sum of (i) 30 day LIBOR plus (ii) a pricing margin range of 1.75% to 2.35%. Advances on loans made prior to December 14, 2015 under the Wells Fargo Facility continue to accrue interest at a per annum rate equal to the sum of (i) 30 day LIBOR plus (ii) a pricing margin range of 2.00% to 2.50%.

(2) The master repurchase facility with Citibank, N.A. (the Citibank Facility ) is subject to three 12-month extensions at our option provided that certain conditions are met and applicable extension fees are paid.

(3) We may request individual loans under the BAML Facility through and including May 26, 2016. However, individual advances on loans under the BAML Facility generally have a two-year maturity, subject to a 12-month extension at our option provided that certain conditions are met and applicable extension fees are paid.

(4) In February 2016, we amended the March 2014 CNB Facility to extend the maturity date to March 11, 2017. We have one 12-month extension at our option provided that certain conditions are met and applicable extension fees are paid, which, if exercised, would extend the final maturity of the March 2014 CNB Facility to March 10, 2018.

(5) The interest rate of the revolving funding facility with City National Bank (the July 2014 CNB Facility ) is LIBOR + 3.00%, comprised of LIBOR + 1.50% and a credit support fee of 1.50% payable to Ares Management.

(6) The revolving master repurchase facility with Metropolitan Life Insurance Company (the MetLife Facility ) is subject to two 12-month extensions at our option provided that certain conditions are met and applicable extension fees are paid.

(7) The price differential (or interest rate) on the revolving master repurchase facility with UBS Real Estate Securities Inc. (the April 2014 UBS Facility ) is one-month LIBOR plus (i) 1.88% per annum, for assets that are subject to an advance for one year or less, (ii) 2.08% per annum, for assets that are subject to an advance in excess of one year but less than two years, and (iii) 2.28% per annum, for assets that are subject to an advance for more than two years; in each case, excluding amortization of commitment and exit fees.

(8) The commitment amount is subject to change at any time at Fannie Mae's discretion. To the extent the ASAP Line of Credit remains active through utilization, there is no expiration date.

(9) The Credit and Guaranty Agreement (the Secured Term Loan ) with Highbridge Principal Strategies, LLC, as administrative agent, and DBD Credit Funding LLC, as collateral agent, has a LIBOR floor of 1.0% on drawn amounts.

## Table of Contents

Our Financing Agreements contain various affirmative and negative covenants, including negative pledges, and provisions related to events of default that are normal and customary for similar financing agreements. See Note 5 to our consolidated financial statements included in this quarterly report on Form 10-Q for more information on our Financing Agreements.

## Commercial Mortgage-Backed Securities and Collateralized Loan Obligations

We may seek to enhance the returns on our senior mortgage loan investments through securitizations, if available. To the extent available, we intend to securitize the senior portion of some of our loans, while retaining the subordinate securities in our investment portfolio. The securitization of this senior portion will be accounted for as either a sale and the loans will be removed from our balance sheet or as a financing and will be classified as loans held for investment in our consolidated balance sheets, depending upon the structure of the securitization.

The following table summarizes our securitizations debt as of March 31, 2016 and December 31, 2015 (\$ in thousands):

	March 31, 2016		As of		December 31, 2015	
	Carrying Amount	Outstanding Principal			Carrying Amount	Outstanding Principal
Commercial mortgage-backed securitization debt (consolidated VIE)	\$ 28,406	\$ 28,406	\$		61,815	\$ 61,856
Collateralized loan obligation securitization debt (consolidated VIE)	156,959	157,656			192,528	193,419
Securitizations debt	\$ 185,365	\$ 186,062	\$		254,343	\$ 255,275

See Note 15 to our consolidated financial statements included in this quarterly report on Form 10-Q for additional terms and details of our securitizations.

## Capital Markets

We may periodically raise additional capital through public offerings of debt and equity securities to fund new investments. On May 9, 2013, we filed a registration statement on Form S-3, with the Securities and Exchange Commission (SEC) in order to permit us to offer, from time to time, in one or more offerings or series of offerings up to \$1.5 billion of our common stock, preferred stock, debt securities, subscription rights to purchase shares of our common stock, warrants representing rights to purchase shares of our common stock, preferred stock or debt securities, or units. On June 17, 2013, the registration statement was declared effective by the SEC.

