

Ares Commercial Real Estate Corp
Form 10-Q
November 05, 2015
[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 September 30, 2015

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)

One North Wacker Drive, 48th Floor, Chicago, IL 60606

(Address of principal executive office) (Zip Code)

(312) 252-7500

(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 November 3, 2015
28,609,650

Table of Contents

ARES COMMERCIAL REAL ESTATE CORPORATION

INDEX

<u>Part I.</u>	<u>Financial Information</u>	
<u>Item 1.</u>	<u>Consolidated Financial Statements</u>	
	<u>Consolidated Balance Sheets as of September 30, 2015 (unaudited) and December 31, 2014</u>	2
	<u>Consolidated Statements of Operations for the three and nine months ended September 30, 2015 and 2014 (unaudited)</u>	3
	<u>Consolidated Statement of Equity for the nine months ended September 30, 2015 (unaudited)</u>	4
	<u>Consolidated Statements of Cash Flows for the nine months ended September 30, 2015 and 2014 (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>	38
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	50
<u>Item 4.</u>	<u>Controls and Procedures</u>	52
<u>Part II.</u>	<u>Other Information</u>	
<u>Item 1.</u>	<u>Legal Proceedings</u>	52
<u>Item 1A.</u>	<u>Risk Factors</u>	53
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	53
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>	53
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	53
<u>Item 5.</u>	<u>Other Information</u>	53
<u>Item 6.</u>	<u>Exhibits</u>	53

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)

	September 30, 2015 (unaudited)	As of	December 31, 2014
ASSETS			
Cash and cash equivalents (\$8 and \$47 related to consolidated VIEs, respectively)	\$ 10,399	\$	16,551
Restricted cash	27,209		66,121
Loans held for investment (\$622,874 and \$848,224 related to consolidated VIEs, respectively)	1,269,954		1,462,584
Loans held for sale, at fair value	94,050		203,006
Mortgage servicing rights, at fair value	60,148		58,889
Other assets (\$3,197 and \$3,438 of interest receivable related to consolidated VIEs, respectively; \$18,352 of other receivables related to consolidated VIEs as of December 31, 2014)	40,426		60,502
Total assets	\$ 1,502,186	\$	1,867,653
LIABILITIES AND EQUITY			
LIABILITIES			
Secured funding agreements	\$ 521,676	\$	552,799
Warehouse lines of credit	83,511		193,165
Convertible notes	68,863		68,395
Commercial mortgage-backed securitization debt (consolidated VIE)	61,856		219,043
Collateralized loan obligation securitization debt (consolidated VIE)	222,187		308,703
Allowance for loss sharing	8,953		12,349
Due to affiliate	2,689		2,735
Dividends payable	7,152		7,147
Other liabilities (\$291 and \$498 of interest payable related to consolidated VIEs, respectively)	33,675		22,431
Total liabilities	1,010,562		1,386,767
Commitments and contingencies (Note 7)			
EQUITY			
Common stock, par value \$0.01 per share, 450,000,000 shares authorized at September 30, 2015 and December 31, 2014, 28,609,650 and 28,586,915 shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively	284		284
Additional paid-in capital	421,006		420,344
Accumulated deficit	(13,717)		(17,674)
Total stockholders' equity	407,573		402,954
Non-controlling interests in consolidated VIEs	84,051		77,932
Total equity	491,624		480,886
Total liabilities and equity	\$ 1,502,186	\$	1,867,653

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 September 30,		For the nine months ended September 30,	
	2015	2014	2015	2014
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net interest margin:				
Interest income from loans held for investment	\$ 20,949	\$ 17,967	\$ 65,131	\$ 50,854
Interest expense	(8,707)	(9,615)	(27,586)	(24,654)
Net interest margin	12,242	8,352	37,545	26,200
Mortgage banking revenue:				
Servicing fees, net	4,114	3,868	11,938	12,581
Gains from mortgage banking activities	9,214	2,473	20,847	9,077
Provision for loss sharing	118	285	1,109	1,346
Change in fair value of mortgage servicing rights	(1,772)	(1,798)	(6,955)	(5,533)
Mortgage banking revenue	11,674	4,828	26,939	17,471
Gain on sale of loans	-	-	-	680
Total revenue	23,916	13,180	64,484	44,351
Expenses:				
Management fees to affiliate	1,490	1,475	4,447	4,445
Professional fees	897	635	2,292	2,663
Compensation and benefits	5,921	4,704	15,992	13,235
Acquisition and investment pursuit costs	-	-	-	20
General and administrative expenses	1,714	2,437	5,177	7,256
General and administrative expenses reimbursed to affiliate	953	1,000	2,959	3,000
Total expenses	10,975	10,251	30,867	30,619
Income from operations before income taxes	12,941	2,929	33,617	13,732
Income tax expense (benefit)	1,231	(1,173)	1,349	(1,764)
Net income attributable to ACRE	11,710	4,102	32,268	15,496
Less: Net income attributable to non-controlling interests	(2,331)	-	(6,860)	-
Net income attributable to common stockholders	\$ 9,379	\$ 4,102	\$ 25,408	\$ 15,496
Net income per common share:				
Basic and diluted earnings per common share	\$ 0.33	\$ 0.14	\$ 0.89	\$ 0.54
Weighted average number of common shares outstanding:				
Basic weighted average shares of common stock outstanding	28,505,729	28,464,613	28,493,989	28,453,719
Diluted weighted average shares of common stock outstanding	28,609,650	28,604,798	28,593,496	28,582,353
Dividends declared per share of common stock	\$ 0.25	\$ 0.25	\$ 0.75	\$ 0.75

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-Controlling	Total
	Shares	Amount	Paid-in	Deficit	Stockholders	Interests	Equity
			Capital		Equity		
Balance at December 31, 2014	28,586,915	\$ 284	\$ 420,344	\$ (17,674)	\$ 402,954	\$ 77,932	\$ 480,886
Stock-based compensation	22,735	-	662	-	662	-	662
Net income	-	-	-	25,408	25,408	6,860	32,268
Dividends declared	-	-	-	(21,451)	(21,451)	-	(21,451)
Contributions from non-controlling interests	-	-	-	-	-	5,685	5,685
Distributions to non-controlling interests	-	-	-	-	-	(6,426)	(6,426)
Balance at September 30, 2015	28,609,650	\$ 284	\$ 421,006	\$ (13,717)	\$ 407,573	\$ 84,051	\$ 491,624

See accompanying notes to consolidated financial statements.

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

(in thousands)

	For the nine months ended September 30,	
	2015	2014
	(unaudited)	(unaudited)
Operating activities:		
Net income	\$ 32,268	\$ 15,496
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of deferred financing costs	6,091	6,315
Change in mortgage banking activities	(11,200)	(2,046)
Change in fair value of mortgage servicing rights	6,955	5,533
Accretion of deferred loan origination fees and costs	(3,504)	(2,692)
Provision for loss sharing	(1,109)	(1,346)
Cash paid to settle loss sharing obligations	(2,264)	(1,703)
Originations of mortgage loans held for sale	(575,038)	(219,780)
Sale of mortgage loans held for sale to third parties	685,138	199,995
Stock-based compensation	662	777
Amortization of convertible notes issuance costs	758	689
Accretion of convertible notes	468	425
Depreciation expense	164	98
Deferred tax expense (benefit)	1,823	(485)
Changes in operating assets and liabilities:		
Restricted cash	41,916	(1,419)
Other assets	18,918	(12,169)
Due to affiliate	(46)	(142)
Other liabilities	2,576	(646)
Net cash provided by (used in) operating activities	204,576	(13,100)
Investing activities:		
Issuance of and fundings on loans held for investment	(153,245)	(469,910)
Principal repayment of loans held for investment	275,159	193,867
Proceeds from sale of a mortgage loan held for sale	74,625	80,197
Receipt of origination fees	810	4,735
Purchases of property and equipment	(90)	(268)
Payments for acquisition of intangible assets	-	(956)
Payments for acquisition of mortgage servicing rights	-	(1,259)
Net cash provided by (used in) investing activities	197,259	(193,594)
Financing activities:		
Proceeds from secured funding agreements	170,525	800,035
Repayments of secured funding agreements	(201,648)	(722,463)
Secured funding costs	(1,320)	(8,254)
Proceeds from issuance of debt of consolidated VIEs	-	308,703
Repayments of debt of consolidated VIEs	(243,703)	(175,984)
Payment of offering costs	-	(113)
Proceeds from warehouse lines of credit	668,055	207,063
Repayments of warehouse lines of credit	(777,709)	(189,519)
Dividends paid	(21,446)	(21,426)
Contributions from non-controlling interests	5,685	-
Distributions to non-controlling interests	(6,426)	-
Net cash provided by (used in) financing activities	(407,987)	198,042

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

Change in cash and cash equivalents		(6,152)		(8,652)
Cash and cash equivalents, beginning of period		16,551		20,100
Cash and cash equivalents, end of period	\$	10,399	\$	11,448

See accompanying notes to consolidated financial statements.

Table of Contents

ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As of September 30, 2015

(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 and other CRE-related 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 and government-sponsored enterprises (GSEs), such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), 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, 2014 filed with the SEC.

Refer to the Company's 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, 2015.

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. Other interest expense related to the unsecured 7.00% Convertible Senior Notes that mature in 2015 (the 2015 Convertible Notes) has been reclassified into interest expense, other interest expense related to the Warehouse Lines of Credit (as defined in Note 5 included in these consolidated financial statements) has been reclassified into gains from mortgage banking activities and other

Table of Contents

interest expense related to escrow accounts has been reclassified into servicing fees, net in the consolidated statements of operations. As of December 31, 2014, the Company no longer presents other interest expense in its consolidated statements of operations.