## Other Sources of Financing

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

In addition to the sources of liquidity described above, in the future, we may also use other sources of financing to fund the origination or acquisition of our target investments or to refinance expiring Financing Agreements and securitizations, including other credit facilities, warehouse facilities, repurchase facilities, non-convertible or convertible debt, securitized financings and other public and private forms of borrowing. These financings may be issued by us or our subsidiaries, be collateralized or non-collateralized, accrue interest at either fixed or floating rates and may involve one or more lenders.

### **Leverage Policies**

We intend to use prudent amounts of leverage to increase potential returns to our stockholders. To that end, subject to maintaining our qualification as a REIT and our exemption from registration under the 1940 Act, we intend to continue to use borrowings to fund the origination or acquisition of our target investments. Given current market conditions and our focus on first or senior mortgages, we currently expect that such leverage would not exceed, on a debt-to-equity basis, a 4-to-1 ratio. Our charter and bylaws do not restrict the amount of leverage that we may use. The amount of leverage we will deploy for particular investments in our target investments will depend upon our Manager's assessment of a variety of factors, which may include, among others, the anticipated liquidity and price volatility of the assets in our investment portfolio, the potential for losses and extension risk in our portfolio, the gap between the duration of our assets and liabilities, including hedges, the availability and cost of financing the assets, our opinion of the creditworthiness of our financing counterparties, the health of the U.S. economy generally or in specific geographic regions and commercial mortgage markets, our outlook for the level and



Table of Contents

volatility of interest rates, the slope of the yield curve, the credit quality of our assets, the collateral underlying our assets, and our outlook for asset spreads relative to the LIBOR curve.

**Dividends**

We intend to make regular quarterly distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT annually distribute at least 90% of its REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, and to the extent that it annually distributes less than 100% of its REIT taxable income in any taxable year, that it pay tax at regular corporate rates on that undistributed portion. We intend to make regular quarterly distributions to our stockholders in an amount equal to or greater than our REIT taxable income (which does not equal net income, as calculated in accordance with GAAP), if and to the extent authorized by our board of directors. As a result, such distributions will not be available to fund investments. Before we make any distributions, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our Financing Agreements and other debt payable. If our cash available for distribution is less than our REIT taxable income, we could be required to sell assets or borrow funds to make cash distributions or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

**OFF-BALANCE SHEET ARRANGEMENTS**

We have commitments to fund various senior mortgage loans, as well as subordinated debt and preferred equity investments in our portfolio, extend credit and sell loans. Commitments to extend credit by ACRE Capital are generally agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee.

Other than as set forth in this quarterly report on Form 10-Q, we do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured investment vehicles, special purpose entities or VIEs, established to facilitate off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities or entered into any commitment or intend to provide additional funding to any such entities.

**RECENT DEVELOPMENTS**

On April 25, 2016, we appointed Rand S. April and James E. Skinner to our board of directors as independent directors.

On April 27, 2016, we originated a \$76.0 million first mortgage loan on a mixed-use property located in New York. At closing, the outstanding principal balance was approximately \$65.6 million. The loan has an interest rate of LIBOR + 4.16% (plus fees) and an initial term of three years.

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

From April 1, 2016 through May 3, 2016, we repurchased a total of 95,062 shares of our common stock in the open market for an aggregate purchase price of \$1.1 million, including expenses paid, under the Stock Buyback Program. The shares were repurchased at an average price of \$11.34 per share, including expenses paid.

From April 1, 2016 through May 3, 2016, ACRE Capital originated \$38.3 million in Fannie Mae, Freddie Mac or HUD loan commitments.

As of May 3, 2016, we had approximately \$140 million in capital, either in cash or in approved but undrawn capacity under our borrowing facilities. After holding in reserve \$10 million in liquidity requirements, we expect to have approximately \$130 million in capital available to fund new loans, fund outstanding commitments on existing loans, repurchase our common shares and for other working capital and general corporate purposes. Assuming that we use all such amount as capital to make new senior loans and we are able to leverage such amount under our financing agreements at a debt-to-equity ratio of 2.5:1, we would have the capacity to fund approximately \$450 million of additional senior loans.