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 periodic 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 September 30, 2015 and December 31, 2014, the Company did not recognize any impairments with respect to its loans held for investment.

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 MSR's 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 September 30, 2015 and December 31, 2014, the Company did not have any loans held for sale in its principal lending business.

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.

Table of Contents***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 a 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 since inception. 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):

	For the three months ended September 30, 2015	For the nine months ended September 30, 2015
Interest income from loans held for investment, excluding non-controlling interests	\$ 18,618	\$ 58,251
Interest income from non-controlling interest investment held by third parties	2,331	6,880
Interest income from loans held for investment	\$ 20,949	\$ 65,131

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 MSR, 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 MSR, 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.

Comprehensive Income

For the three and nine months ended September 30, 2015 and 2014, comprehensive income equaled net income; therefore, a separate consolidated statement of comprehensive income is not included in the accompanying consolidated financial statements.

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 (as defined in Note 5 included in these consolidated financial statements), securitizations debt and the 2015 Convertible Notes in net interest margin. For the three and nine months ended September 30, 2015 and 2014, interest expense is comprised of the following (\$ in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2015	2014	2015	2014
Secured funding agreements and securitizations debt	\$ 7,063	\$ 8,010	\$ 22,737	\$ 19,917
Convertible notes	1,644	1,605	4,849	4,737
Interest expense	\$ 8,707	\$ 9,615	\$ 27,586	\$ 24,654

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. Early application is not permitted. The Company is currently evaluating the impact of adopting this ASU on its consolidated financial statements.

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 modifies the consolidation analysis for limited and general partnerships and similar type entities, as well as variable interests in a variable interest entity, 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, including interim periods within that reporting period. Early adoption is permitted. The Company is currently evaluating the impact of adopting this ASU on its 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 modifies the requirements for reporting debt issuance costs. Under the amendments in ASU No. 2015-03, debt issuance costs related to a recognized debt liability will no longer be recorded as a separate asset, but will be 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 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 on or after December 15, 2015, and interim periods within those fiscal years, with early adoption permitted. The Company is currently evaluating the impact of adopting this ASU on its consolidated financial statements.

3. LOANS HELD FOR INVESTMENT

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

As of September 30, 2015, the Company had originated or co-originated 39 loans held for investment, excluding 21 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 September 30, 2015. During the nine months ended September 30, 2015, the Company funded approximately \$154.5 million of outstanding principal, received repayments of \$275.2 million of outstanding principal and sold a \$75.0 million loan to a third party as described in more detail in the tables below. Such investments are referred to herein as the Company's investment portfolio. As of September 30, 2015, 65.4% of the Company's loans have LIBOR floors, with a weighted average floor of 0.24%, 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 September 30, 2015 and December 31, 2014 (\$ in thousands):

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

Table of Contents

As of September 30, 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	\$ 984,748	\$ 989,808	4.4%	5.0%	1.5
Subordinated debt and preferred equity investments	201,919	204,095	10.7%	11.1%	6.1
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,186,667	\$ 1,193,903	5.5%	6.0%	2.3

As of December 31, 2014

	Carrying Amount (1)	Outstanding Principal (1)	Weighted Average Interest Rate	Weighted Average Unleveraged Effective Yield (2)	Weighted Average Remaining Life (Years)
Senior mortgage loans	\$ 1,156,476	\$ 1,164,055	4.5%	5.0%	2.1
Subordinated debt and preferred equity investments	228,499	231,226	10.3%	10.7%	6.1
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,384,975	\$ 1,395,281	5.5%	6.0%	2.8

(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 the Company as of September 30, 2015 and December 31, 2014 as weighted by the Outstanding Principal balance of each loan.

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

	As of September 30, 2015	
	Carrying Amount	Outstanding Principal
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,186,667	\$ 1,193,903
Non-controlling interest investment held by third parties	83,287	83,287
Loans held for investment	\$ 1,269,954	\$ 1,277,190

	As of December 31, 2014	
	Carrying Amount	Outstanding Principal
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,384,975	\$ 1,395,281
Non-controlling interest investment held by third parties	77,609	77,609

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

Loans held for investment	\$	1,462,584	\$	1,472,890
---------------------------	----	-----------	----	-----------

A more detailed listing of the Company's investment portfolio, excluding non-controlling interests, based on information available as of September 30, 2015 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)
Senior Mortgage Loans:							
Office	TX	\$ 76.1	\$ 75.5	L+5.00%	6.1%	Jan 2017	I/O
Retail	IL	73.6	73.2	L+4.00%	(5) 4.6%	Aug 2017	I/O
Mixed-use	IL	49.7	49.2	L+3.60%	4.2%	Oct 2018	I/O
Office	FL	47.3	47.3	L+5.25%	5.4%	Apr 2016	I/O
Multifamily	TX	44.7	44.6	L+3.75%	4.5%	July 2016	I/O
Healthcare	NY	41.6	41.3	L+5.00%	5.8%	Dec 2016	I/O
Industrial	MO/KS	37.6	37.4	L+4.30%	5.1%	Jan 2017	P/I
Hotel	NY	36.5	36.1	L+4.75%	5.4%	June 2018	I/O
Multifamily	FL	35.9	35.8	L+3.75%	4.7%	Mar 2017	I/O
Multifamily	TX	35.0	35.0	L+3.75%	4.5%	July 2016	I/O
Office	FL	34.0	33.9	L+3.65%	4.0%	Oct 2017	I/O
Industrial	OH	33.4	33.2	L+4.20%	4.7%	May 2018	I/O
Office	OH	31.6	31.6	L+5.35%-L+5.00% (6)	6.0%	Nov 2015	I/O
Retail	IL	29.9	29.7	L+3.25%	3.9%	Sep 2018	I/O
Office	CA	28.1	27.9	L+4.50%	5.2%	Apr 2017	I/O
Multifamily	NY	28.0	27.8	L+3.75%	4.4%	Oct 2017	I/O
Multifamily	TX	27.6	27.5	L+3.65%	4.4%	Jan 2017	I/O
Office	OR	27.6	27.4	L+3.75%	4.4%	Oct 2018	I/O
Mixed-use	NY	27.6	27.5	L+4.25%	4.8%	Aug 2017	I/O
Office	KS	25.5	25.5	L+5.00%	5.8%	Mar 2016	I/O
Multifamily	TX	25.0	24.9	L+3.65%	4.4%	Jan 2017	I/O
Multifamily	GA	23.1	23.0	L+3.85%	4.8%	May 2017	I/O
Multifamily	AZ	22.1	22.1	L+4.25%	5.5%	Sep 2016	I/O
Industrial	VA	19.0	19.0	L+5.25%	6.4%	Dec 2015	I/O
Office	CO	18.0	17.8	L+3.95%	4.6%	Dec 2017	I/O
Office	CA	15.9	15.8	L+3.75%	4.5%	July 2016	I/O
Multifamily	NC	15.8	15.7	L+4.00%	4.8%	Apr 2017	I/O
Office	CA	14.9	14.9	L+4.50%	5.3%	July 2016	I/O
Multifamily	NY	14.9	14.8	L+3.85%	4.4%	Nov 2017	I/O
Office	CA	14.5	14.5	L+4.75%	5.8%	Feb 2016	I/O
Mixed-use	NY	13.0	12.9	L+3.95%	4.8%	Sep 2017	I/O
Multifamily	FL	12.1	12.0	L+3.75%	4.6%	Apr 2017	I/O
Industrial	CA	10.1	10.0	L+5.25%	6.3%	May 2017	I/O
Subordinated Debt and Preferred Equity Investments:							
Multifamily	GA and FL	48.6	48.0	L+11.85%	(7) 12.3%	June 2021	I/O
Multifamily	NY	33.3	33.2	L+8.07%	8.5%	Jan 2019	I/O
Office	GA	14.3	14.3	9.50%	9.5%	Aug 2017	I/O
Mixed-use	NY	16.4	16.3	11.50%	(8) 12.1%	Nov 2016	I/O
Multifamily	TX	4.9	4.8	L+11.00%	(9) 11.6%	Oct 2016	I/O
Various	Diversified (10)	86.7	85.3	10.95%	11.4%	Dec 2024	I/O
Total/Weighted Average		\$ 1,193.9	\$ 1,186.7		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 September 30, 2015 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 September 30, 2015 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.

Table of Contents

- (4) I/O = interest only, P/I = principal and interest. In January 2015, amortization began on the senior Missouri/Kansas loan, which had an outstanding principal balance of \$37.6 million as of September 30, 2015. In May 2017, amortization will begin on the senior Ohio loan, which had an outstanding principal balance of \$33.4 million as of September 30, 2015. The remainder of the loans in the Company's principal lending portfolio are non-amortizing through their primary terms.
- (5) In April 2015, the Company entered into a loan modification that lowered the interest rate to L+4.00% with a 4.20% interest rate floor and extended the make-whole provision to November 2016.
- (6) The initial interest rate for this loan of L+5.35% steps down based on performance hurdles to L+5.00%.
- (7) 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.
- (8) 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.
- (9) The preferred return is L+11.00% with a L+9.00% current pay and up to a capped dollar amount as PIK.
- (10) The preferred equity investment is in an entity whose assets are comprised of multifamily, student housing and medical office properties.

For the nine months ended September 30, 2015, the activity in the Company's loan portfolio was as follows (\$ in thousands):

Balance at December 31, 2014	\$	1,462,584
Initial funding		100,205
Receipt of origination fees, net of costs		(810)
Additional funding		54,255
Amortizing payments		(447)
Loan payoffs		(274,712)
Loans sold to third parties (1)		(74,625)
Origination fee accretion		3,504
Balance at September 30, 2015	\$	1,269,954

- (1) In July 2015, the Company sold a loan to a third party that was previously classified as held for investment. At the time of the sale, the loan had an unleveraged effective yield of 4.2% as compared to the 4.9% weighted average unleveraged effective yield for all senior loans held by the Company. No gain or loss was recognized on the sale.

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

No impairment charges have been recognized during the three and nine months ended September 30, 2015 and 2014.

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 September 30, 2015 and December 31, 2014, the carrying value of MSRs was approximately \$60.1 million and \$58.9 million, respectively. As of September 30, 2015 and December 31, 2014, ACRE Capital had a servicing portfolio consisting of 977 and 976 loans, respectively, with an unpaid principal balance of \$4.7 billion and \$4.1 billion, respectively, which excludes ACRE's loans held for investment portfolio (see Note 13).

Activity related to MSRs as of and for the nine months ended September 30, 2015 and 2014 was as follows (\$ in thousands):

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

Table of Contents

Balance at December 31, 2014	\$	58,889
Additions, following sale of loan		10,050
Changes in fair value		(6,955)
Prepayments and write-offs		(1,836)
Balance at September 30, 2015	\$	60,148
Balance at December 31, 2013	\$	59,640
MSRs acquired in asset acquisition		1,259
Additions, following sale of loan		5,779
Changes in fair value		(5,533)
Prepayments and write-offs		(1,531)
Balance at September 30, 2014	\$	59,614

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 September 30, 2015 and December 31, 2014 by approximately \$1.9 million and \$1.8 million, respectively.

5. DEBT

Financing Facilities

The Company 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 Wells Fargo Facility, the Citibank Facility, the Capital One Facility, the BAML Facility, the CNB Facilities, the MetLife Facility and the UBS Facilities (individually defined below and collectively, the Secured Funding Agreements). The Company refers to the Warehouse Lines of Credit and the Secured Funding Agreements as the Financing Facilities. As of September 30, 2015 and December 31, 2014, the outstanding balances and total commitments under the Financing Facilities consisted of the following (\$ in thousands):

	As of September 30, 2015		As of December 31, 2014	
	Outstanding Balance	Total Commitment	Outstanding Balance	Total Commitment
Wells Fargo Facility	\$ 124,201	\$ 225,000	\$ 120,766	\$ 225,000
Citibank Facility	112,132	250,000	93,432	250,000
Capital One Facility	-	-	-	100,000
BAML Facility	-	50,000	-	-
March 2014 CNB Facility	-	50,000	42,000	50,000
July 2014 CNB Facility	73,900	75,000 (2)	75,000	75,000
MetLife Facility	104,756	180,000	144,673	180,000
April 2014 UBS Facility	49,444	140,000 (3)	19,685	140,000
December 2014 UBS Facility	57,243	57,243 (4)	57,243	57,243
ASAP Line of Credit	17,550	80,000 (5)	58,469	80,000 (5)
BAML Line of Credit	65,961	135,000 (6)	134,696	180,000 (6)
Total	\$ 605,187	\$ 1,242,243	\$ 745,964	\$ 1,337,243

(1) The secured revolving funding facility with Capital One, National Association (as amended, the Capital One Facility) matured on May 18, 2015. The Capital One Facility had been repaid in full and its term was not extended.

(2) During the three months ended September 30, 2015, the maturity date of the July 2014 CNB Facility was extended to July 31, 2016.

Table of Contents

- (3) See Note 18 included in these consolidated financial statements for information on a subsequent event relating to the April 2014 UBS Facility.
- (4) During the three months ended September 30, 2015, the maturity date of the December 2014 UBS Facility was extended to July 6, 2016.
- (5) The commitment amount is subject to change at any time at Fannie Mae's discretion.
- (6) During the three months ended December 31, 2014, the BAML Line of Credit's commitment size temporarily increased from \$80.0 million to \$180.0 million for the period November 25, 2014 through January 26, 2015. During the nine months ended September 30, 2015, the BAML Line of Credit's commitment size increased from \$80.0 million to \$135.0 million and temporarily increased from \$135.0 million to \$185.0 million for the period April 15, 2015 to June 1, 2015.

Some of the Company's Financing Facilities are collateralized by i) assignments of specific loans 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 securitized debt, or iii) interests in wholly owned entity subsidiaries that hold the Company's loans held for investment. The Financing Facilities (excluding the Warehouse Lines of Credit) are guaranteed by the Company. Generally, the Company partially offsets interest rate risk by matching the interest index of loans held for investment with the Financing Facilities used to fund them. The Company's Financing Facilities contain various affirmative and negative covenants. As of September 30, 2015, the Company is in compliance in all material respects with the terms of each respective Financing Facility.

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. In December 2014, the Company amended and restated the Wells Fargo Facility to, among other things, extend the maturity date from December 14, 2014 to December 14, 2015 and waive the non-utilization fee from December 14, 2014 through April 14, 2015. Provided that certain conditions are met and applicable extension fees are paid, the maturity date is subject to two 12-month extensions at the Company's option. 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. 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 2.00%-2.50%. Subject to the waiver set forth above, 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 and nine months ended September 30, 2015, the Company incurred a non-utilization fee of \$65 thousand and \$120 thousand, respectively. For the three and nine months ended September 30, 2014, the Company incurred a non-utilization fee of \$82 thousand and \$154 thousand, respectively.

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.

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

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. Under the Citibank Facility, the maturity date 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 and nine months ended September 30, 2015, the Company incurred a non-utilization fee of \$88 thousand and \$282 thousand, respectively. For the three and nine months ended September 30, 2014, the Company incurred a non-utilization fee of \$118 thousand and \$191 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. 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. However, 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

Table of Contents

ranging from 2.25% to 2.75% depending upon the type of asset securing such advance. The BAML Facility contains mandatory prepayment events with respect to individual advances if certain specified coverage ratio or other credit based tests are not met with respect to the related eligible assets. 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 and nine months ended September 30, 2015, the Company incurred a non-utilization fee of \$16 thousand and \$21 thousand, respectively.

The BAML Facility is fully guaranteed by the Company and a subsidiary of the Company has pledged its equity interest in the Company's subsidiary, ACRC Lender B LLC, to secure the obligations under the BAML Facility. The agreements governing the BAML Facility contain various customary representations and warranties, and impose certain customary covenants on the Company, including that the Company is obligated to maintain certain ratios of debt to net worth, fixed charges and other financial conditions.

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. 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 and nine months ended September 30, 2015, the Company incurred a non-utilization fee of \$46 thousand and \$130 thousand, respectively. For the three and nine months ended September 30, 2014, the Company incurred a non-utilization fee of \$7 thousand and \$50 thousand, respectively. The initial maturity date is March 11, 2016, subject to one 12-month extension at the Company's option provided that certain conditions are met and applicable extension fees are paid.

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. 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 and nine months ended September 30, 2015, the Company did not incur a non-utilization fee. For the three and nine months ended September 30, 2014, the Company incurred a non-utilization fee of \$13 thousand in each period. On July 21, 2015, the Company exercised a 12-month extension option to extend the maturity date of the July 2014 CNB Facility. The extended maturity date of the July 2014 CNB Facility is July 31, 2016. 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. 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. The initial 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.

Table of Contents

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, commercial real estate mezzanine loans and other assets meeting defined eligibility criteria that are approved by UBS in its sole discretion. The price differential (or interest rate) on the April 2014 UBS Facility is one-month LIBOR plus 1.88%. 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. The initial maturity date of the April 2014 UBS Facility is April 7, 2017, subject to annual extensions in UBS's sole discretion. See Note 18 included in these consolidated financial statements for information on a subsequent event relating to the April 2014 UBS Facility.

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 (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. On August 6, 2015, the Company extended the scheduled repurchase date of the December 2014 UBS Facility to 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.

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

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

In November 2014, ACRE Capital amended its line of credit with Bank of America, N.A. (as amended and restated, the BAML Line of Credit) to, among other things, temporarily increase the size of the commitment from \$80.0 million to \$180.0 million for the period November 25, 2014 through January 26, 2015. In February 2015, ACRE Capital amended the BAML Line of Credit to, among other things, increase the size of the commitment from \$80.0 million to \$135.0 million and extend the maturity date to June 30, 2016. In April 2015, the agreement governing the BAML Line of Credit was amended to, among other things, temporarily increase the commitment size from \$135.0 million to \$185.0 million for the period April 15, 2015 to June 1, 2015. The stated interest rate on the BAML Line of Credit is LIBOR Daily Floating Rate plus 1.60%. 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 and nine months ended September 30, 2015, the Company incurred a non-utilization fee of \$18 thousand and \$50 thousand, respectively. For the three and nine months ended September 30, 2014, the Company incurred a non-utilization fee of \$15 thousand and \$58 thousand, respectively.

2015 Convertible Notes

On December 19, 2012, the Company issued \$69.0 million aggregate principal amount of the 2015 Convertible Notes. Of this aggregate principal amount, \$60.5 million aggregate principal amount of the 2015 Convertible Notes was sold to the initial purchasers (including \$9.0 million pursuant to the initial purchasers' exercise in full of their over-allotment option) and \$8.5 million aggregate principal amount of the 2015 Convertible Notes was sold directly to certain directors, officers and affiliates of the Company in a private placement.