As of May 3, 2016, the total unfunded commitments for our existing loans held for investment were approximately \$82 million. In addition, borrowings under our Secured Funding Agreements were approximately \$635 million, borrowings under our Secured Term Loan was approximately \$75 million, debt issued in the form of CMBS was approximately \$3 million and debt issued in the form of CLO was approximately \$158 million.

On May 5, 2016, we declared a cash dividend of \$0.26 per common share for the second quarter of 2016. The second

Table of Contents

quarter 2016 dividend is payable on July 15, 2016 to common stockholders of record as of June 30, 2016.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

As part of our risk management strategy, our Manager closely monitors our portfolio and actively manages the credit, interest rate, market, prepayment, real estate inflation and financing risks associated with holding a portfolio of our target investments. We manage our portfolio through an interactive process with our Manager and Ares Management and service our target investments through a combination of direct servicing by ACRE Capital and use of our Manager's servicer. ACRE Capital and one of its subsidiaries serve as the primary servicer of our investments. ACRE Capital is a Standard & Poor's rated commercial primary servicer that is also included on Standard & Poor's Select Servicer List. Our Manager's servicer, which is a Standard & Poor's rated commercial special servicer that is included on Standard & Poor's Select Servicer List, serves as the special servicer for non-routine investment servicing issues. Our Manager has an Investment Committee that oversees compliance with our investment strategy and guidelines, investment portfolio holdings and financing strategy. We seek to manage our risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market value while, at the same time, seeking to provide an opportunity to stockholders to realize attractive risk-adjusted returns through ownership of our capital stock. While we do not seek to avoid risk completely, we believe the risks can be quantified from historical experience and seek to actively manage those risks, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

***Credit Risk***

We are subject to varying degrees of credit risk in connection with holding our target investments. We have exposure to credit risk on our CRE loans and other target investments in our principal lending business. Our Manager seeks to manage credit risk by performing our due diligence process prior to origination or acquisition and through the use of non-recourse financing, when and where available and appropriate. Credit risk is also addressed through our Manager's ongoing review of our investment portfolio. In addition, with respect to any particular principal lending target investment, our Manager's investment team evaluates, among other things, relative valuation, comparable analysis, supply and demand trends, shape of yield curves, delinquency and default rates, recovery of various sectors and vintage of collateral.

In addition, we are exposed to credit risk in our mortgage banking business where, under the Master Loss Sharing Agreement, ACRE Capital is responsible for absorbing certain losses incurred by Fannie Mae with respect to loans originated under the DUS program. See Note 6 to our consolidated financial statements included in this quarterly report on Form 10-Q for further discussion of the Master Loss Sharing Agreement with Fannie Mae. ACRE Capital uses several tools to manage its risk-sharing obligation, including maintenance of disciplined underwriting and approval processes and procedures, and periodic review and evaluation of underwriting criteria based on underlying multifamily housing market data and limitation of exposure to particular geographic markets and submarkets and to individual borrowers.

***Interest Rate Risk***

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and our related financing obligations, including our borrowings under the Financing Agreements. We primarily originate or acquire floating rate mortgage assets and finance those assets with index-matched floating rate liabilities. As a result, we significantly reduce our exposure to changes in

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

portfolio value and cash flow variability related to changes in interest rates. However, we regularly measure our exposure to interest rate risk and assess interest rate risk and manage our interest rate exposure on an ongoing basis by comparing our interest rate sensitive assets to our interest rate sensitive liabilities. Based on that review, we determine whether or not we should enter into hedging transactions and derivative financial instruments, such as forward sale commitments and interest rate floors in order to mitigate our exposure to changes in interest rates.

While hedging activities may mitigate our exposure to adverse fluctuations in interest rates, certain hedging transactions that we may enter into in the future, such as interest rate swap agreements, may also limit our ability to participate in the benefits of lower interest rates with respect to our investments. In addition, there can be no assurance that we will be able to effectively hedge our interest rate risk.