The 2015 Convertible Notes bear interest at a rate of 7.00% per year, payable semiannually in arrears on June 15 and December 15 of each year, beginning on June 15, 2013. The estimated effective interest rate of the 2015 Convertible Notes,

Table of Contents

which is 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 and nine months ended September 30, 2015 and 2014. For the three and nine months ended September 30, 2015, the interest expense incurred on this indebtedness was \$1.6 million and \$4.8 million, respectively. For the three and nine months ended September 30, 2014, the interest expense incurred on this indebtedness was \$1.6 million and \$4.7 million, respectively. The 2015 Convertible Notes will mature on December 15, 2015, unless previously converted or repurchased in accordance with their terms.

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 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 (i) the loan does not meet specific underwriting criteria, (ii) the loan is defaulted within twelve (12) months after it is purchased by Fannie Mae, or (iii) 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

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

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 September 30, 2015 and December 31, 2014, the preliminary estimate of the portion of such contributions towards such losses relating to the allowance for loss sharing of ACRE Capital is \$387 thousand and \$494 thousand, respectively, 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

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

Table of Contents

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 nine months ended September 30, 2015 and 2014 is as follows (\$ in thousands):

Balance at December 31, 2014	\$	12,349
Current period provision for loss sharing		(1,109)
Settlements/Writeoffs		(2,287)
Balance at September 30, 2015	\$	8,953
Balance at December 31, 2013	\$	16,480
Current period provision for loss sharing		(1,346)
Settlements/Writeoffs		(1,812)
Balance at September 30, 2014	\$	13,322

As of September 30, 2015 and December 31, 2014, 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 \$3.2 billion. Additionally, as of September 30, 2015 and December 31, 2014, the non-at risk pool was \$912 thousand and \$2.0 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 September 30, 2015 and December 31, 2014, 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	
	September 30, 2015	December 31, 2014
Total commitments	\$ 1,310,459	\$ 1,565,117
Less: funded commitments	(1,193,903)	(1,395,281)
Total unfunded commitments	\$ 116,556	\$ 169,836

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. As of September 30, 2015 and December 31, 2014, ACRE Capital had the following commitments to sell and fund loans (\$ in thousands):

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

	As of	
	September 30, 2015	December 31, 2014
Commitments to sell loans	\$ 207,111	\$ 249,803
Commitments to fund loans	\$ 118,517	\$ 51,109

Occasionally for both ACRE and ACRE Capital, the commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements.

The Company from time to time may be party to litigation relating to claims arising in the normal course of business. As of September 30, 2015, the Company is not aware of any legal claims that could materially impact its business, financial condition or results of operations.

Table of Contents

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 September 30, 2015, the Company entered into 20 loan commitments and 20 forward sale commitments. For the nine months ended September 30, 2015, the Company entered into 67 loan commitments and 67 forward sale commitments. For the three months ended September 30, 2014, the Company entered into 11 loan commitments and 11 forward sale commitments. For the nine months ended September 30, 2014, the Company entered into 21 loan commitments and 21 forward sale commitments.

As of September 30, 2015, the Company had nine loan commitments with a total notional amount of \$118.5 million and 13 forward sale commitments with a total notional amount of \$207.1 million, with maturities ranging from 29 days to 24 months that were not designated as hedges in qualifying hedging relationships. As of December 31, 2014, the Company had one loan commitment with a total notional amount of \$51.1 million and ten forward sale commitments with a total notional amount of \$249.8 million, with maturities ranging from nine days to 23 months that were not designated as hedges in qualifying hedging relationships.

MSR purchase commitments

In March 2015, ACRE Capital entered into a MSR purchase agreement with a third party to purchase the servicing rights for a HUD loan. Under the purchase agreement, the purchase price for the servicing rights was \$500 thousand and ACRE Capital is expected to assume the rights to service the loan in October 2015. In July 2015, ACRE Capital entered into a second purchase agreement with a third party to purchase the servicing rights for a HUD loan. Under the second purchase agreement, the purchase price for the servicing rights was \$325 thousand and ACRE Capital is expected to assume the rights to service the loan in February 2016. The derivative assets associated with the rights to service these loans are included within other assets in the consolidated balance sheets as of September 30, 2015.

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

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 September 30, 2015 and December 31, 2014 (\$ in thousands):

	September 30, 2015		As of	December 31, 2014	
	Balance Sheet Location	Fair Value		Balance Sheet Location	Fair Value
Derivatives not designated as hedging instruments					
Loan commitments	Other assets	\$ 8,492		Other assets	\$ 3,082
Forward sale commitments	Other assets	-		Other assets	116
MSR purchase commitments	Other assets	857		Other assets	-
Forward sale commitments	Other liabilities	(4,985)		Other liabilities	(1,528)
Total derivatives not designated as hedging instruments		\$ 4,364			\$ 1,670

Table of Contents**9. EQUITY***Common Stock*

There were no shares issued in public or private offerings for the nine months ended September 30, 2015 and for the year ended December 31, 2014.

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, 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.

During the year ended December 31, 2014, an ACRE Capital employee was granted restricted stock that vests in proportion to certain financial performance targets being met over a specified period of time. The fair value of the performance based restricted stock granted is recorded to expense on an accelerated basis using the accelerated attribution method over the performance period for the award, with an offsetting increase in stockholders' equity.

The following table details the restricted stock grants awarded as of September 30, 2015:

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

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

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 September 30, 2015:

Table of Contents*Schedule of Non-Vested Share and Share Equivalents*

	Restricted Stock Grants Directors	Restricted Stock Grants Officer	Restricted Stock Grants Employees	Total
Balance as of December 31, 2014	21,324	10,936	78,654	110,914
Granted	25,555	-	-	25,555
Vested	(19,890)	(4,686)	(16,091)	(40,667)
Forfeited	(2,820)	-	-	(2,820)
Balance as of September 30, 2015	24,169	6,250	62,563	92,982

Future Anticipated Vesting Schedule

	Restricted Stock Grants Directors	Restricted Stock Grants Officer	Restricted Stock Grants Employees (1)	Total
2015	7,224	1,564	-	8,788
2016	16,111	4,686	30,381	51,178
2017	834	-	-	834
2018	-	-	-	-
2019	-	-	-	-
Total	24,169	6,250	30,381	60,800

(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 September 30, 2015, ACRC KA's total equity was \$171.6 million, of which \$87.5 million was owned by the Company and \$84.1 million was allocated to non-controlling interests held by third parties. As of December 31, 2014, ACRC KA's total equity was \$170.7 million, of which \$92.8 million was owned by the Company and \$77.9 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 and nine months ended September 30, 2015 and 2014 (\$ in thousands, except share and per share data):

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

	For the three months ended September 30,		For the nine months ended September 30,	
	2015	2014	2015	2014
Net income attributable to common stockholders:	\$ 9,379	\$ 4,102	\$ 25,408	\$ 15,496
Divided by:				
Basic weighted average shares of common stock outstanding:	28,505,729	28,464,613	28,493,989	28,453,719
Non-vested restricted stock	103,921	140,185	99,507	128,634
Diluted weighted average shares of common stock outstanding:	28,609,650	28,604,798	28,593,496	28,582,353
Basic earnings per common share:	\$ 0.33	\$ 0.14	\$ 0.89	\$ 0.54
Diluted earnings per common share:	\$ 0.33	\$ 0.14	\$ 0.89	\$ 0.54

The Company has considered the impact of the 2015 Convertible Notes and the restricted shares on diluted earnings per common share. The number of shares of common stock that the 2015 Convertible Notes are convertible into were not

Table of Contents

included in the computation of diluted net income per common share because the inclusion of those shares would have been anti-dilutive for the three and nine months ended September 30, 2015 and 2014.

11. INCOME TAX

The Company established a taxable REIT subsidiary (TRS), TRS Holdings, 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 and nine months ended September 30, 2015 and 2014 (\$ in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2015	2014	2015	2014
Current	\$ 76	\$ (817)	\$ (474)	\$ (1,279)
Deferred	1,155	(356)	1,823	(485)
Total income tax expense (benefit)	\$ 1,231	\$ (1,173)	\$ 1,349	\$ (1,764)

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 September 30, 2015 and December 31, 2014, 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 December 31, 2014, TRS Holdings had a net operating loss carryforward of \$3.9 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):

	September 30, 2015	As of	December 31, 2014
Deferred tax assets			
Mortgage servicing rights	\$ 4,967	\$	2,844
Net operating loss carryforward	1,428		1,465
Other temporary differences	1,447		1,055
Sub-total-deferred tax assets	7,842		5,364
Deferred tax liabilities			
Basis difference in assets from acquisition of ACRE Capital	(2,709)		(2,654)
Components of gains from mortgage banking activities	(8,196)		(4,046)
Amortization of intangible assets	(266)		(170)
Sub-total-deferred tax liabilities	(11,171)		(6,870)
Net deferred tax liability	\$ (3,329)	\$	(1,506)

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.

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

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 and nine months ended September 30, 2015 and 2014:

	For the three months ended September 30,		For the nine months ended September 30,	
	2015	2014	2015	2014
Federal statutory rate	35.0 %	35.0 %	35.0 %	35.0 %
State income taxes	3.6 %	2.4 %	3.6 %	2.4 %
Federal benefit of state tax deduction	(1.3)%	(0.8)%	(1.3)%	(0.8)%
Effective tax rate	37.3 %	36.6 %	37.3 %	36.6 %

Table of Contents

As of September 30, 2015, tax years 2011 through 2014 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 September 30, 2015 and December 31, 2014, the outstanding principal balance of the Intercompany Notes was \$51.9 million and \$50.9 million, respectively. 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:

- 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.

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

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 September 30, 2015 and December 31, 2014 (\$ in thousands):

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

Table of Contents

	Fair Value as of September 30, 2015			Total
	Level I	Level II	Level III	
Loans held for sale	\$ -	\$ 94,050	\$ -	\$ 94,050
Mortgage servicing rights	-	-	60,148	60,148
Derivative assets:				
Loan commitments	-	-	8,492	8,492
MSR purchase commitments	-	-	857	857
Derivative liabilities:				
Forward sale commitments	-	-	(4,985)	(4,985)

	Fair Value as of December 31, 2014			Total
	Level I	Level II	Level III	
Loans held for sale	\$ -	\$ 203,006	\$ -	\$ 203,006
Mortgage servicing rights	-	-	58,889	58,889
Derivative assets:				
Loan commitments	-	-	3,082	3,082
Forward sale commitments	-	-	116	116
Derivative liabilities:				
Forward sale commitments	-	-	(1,528)	(1,528)

There were no transfers between the levels as of September 30, 2015 and December 31, 2014. Transfers between levels are recognized based on the fair value of the financial instrument at the beginning of the period.

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 MSR and the MSR purchase commitments 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 September 30, 2015 (\$ in thousands):

Asset Category	Fair Value	Primary Valuation Technique	Unobservable Input		Weighted Average
			Input	Range	
Mortgage servicing rights	\$ 60,148	Discounted cash flow	Discount rate	8 - 14%	11.2%
Loan commitments and forward sale commitments	3,507	Discounted cash flow	Discount rate	8 - 12%	8.2%
MSR purchase commitments	857	Discounted cash flow	Discount rate	8 - 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, 2014 (\$ in thousands):

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

Asset Category	Fair Value	Primary Valuation Technique	Unobservable Input		Weighted Average
			Input	Range	
Mortgage servicing rights	\$ 58,889	Discounted cash flow	Discount rate	8 - 14%	11.4%
Loan commitments and forward sale commitments	1,670	Discounted cash flow	Discount rate	8 - 8%	8.0%

The table above is not intended to be all-inclusive, but instead is 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,

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

Table of Contents

each in isolation, may have changed the fair value of the financial instruments. Generally, an increase in market yields or discount rates or 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 nine months ended September 30, 2015 and 2014 (\$ in thousands):

Beginning balance, as of December 31, 2014	\$	1,670
Settlements		(22,537)
Realized gains (losses) recorded in net income (1)		20,867
Unrealized gains (losses) recorded in net income (1)		4,364
Ending balance, as of September 30, 2015	\$	4,364
Beginning balance, as of December 31, 2013	\$	3,527
Settlements		(7,985)
Realized gains (losses) recorded in net income (1)		4,458
Unrealized gains (losses) recorded in net income (1)		743
Ending balance, as of September 30, 2014	\$	743

(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 September 30, 2015 and December 31, 2014, the carrying values and fair values of the Company's financial assets and liabilities recorded at cost are as follows (\$ in thousands):

	Level in Fair Value Hierarchy	As of			
		September 30, 2015		December 31, 2014	
		Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:					
Loans held for investment	3	\$ 1,269,954	\$ 1,277,190	\$ 1,462,584	\$ 1,472,890
Financial liabilities:					
Secured funding agreements	2	\$ 521,676	\$ 521,676	\$ 552,799	\$ 552,799
Warehouse lines of credit	2	83,511	83,511	193,165	193,165

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

Convertible notes	2	68,863	69,000	68,395	69,000
Commercial mortgage-backed securitization debt (consolidated VIE)	3	61,856	61,856	219,043	219,043
Collateralized loan obligation securitization debt (consolidated VIE)	3	222,187	222,187	308,703	308,703

The carrying values of cash and cash equivalents, restricted cash, interest receivable, due to affiliate 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 Facilities, convertible notes, CMBS debt and collateralized loan obligation (CLO) debt are recorded at outstanding principal, which is the Company's best estimate of the fair value.

Table of Contents

13. RELATED PARTY TRANSACTIONS

Management Agreement

The Company is subject 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 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 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 and nine months ended September 30, 2015 and 2014.

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

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

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.

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

Table of Contents

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.

There was an amendment to the Management Agreement whereby ACREM agreed not to seek reimbursement of restricted costs in excess of \$1.0 million per quarter for the quarterly periods between September 30, 2013 through December 31, 2014.

Summarized below are the related party costs incurred by the Company, including ACRE Capital, for the three and nine months ended September 30, 2015 and 2014 and amounts payable to the Company's Manager as of September 30, 2015 and December 31, 2014 (\$ in thousands):

	Incurred				Payable as of			
	For the three months ended September 30,		For the nine months ended September 30,		September 30,		December 31,	
	2015	2014	2015	2014	2015	2014		
<i>Affiliate Payments</i>								
Management fees	\$ 1,490	\$ 1,475	\$ 4,447	\$ 4,445	\$ 1,490	\$ 1,471		
General and administrative expenses	953	1,000	2,959	3,000	953	1,000		
Direct costs	357	179	1,158	434	246	264		
	\$ 2,800	\$ 2,654	\$ 8,564	\$ 7,879	\$ 2,689	\$ 2,735		

Ares Investments Holdings LLC

As of September 30, 2015 and December 31, 2014, Ares Investments Holdings LLC, a wholly owned subsidiary of Ares Management, owned \$1.2 million aggregate principal amount of the 2015 Convertible Notes.

Credit Support Fee Agreement

On July 30, 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 and nine months ended September 30, 2015, the Company incurred a credit support fee of \$266 thousand and \$811 thousand, respectively, under the July 2014 CNB Facility which is included within interest expense in the Company's consolidated statements of operations. During the three and nine months ended September 30, 2014, the Company incurred a credit support fee of \$40 thousand under the July 2014 CNB Facility which is included within interest expense in the Company's consolidated statements of operations. In

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

connection with the Credit Support Fee Agreement on July 30, 2014, the Company entered into a Pledge Agreement pursuant to which the Company pledged to Ares Management its ownership interests in its wholly owned direct subsidiary, ACRC Holdings LLC, the holding entity for the Company's principal lending business. On July 21, 2015, the Company exercised a 12-month extension option to extend the maturity date of the July 2014 CNB Facility until July 31, 2016. 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 nine months ended September 30, 2015 and 2014 (\$ in thousands, except per share data):

Table of Contents

Date declared	Record date	Payment date	Per share amount	Total amount
For the nine months ended September 30, 2015				
July 30, 2015	September 30, 2015	October 15, 2015	\$ 0.25	\$ 7,152
May 7, 2015	June 30, 2015	July 15, 2015	0.25	7,152
March 5, 2015	March 31, 2015	April 15, 2015	0.25	7,146
Total cash dividends declared for the nine months ended September 30, 2015			\$ 0.75	\$ 21,450
For the nine months ended September 30, 2014				
August 6, 2014	September 30, 2014	October 15, 2014	\$ 0.25	\$ 7,151
May 7, 2014	June 30, 2014	July 16, 2014	0.25	7,151
March 17, 2014	March 31, 2014	April 16, 2014	0.25	7,147
Total cash dividends declared for the nine months ended September 30, 2014			\$ 0.75	\$ 21,449

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 it initiated and (b) the CLO transaction and the Company's retained interests in the subordinated notes and preferred equity of the issuer 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 CMBS and the CLO together are referred hereon 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 November 1, 2013 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 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 to third parties pursuant to an offering made privately in transactions exempt from the registration requirements of the Securities Act

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

of 1933. 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.

Table of Contents

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.

Summary

As the directing holder of the Securitization VIEs, the Company has the ability to direct activities that could significantly impact their economic performance. However, in those instances where an unrelated third party has the right to unilaterally remove the special servicer, the Company does 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 party to remove the special servicer without cause; however, 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.

ACRES is designated as special servicer and ACRE Capital as primary servicer of the Securitization VIEs. 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 these securitization entities are restricted and can only be used to fulfill the obligations of the entities. Additionally, the obligations of the securitization entities 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 September 30, 2015 and December 31, 2014, 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 and nine months ended September 30, 2015, the Company incurred interest expense related to the Securitization VIEs of \$1.8 million and \$6.0 million, respectively, which is included within interest expense in the Company s consolidated statements of operations. For the three and nine months ended September 30, 2014, the Company incurred interest expense related to the Securitization VIEs of \$2.3 million and \$6.4 million, respectively, which is included within interest expense in the Company s consolidated statements of operations.

Investment in VIE

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

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 are 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 September 30, 2015 and December 31, 2014, the Company owns a controlling financial interest of 51.0% and 54.3%, respectively, of the equity shares in the VIE and the third party institutional investors own the remaining 49.0% and 45.7%, respectively, 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

Table of Contents

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 September 30, 2015 and December 31, 2014, the carrying value of the preferred equity investment, which is net of unamortized fees and origination costs, was \$168.6 million and \$168.4 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 the VIE is limited to the outstanding principal of its investment in the entity. As of September 30, 2015 and December 31, 2014, the Company's maximum risk of loss solely with respect to this investment was \$86.7 million and \$92.4 million, respectively.

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 provided, any financial support for any of the Company's unconsolidated VIEs. As such, the risks associated with the Company's involvement in these VIEs are limited to the outstanding principal of the Company's investment in the entity.

The following table presents the carrying value and the maximum exposure of unconsolidated VIEs as of September 30, 2015 and December 31, 2014 (\$ in thousands):

	As of	
	September 30, 2015	December 31, 2014
Carrying value	\$ 52,827	\$ 38,982
Maximum exposure to loss	\$ 53,416	\$ 39,608

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

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 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.