In addition to the risks related to fluctuations in asset values and cash flows associated with movements in interest rates, there is also the risk of non-performance on floating rate assets. In the case of a significant increase in interest rates, the additional debt service payments due from our borrowers may strain the operating cash flows of the real estate assets underlying our mortgages and, potentially, contribute to non-performance or, in severe cases, default.

Table of Contents***Interest Rate Effect on Net Interest Margin***

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing. The cost of our borrowings generally is based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally increase while the yields earned on our leveraged fixed-rate mortgage assets remain static, which could result in a decline in our net interest spread and net interest margin.

For the three months ended March 31, 2016, the following fluctuations in the average 30-day LIBOR would have resulted in the following increases in net interest margin on our loans held for investment (\$ in millions):

<b>Change in Average 30-Day LIBOR</b>	<b>For the three months ended March 31, 2016</b>	
Up 300 basis points	\$	1.9
Up 200 basis points	\$	1.3
Up 100 basis points	\$	0.7
Down to 0 basis points	\$	0.1

The severity of any such impact depends on our asset/liability composition at the time as well as the magnitude and duration of the interest rate increase and any applicable floors and caps. Further, an increase in short-term interest rates could also have a negative impact on the market value of our target investments. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

***Interest Rate Cap and Floor Risk***

We primarily originate or acquire floating rate mortgage assets. These are assets in which the mortgages may be subject to periodic and lifetime interest rate caps and floors, which limit the amount by which the asset's interest yield change during any given period. However, our borrowing costs pursuant to our financing agreements sometimes are not subject to similar restrictions or have different floors and caps. As a result, in a period of increasing interest rates, interest rate costs on our borrowings could increase without limitation by caps, while the interest rate yields on our floating rate mortgage assets could be limited if we do not implement effective caps. In addition, floating rate mortgage assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. This could result in our receipt of less cash income on such assets than we would need to pay the interest cost on our related borrowings. In addition, in a period of decreasing interest rates, the interest rate yields on our floating rate mortgage assets could decrease, while the interest rate costs on certain of our borrowings could be fixed at a higher floor. These factors could lower our net interest income or cause a net loss during periods of decreasing interest rates, which would harm our financial condition, cash flows and results of operations.

***Market Risk***

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

The estimated fair values of our investments fluctuate primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the estimated fair value of the fixed-rate securities would be expected to decrease; conversely, in a decreasing interest rate environment, the estimated fair value of the fixed-rate securities would be expected to increase. As market volatility increases or liquidity decreases, the fair value of our investments may be adversely impacted.

The fair value of ACRE Capital's MSRs is subject to market risk. A 100 basis point increase or decrease in the weighted average discount rate would decrease or increase, respectively, the fair value of ACRE Capital's MSRs by approximately \$1.9 million and \$2.0 million as of March 31, 2016 and December 31, 2015, respectively.

### *Prepayment and Securitizations Repayment Risk*

Our net income and earnings may be affected by prepayment rates on our existing CRE loans. When we originate our CRE loans, we anticipate that we will generate an expected yield. When borrowers prepay their CRE loans faster than we expect, we may be unable to replace these CRE loans with new CRE loans that will generate yields which are as high as the prepaid CRE loans. Additionally, principal repayment proceeds from mortgage loans in the CMBS and CLO are applied

Table of Contents

sequentially, first going to pay down the senior CMBS and CLO notes. We will not receive any proceeds from repayment of loans in the CMBS or CLO until all senior notes are repaid in full.

***Financing Risk***

We borrow funds under our Financing Agreements to finance our target assets. Over time, as market conditions change, in addition to these financings, we may use other forms of leverage. Weakness or volatility in the financial markets, the commercial real estate and mortgage markets and the economy generally could adversely affect one or more of our potential lenders and could cause one or more of our potential lenders to be unwilling or unable to provide us with financing or to increase the costs of that financing.

***Real Estate Risk***

Commercial mortgage assets are subject to volatility and may be affected adversely by a number of factors, including, but not limited to, national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions; changes or continued weakness in specific industry segments; local markets with a significant exposure to the energy sector; construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. In addition, decreases in property values reduce the value of the collateral and the potential proceeds available to a borrower to repay the underlying loan or loans, as the case may be, which could also cause us to suffer losses. We seek to manage these risks through our underwriting and asset management processes.