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

Table of Contents

The table below presents the Company's total assets as of September 30, 2015 by business segment (\$ in thousands):

	Principal Lending	Mortgage Banking	Total
Cash and cash equivalents	\$ 5,103	\$ 5,296	\$ 10,399
Restricted cash	11,689	15,520	27,209
Loans held for investment	1,269,954	-	1,269,954
Loans held for sale, at fair value	-	94,050	94,050
Mortgage servicing rights, at fair value	-	60,148	60,148
Other assets	20,087	20,339	40,426
Total Assets	\$ 1,306,833	\$ 195,353	\$ 1,502,186

The table below presents the Company's total assets as of December 31, 2014 by business segment (\$ in thousands):

	Principal Lending	Mortgage Banking	Total
Cash and cash equivalents	\$ 15,045	\$ 1,506	\$ 16,551
Restricted cash	49,679	16,442	66,121
Loans held for investment	1,462,584	-	1,462,584
Loans held for sale, at fair value	-	203,006	203,006
Mortgage servicing rights, at fair value	-	58,889	58,889
Other assets	45,457	15,045	60,502
Total Assets	\$ 1,572,765	\$ 294,888	\$ 1,867,653

The table below presents the Company's consolidated net income for the three months ended September 30, 2015 by business segment (\$ in thousands):

Table of Contents

	Principal Lending	Mortgage Banking	Total
Net interest margin:			
Interest income from loans held for investment	\$ 20,949	\$ -	\$ 20,949
Interest expense	(8,707)	- (2)	(8,707)
Net interest margin	12,242 (1)	-	12,242
Mortgage banking revenue:			
Servicing fees, net	-	4,114 (2)	4,114
Gains from mortgage banking activities	-	9,214	9,214
Provision for loss sharing	-	118	118
Change in fair value of mortgage servicing rights	-	(1,772)	(1,772)
Mortgage banking revenue	-	11,674	11,674
Total revenue	12,242	11,674	23,916
Expenses:			
Management fees to affiliate	1,351	139	1,490
Professional fees	617	280	897
Compensation and benefits	-	5,921	5,921
General and administrative expenses	698	1,016	1,714
General and administrative expenses reimbursed to affiliate	840	113	953
Total expenses	3,506	7,469	10,975
Income from operations before income taxes	8,736	4,205	12,941
Income tax expense	3	1,228	1,231
Net income attributable to ACRE	8,733	2,977	11,710
Less: Net income attributable to non-controlling interests	(2,331)	-	(2,331)
Net income attributable to common stockholders	\$ 6,402	\$ 2,977	\$ 9,379

(1) Revenues from two of the Company's borrowers in the principal lending segment represented approximately 25.9% of the Company's consolidated revenues for the three months ended September 30, 2015.

(2) Interest expense does not include interest expense related to the Intercompany Notes, as described in Note 11. Additionally, servicing fees, net does not include servicing fee revenue related to the primary servicing of ACRE's loan portfolio by ACRE Capital, as described in Note 13. The intercompany interest expense and servicing fee revenue are eliminated in 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 income for the three months ended September 30, 2015 would have been \$1.1 million, \$4.2 million and \$2.0 million, respectively, for mortgage banking.

The table below presents the Company's consolidated net income for the three months ended September 30, 2014 by business segment (\$ in thousands):

Table of Contents

	Principal Lending	Mortgage Banking	Total
Net interest margin:			
Interest income from loans held for investment	\$ 17,967	\$ -	\$ 17,967
Interest expense	(9,615)	(2)	(9,615)
Net interest margin	8,352 (1)	-	8,352
Mortgage banking revenue:			
Servicing fees, net	-	3,868	3,868
Gains from mortgage banking activities	-	2,473	2,473
Provision for loss sharing	-	285	285
Change in fair value of mortgage servicing rights	-	(1,798)	(1,798)
Mortgage banking revenue	-	4,828	4,828
Total revenue	8,352	4,828	13,180
Expenses:			
Management fees to affiliate	1,356	119	1,475
Professional fees	454	181	635
Compensation and benefits	-	4,704	4,704
General and administrative expenses	754	1,683	2,437
General and administrative expenses reimbursed to affiliate	865	135	1,000
Total expenses	3,429	6,822	10,251
Income (loss) from operations before income taxes	4,923	(1,994)	2,929
Income tax expense (benefit)	3	(1,176)	(1,173)
Net income (loss) attributable to common stockholders	\$ 4,920	\$ (818)	\$ 4,102

(1) Revenues from one of the Company's borrowers in the principal lending segment represented approximately 20.0% of the Company's consolidated revenues for the three months ended September 30, 2014.

(2) Interest expense does not include interest expense related to the Intercompany Notes, as described in Note 11. The intercompany interest expense is eliminated in the consolidated financial statements of the Company. If intercompany interest expense were included in the consolidated financial statements, interest expense and net loss for the three months ended September 30, 2014 would have been \$936 thousand and \$1.8 million, respectively, for mortgage banking.

The table below presents the Company's consolidated net income for the nine months ended September 30, 2015 by business segment (\$ in thousands):

Table of Contents

	Principal Lending	Mortgage Banking	Total
Net interest margin:			
Interest income from loans held for investment	\$ 65,131	\$ -	\$ 65,131
Interest expense	(27,586)	(2)	(27,586)
Net interest margin	37,545 (1)	-	37,545
Mortgage banking revenue:			
Servicing fees, net	-	11,938 (2)	11,938
Gains from mortgage banking activities	-	20,847	20,847
Provision for loss sharing	-	1,109	1,109
Change in fair value of mortgage servicing rights	-	(6,955)	(6,955)
Mortgage banking revenue	-	26,939	26,939
Total revenue	37,545	26,939	64,484
Expenses:			
Management fees to affiliate	4,040	407	4,447
Professional fees	1,535	757	2,292
Compensation and benefits	-	15,992	15,992
General and administrative expenses	2,144	3,033	5,177
General and administrative expenses reimbursed to affiliate	2,591	368	2,959
Total expenses	10,310	20,557	30,867
Income from operations before income taxes	27,235	6,382	33,617
Income tax expense (benefit)	(15)	1,364	1,349
Net income attributable to ACRE	27,250	5,018	32,268
Less: Net income attributable to non-controlling interests	(6,860)	-	(6,860)
Net income attributable to common stockholders	\$ 20,390	\$ 5,018	\$ 25,408

(1) Revenues from two of the Company's borrowers in the principal lending segment represented approximately 28.6% of the Company's consolidated revenues for the nine months ended September 30, 2015.

(2) Interest expense does not include interest expense related to the Intercompany Notes, as described in Note 11. Additionally, servicing fees, net does not include servicing fee revenue related to the primary servicing of ACRE's loan portfolio by ACRE Capital, as described in Note 13. The intercompany interest expense and servicing fee revenue are eliminated in 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 income for the nine months ended September 30, 2015 would have been \$3.2 million, \$12.3 million and \$2.2 million, respectively, for mortgage banking.

Table of Contents

The table below presents the Company's consolidated net income for the nine months ended September 30, 2014 by business segment (\$ in thousands):

	Principal Lending	Mortgage Banking	Total
Net interest margin:			
Interest income from loans held for investment	\$ 50,854	\$ -	\$ 50,854
Interest expense	(24,654)	(2)	(24,654)
Net interest margin	26,200 (1)	-	26,200
Mortgage banking revenue:			
Servicing fees, net	-	12,581	12,581
Gains from mortgage banking activities	-	9,077	9,077
Provision for loss sharing	-	1,346	1,346
Change in fair value of mortgage servicing rights	-	(5,533)	(5,533)
Mortgage banking revenue	-	17,471	17,471
Gain on sale of loans	680	-	680
Total revenue	26,880	17,471	44,351
Expenses:			
Management fees to affiliate	4,092	353	4,445
Professional fees	1,902	761	2,663
Compensation and benefits	-	13,235	13,235
Acquisition and investment pursuit costs	20	-	20
General and administrative expenses	2,230	5,026	7,256
General and administrative expenses reimbursed to affiliate	2,547	453	3,000
Total expenses	10,791	19,828	30,619
Income (loss) from operations before income taxes	16,089	(2,357)	13,732
Income tax expense (benefit)	237	(2,001)	(1,764)
Net income (loss) attributable to common stockholders	\$ 15,852	\$ (356)	\$ 15,496

(1) Revenues from one of the Company's borrowers in the principal lending segment represented approximately 15.8% of the Company's consolidated revenues for the nine months ended September 30, 2014.

(2) Interest expense does not include interest expense related to the Intercompany Notes, as described in Note 11. The intercompany interest expense is eliminated in the consolidated financial statements of the Company. If intercompany interest expense were included in the consolidated financial statements, interest expense and net loss for the nine months ended September 30, 2014 would have been \$2.7 million and \$3.1 million, respectively, for mortgage banking.

17. COSTS ASSOCIATED WITH RESTRUCTURING ACTIVITIES

During the three months ended March 31, 2014, the Company began restructuring and relocating certain ACRE Capital support services in order to centralize the ACRE Capital platform into one location, including the asset management team and leadership. For the three months ended September 30, 2015, the Company did not incur any restructuring costs in the mortgage banking segment. For the nine months ended September 30, 2015, the Company incurred restructuring costs in the mortgage banking segment of \$44 thousand. For the three and nine months

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

ended September 30, 2014, the Company incurred restructuring costs in the mortgage banking segment of \$223 thousand and \$778 thousand, respectively.

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

Table of Contents

The table below presents a reconciliation of the liability attributable to restructuring costs incurred in the mortgage banking segment as of and for the nine months ended September 30, 2015 and 2014 (\$ in thousands):

		Employee Termination Costs
Beginning balance, as of December 31, 2014	\$	225
Accruals		44
Payments		(269)
Ending balance, as of September 30, 2015	\$	-
		Employee Termination Costs
Beginning balance, as of December 31, 2013	\$	-
Accruals		778
Payments		(485)
Ending balance, as of September 30, 2014	\$	293

The employee termination costs above are associated with employee severance compensation, retention bonuses and guaranteed bonuses to certain key employees, insurance and outplacement. The costs incurred above are included within general and administrative expenses in the Company's consolidated statements of operations. As of December 31, 2014, the restructuring was complete and all costs were measured; however, the Company recognized restructuring costs through the first quarter of 2015. This measurement included employee costs for employees that were required to render service (beyond a minimum retention period) in order to receive the termination benefits; the Company recognized a liability ratably over the service period.

18. 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 nine months ended September 30, 2015, except as disclosed below.

On October 21, 2015, the Company extended the maturity of the April 2014 UBS Facility to October 21, 2018, which is subject to annual extensions in UBS's sole discretion.

As of November 3, 2015, ACRE Capital had originated \$32.6 million quarter to date in Fannie Mae, Freddie Mac or HUD loan commitments.

On November 5, 2015, the Company declared a cash dividend of \$0.25 per common share for the fourth quarter of 2015. The fourth quarter 2015 dividend is payable on January 19, 2016 to common stockholders of record as of December 31, 2015.

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, 2014. 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 timing of cash flows, if any, from our investments;
- the state of the U.S. economy generally or in specific geographic regions;
- defaults by borrowers in paying debt service on outstanding items;
- actions and initiatives of the U.S. Government and changes to U.S. Government policies;
- our ability to obtain and maintain financing arrangements, including securitizations;
- 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;
- general volatility of the securities markets in which we may invest;
- the impact of a protracted decline in the liquidity of credit markets on our business;
- the uncertainty surrounding the strength of the U.S. economic recovery;
- the return or impact of current and future investments;
- allocation of investment opportunities to us by Ares Commercial Real Estate Management LLC;
- 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;
- changes in governmental regulations, tax law and rates, and similar matters (including interpretation thereof);

Table of Contents

- our ability to maintain our qualification as a real estate investment trust for U.S. federal income tax purposes (a REIT);
- our ability to maintain our exemption from registration under the Investment Company Act of 1940 (the 1940 Act), as amended;
- availability of investment opportunities in mortgage-related and real estate-related investments and securities;
- the ability of our Manager to locate suitable investments for us, monitor, service and administer our investments and execute our investment strategy;
- the ability of ACRE Capital LLC (ACRE Capital) to originate and sell mortgage loans;
- our ability to successfully complete and integrate any acquisitions;
- the impact of committed loans failing to close;
- availability of qualified personnel;
- estimates relating to our ability to make distributions to our stockholders in the future;
- our understanding of our competition;
- 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.

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, 2014 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 Ares Commercial Real Estate Management LLC (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 (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 the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), 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 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.

Table of Contents

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 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 Third Quarter of 2015

- ACRE originated and funded a \$22.1 million first mortgage loan on a multifamily property located in Arizona.
- ACRE sold a \$75.0 million senior loan collateralized by office properties in California to a third party at a sale price equal to 100% of the par value of the loan.
- ACRE Capital rate-locked \$207.5 million in loan commitments.
- Exercised a 12-month extension option on the \$75.0 million revolving funding facility (the July 2014 CNB Facility) with City National Bank, extending the maturity date of the July 2014 CNB Facility until July 31, 2016.

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

- Extended the scheduled repurchase date on the \$57.2 million global master repurchase agreement (the December 2014 UBS Facility) with UBS AG. The extended maturity date of the December 2014 UBS Facility is July 6, 2016.
- Todd Schuster resigned as Chief Executive Officer, President and Director of the Company.
- John Jardine, Vice President of the Company and Partner in Ares Management's Real Estate Group, was appointed to serve as a Director, President and Co-Chief Executive Officer of the Company. In addition, Robert L. Rosen, Director and Chairman of the Company's Board of Directors (the Board), was appointed to serve as Interim Co-Chief Executive Officer of the Company.

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**Investment Portfolio**

As of September 30, 2015, we have originated or co-originated 39 loans held for investment, excluding 21 loans that were repaid or sold since inception. Such investments are referred to herein as our investment portfolio. As of September 30, 2015, 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 nine months ended September 30, 2015, we funded approximately \$154.5 million of outstanding principal, received repayments of \$275.2 million of outstanding principal and sold a \$75.0 million loan to a third party. As of September 30, 2015, 65.4% of our loans have LIBOR floors, with a weighted average floor of 0.24%, calculated based on loans with LIBOR floors. References to LIBOR or L are to 30-day LIBOR (unless otherwise specifically stated).

As of September 30, 2015, all loans were paying in accordance with their contractual terms. During the three and nine months ended September 30, 2015, 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 September 30, 2015 (\$ in thousands):

	As of September 30, 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	\$ 984,748	\$ 989,808	4.4%	5.0%	1.5
Subordinated debt and preferred equity investments	201,919	204,095	10.7%	11.1%	6.1
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,186,667	\$ 1,193,903	5.5%	6.0%	2.3

(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 September 30, 2015 as weighted by the Outstanding Principal balance of each loan.

Non-Controlling Interests

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

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.

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

	As of September 30, 2015	
	Carrying Amount	Outstanding Principal
Total loans held for investment portfolio (excluding non-controlling interests held by third parties)	\$ 1,186,667	\$ 1,193,903
Non-controlling interest investment held by third parties	83,287	83,287
Loans held for investment	\$ 1,269,954	\$ 1,277,190

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

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

Table of Contents

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 September 30, 2015	For the nine months ended September 30, 2015
Interest income from loans held for investment, excluding non-controlling interests	\$ 18,618	\$ 58,251
Interest income from non-controlling interest investment held by third parties	2,331	6,880
Interest income from loans held for investment	\$ 20,949	\$ 65,131

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, 2014. 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 the consolidated results of operations for the three and nine months ended September 30, 2015 and 2014 (\$ in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2015 (unaudited)	2014 (unaudited)	2015 (unaudited)	2014 (unaudited)
Net interest margin:				
Interest income from loans held for investment	\$ 20,949	\$ 17,967	\$ 65,131	\$ 50,854
Interest expense	(8,707)	(9,615)	(27,586)	(24,654)
Net interest margin	12,242	8,352	37,545	26,200
Mortgage banking revenue:				
Servicing fees, net (1)	4,114	3,868	11,938	12,581
Gains from mortgage banking activities (2)	9,214	2,473	20,847	9,077
Provision for loss sharing	118	285	1,109	1,346
Change in fair value of mortgage servicing rights	(1,772)	(1,798)	(6,955)	(5,533)
Mortgage banking revenue	11,674	4,828	26,939	17,471
Gain on sale of loans	-	-	-	680
Total revenue	23,916	13,180	64,484	44,351
Expenses:				
Management fees to affiliate	1,490	1,475	4,447	4,445

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

Professional fees	897	635	2,292	2,663
Compensation and benefits	5,921	4,704	15,992	13,235
Acquisition and investment pursuit costs	-	-	-	20
General and administrative expenses	1,714	2,437	5,177	7,256
General and administrative expenses reimbursed to affiliate	953	1,000	2,959	3,000
Total expenses	10,975	10,251	30,867	30,619
Income from operations before income taxes	12,941	2,929	33,617	13,732
Income tax expense (benefit)	1,231	(1,173)	1,349	(1,764)
Net income attributable to ACRE	11,710	4,102	32,268	15,496
Less: Net income attributable to non-controlling interests	(2,331)	-	(6,860)	-
Net income attributable to common stockholders	\$ 9,379	\$ 4,102	\$ 25,408	\$ 15,496

Table of Contents

(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 MSRs 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 includes the initial fair value of MSRs, 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, the Warehouse Lines of Credit).

Comparison of Three Months Ended September 30, 2015 and 2014

Net Interest Margin

For the three months ended September 30, 2015 and 2014, net interest margin was approximately \$12.2 million and \$8.4 million, respectively. For the three months ended September 30, 2015 and 2014, interest income from loans held for investment of \$20.9 million and \$18.0 million, respectively, was generated by weighted average earning assets of \$1.2 billion, offset by \$8.7 million and \$9.6 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 Capital One Facility, the BAML Facility, the CNB Facilities, the MetLife Facility and the UBS Facilities (individually defined below, and collectively defined as the Secured Funding Agreements), securitization debt and convertible notes were \$894.7 million and \$901.1 million for the three months ended September 30, 2015 and 2014, respectively. The increase in net interest margin for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 primarily relates to the inclusion of interest income of \$2.3 million from non-controlling interests and a decrease in our weighted average borrowing costs resulting from amendments to our Secured Funding Agreements for the three months ended September 30, 2015. For the three months ended September 30, 2014, we did not have any interest income from non-controlling interests.

Mortgage Banking Revenue

For the three months ended September 30, 2015 and 2014, net servicing fees were approximately \$4.1 million and \$3.9 million, respectively. For the three months ended September 30, 2015 and 2014, net gains from mortgage banking activities were approximately \$9.2 million and \$2.5 million, respectively. The increase in mortgage banking revenue for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 primarily relates to an increase in our loan originations for the three months ended September 30, 2015. ACRE Capital rate-locked 20 loans totaling \$207.5 million in commitments for the three months ended September 30, 2015 compared to 11 loans totaling \$52.0 million in commitments for the three months ended September 30, 2014.