***Inflation Risk***

Virtually all of our assets and liabilities are sensitive to interest rates. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. In each case, in general, our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

**Item 4. Controls and Procedures**

The Company's management, with the participation of the Company's Co-Chief Executive Officers and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act). Based upon such evaluation, the Company's Co-Chief Executive Officers and Chief Financial Officer concluded that its disclosure controls and procedures were effective, as of March 31, 2016, to provide assurance that information that is required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported, within the time periods specified by the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its Co-Chief Executive Officers and Chief Financial Officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. During the three months ended March 31, 2016, there

## Edgar Filing: Ares Commercial Real Estate Corp - Form 10-Q

was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **PART II OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

In the normal course of business, we may be subject to various legal proceedings from time to time. Furthermore, third parties may try to seek to impose liability on us in connection with our loans. As of March 31, 2016, we were not subject to any material pending legal proceedings.

#### **Item 1A. Risk Factors**

There have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2015. You should carefully consider the risk factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2015, which could materially affect our business, financial condition and/or operating results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition and/or operating results.



Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds*****Stock Buyback Program***

In May 2015, we announced that the Company's board of directors authorized us to repurchase up to \$20 million of our outstanding common stock over a period of one year. In February 2016, we announced that the Company's board of directors increased the size of the existing \$20 million Stock Buyback Program to \$30 million and extended the Stock Buyback Program through March 31, 2017. Purchases made pursuant to the Stock Buyback Program will be made in either the open market or in privately negotiated transactions, from time to time and as permitted by federal securities laws and other legal requirements. Repurchases may be suspended or discontinued at any time. In connection with this Stock Buyback Program, in March 2016, we entered into a Rule 10b5-1 plan to repurchase shares of our common stock in accordance with certain parameters set forth in the Stock Buyback Program.

Repurchases of our common stock under our Stock Buyback Program were as follows (in thousands, except shares and per share data):

Period	Total Number of Shares Purchased	Average Price Paid Per Share (1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
January 1, 2016 through January 31, 2016				\$ 20,000
February 1, 2016 through February 29, 2016				\$ 30,000
March 1, 2016 through March 31, 2016	34,854	\$ 10.28	34,854	\$ 29,642
Total	34,854	\$ 10.28	34,854	

(1) Amount includes expenses paid.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

Table of Contents

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Exhibit Description</b>
3.1*	Articles of Amendment and Restatement of Ares Commercial Real Estate Corporation. (1)
3.2*	Amended and Restated Bylaws of Ares Commercial Real Estate Corporation. (2)
10.1*	Amendment No. 2 to Bridge Loan Warehousing Credit and Security Agreement dated as of February 26, 2016, among ACRC Lender B LLC and Bank Of America, N.A. (1)
10.2*	Amendment No. 3 to Credit Agreement dated as of February 26, 2016, by and among ACRC Lender LLC, as borrower, City National Bank, a national banking association, as arranger and administrative agent, and the lenders party thereto. (1)
31.1	Certification of Co-Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Co-Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.3	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Co-Chief Executive Officers and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

---

\* Previously filed

(1) Incorporated by reference to Exhibits 3.1, 10.52 and 10.53, as applicable, to the Company's Form 10-K (File No. 001-35517), filed on March 1, 2016.

(2) Incorporated by reference to Exhibits 3.2 to the Company's Form S-8 (File No. 333-181077), filed on May 1, 2012.

Table of Contents

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**ARES COMMERCIAL REAL ESTATE CORPORATION**

Date: May 5, 2016	By	/s/ John Jardine John Jardine <i>Co-Chief Executive Officer (Principal Executive Officer)</i>
Date: May 5, 2016	By	/s/ Robert L. Rosen Robert L. Rosen <i>Interim Co-Chief Executive Officer (Principal Executive Officer)</i>
Date: May 5, 2016	By	/s/ Tae-Sik Yoon Tae-Sik Yoon <i>Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)</i>