Operating Expenses

For the three months ended September 30, 2015 and 2014, we incurred operating expenses of \$11.0 million and \$10.3 million, respectively. The increase in operating expenses for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 primarily relates to an increase in commission expense and other performance based compensation due to an increase in our loan originations at ACRE Capital.

Related Party Expenses

Related party expenses for the three months ended September 30, 2015 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. Related party expenses for the three months ended September 30, 2014 included \$1.5 million in management fees due to our Manager and \$1.0 million for our share of allocable general and administrative expenses.

Other Expenses

Professional fees for the three months ended September 30, 2015 and 2014 were \$0.9 million and \$0.6 million, respectively. The increase in professional fees for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 primarily relates to an increase in the use of third party professionals. General and administrative expenses for the three months ended September 30, 2015 and 2014 were \$1.7 million and \$2.4 million, respectively. The

Table of Contents

decrease in general and administrative expenses for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 primarily relates to the completion of the restructuring of ACRE Capital and associated charges.

Compensation and Benefits

Compensation and benefits for the three months ended September 30, 2015 and 2014 was \$5.9 million and \$4.7 million, respectively, all of which related to ACRE Capital. The increase in compensation and benefits for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 primarily relates to an increase in commission expense and other performance based compensation due to an increase in our loan originations for the three months ended September 30, 2015 and due to the turnover and replacement of employees at ACRE Capital in connection with the restructuring and strengthening of the ACRE Capital platform.

Comparison of Nine Months Ended September 30, 2015 and 2014

Net Interest Margin

For the nine months ended September 30, 2015 and 2014, the net interest margin was approximately \$37.5 million and \$26.2 million, respectively. For the nine months ended September 30, 2015 and 2014, interest income from loans held for investment of \$65.1 million and \$50.9 million, respectively, was generated by weighted average earning assets of \$1.3 billion and \$1.1 billion, respectively, offset by \$27.6 million and \$24.7 million, respectively, of interest expense, unused fees and amortization of deferred loan costs. The weighted average borrowings under the Secured Funding Agreements, securitization debt and convertible notes were \$956.5 million and \$845.7 million for the nine months ended September 30, 2015 and 2014, respectively. The increase in net interest margin for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 primarily relates to the inclusion of interest income of \$6.9 million from non-controlling interests, an increase in our weighted average earning assets, a decrease in our weighted average borrowing costs resulting from amendments to our Secured Funding Agreements and an increase in our use of leverage for the nine months ended September 30, 2015. For the nine months ended September 30, 2014, we did not have any interest income from non-controlling interests.

Mortgage Banking Revenue

For the nine months ended September 30, 2015 and 2014, net servicing fees were approximately \$11.9 million and \$12.6 million, respectively. For the nine months ended September 30, 2015 and 2014, net gains from mortgage banking activities were approximately \$20.8 million and \$9.1 million, respectively. The increase in mortgage banking revenue for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 primarily relates to an increase in our loan originations for the nine months ended September 30, 2015. ACRE Capital rate-locked 67 loans totaling \$642.5 million in commitments for the nine months ended September 30, 2015 compared to 21 loans totaling \$183.3 million in commitments for the nine months ended September 30, 2014.

Operating Expenses

For the nine months ended September 30, 2015 and 2014, we incurred operating expenses of \$30.9 million and \$30.6 million, respectively. The increase in operating expenses for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 primarily relates to an increase in commission expense and other performance based compensation due to an increase in our loan originations at ACRE Capital. This increase was partially offset by a reduction in general and administrative expenses due to the completion of the restructuring of ACRE Capital and associated charges.

Related Party Expenses

Related party expenses for the nine months ended September 30, 2015 included \$4.4 million in management fees due to our Manager and \$3.0 million for our share of allocable general and administrative expenses for which we were required to reimburse our Manager pursuant to the Management Agreement. Related party expenses for the nine months ended September 30, 2014 included \$4.4 million in management fees due to our Manager and \$3.0 million for our share of allocable general and administrative expenses.

Other Expenses

Professional fees for the nine months ended September 30, 2015 and 2014 were \$2.3 million and \$2.7 million, respectively. The decrease in professional fees for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 primarily relates to a decrease in the use of third party professionals. Acquisition and investment

Table of Contents

pursuit costs related to the acquisition of ACRE Capital for the nine months ended September 30, 2014 was \$20 thousand. General and administrative expenses for the nine months ended September 30, 2015 and 2014 were \$5.2 million and \$7.3 million, respectively. The decrease in general and administrative expenses for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 primarily relates to the completion of the restructuring of ACRE Capital and associated charges.

Compensation and Benefits

Compensation and benefits for the nine months ended September 30, 2015 and 2014 was \$16.0 million and \$13.2 million, respectively, all of which related to ACRE Capital. The increase in compensation and benefits for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 primarily relates to an increase in commission expense and other performance based compensation due to an increase in our loan originations for the nine months ended September 30, 2015 and due to the turnover and replacement of employees at ACRE Capital in connection with the restructuring and strengthening of the ACRE Capital platform.

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 and the Warehouse Lines of Credit (collectively, the Financing Facilities), 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 security (CMBS) and collateralized loan obligation (CLO) 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. Our unsecured 7.00% Convertible Senior Notes (2015 Convertible Notes) are scheduled to mature on December 15, 2015. We believe that we will have sufficient current liquidity and access to additional liquidity to repay the aggregate principal amount of the 2015 Convertible Notes at maturity.

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 November 3, 2015. 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.

Cash Flows

The following table sets forth changes in cash and cash equivalents for the nine months ended September 30, 2015 and 2014 (\$ in thousands):

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

	For the nine months ended September 30,	
	2015	2014
Net income	\$ 32,268	\$ 15,496
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Net cash provided by (used in) operating activities	172,308	(28,596)
Net cash provided by (used in) investing activities	204,576	(13,100)
Net cash provided by (used in) financing activities	197,259	(193,594)
Change in cash and cash equivalents	(407,987)	198,042
	\$ (6,152)	\$ (8,652)

During the nine months ended September 30, 2015 and 2014, cash and cash equivalents decreased by \$6.2 million and \$8.7 million, respectively.

Table of Contents

Operating Activities

For the nine months ended September 30, 2015 and 2014, net cash provided by (used in) operating activities totaled \$204.6 million and \$(13.1) million, respectively. This change in net cash provided by (used in) operating activities was primarily related to the proceeds received from the sale of mortgage loans held for sale to third parties exceeding the cash used to originate and fund mortgage loans held for sale. For the nine months ended September 30, 2015, adjustments to net income related to operating activities primarily included originations of mortgage loans held for sale of \$575.0 million, sale of mortgage loans held for sale to third parties of \$685.1 million, change in the fair value of MSR of \$7.0 million, change in restricted cash of \$41.9 million and change in other assets of \$18.9 million. For the nine months ended September 30, 2014, adjustments to net income related to operating activities primarily included originations of mortgage loans held for sale of \$219.8 million, sale of mortgage loans held for sale to third parties of \$200.0 million, change in the fair value of MSR of \$5.5 million, change in mortgage banking activities of \$2.0 million, and change in other assets of \$12.2 million.

Investing Activities

For the nine months ended September 30, 2015 and 2014, net cash provided by (used in) investing activities totaled \$197.3 million and \$(193.6) million, respectively. This change in net cash provided by (used in) investing activities was primarily related to the cash received for the principal repayment of loans held for investment exceeding the cash used for the origination of new loans held for investment for the nine months ended September 30, 2015.

Financing Activities

For the nine months ended September 30, 2015, net cash used in financing activities totaled \$408.0 million and primarily related to repayments of our Secured Funding Agreements of \$201.6 million, repayments of debt of consolidated VIEs of \$243.7 million, and repayments of our Warehouse Lines of Credit of \$777.7 million partially offset by proceeds from our Secured Funding Agreements of \$170.5 million and proceeds from our Warehouse Lines of Credit of \$668.1 million. For the nine months ended September 30, 2014, net cash provided by financing activities totaled \$198.0 million and related primarily to proceeds from Secured Funding Agreements of \$800.0 million and proceeds from issuance of debt of consolidated VIEs of \$308.7 million, partially offset by repayments of our Secured Funding Agreements of \$722.5 million and repayments of debt of consolidated VIEs of \$176.0 million.

Summary of Financing Facilities

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

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

Table of Contents

	Total Commitment	September 30, 2015		Maturity Date	As of		December 31, 2014		Maturity Date	
		Outstanding Balance	Interest Rate		Total Commitment	Outstanding Balance	Interest Rate			
Secured funding agreements:										
Wells Fargo Facility	\$ 225,000	\$ 124,201	LIBOR+2.00 to 2.50%	December 14, 2015	(1) \$ 225,000	\$ 120,766	LIBOR+2.00 to 2.50%	December 14, 2015	(1)	
Citibank Facility	250,000	112,132	LIBOR+2.00 to 2.50%	December 8, 2016	(2) 250,000	93,432	LIBOR+2.00 to 2.50%	December 8, 2016	(2)	
Capital One Facility	-	-	-	-	(3) 100,000	-	LIBOR+2.00 to 3.50%	-	(4)	
BAML Facility March 2014	50,000	-	LIBOR+2.25 to 2.75%	May 26, 2016	(5) -	-	-	-	(6)	
CNB Facility July 2014	50,000	-	LIBOR+3.00%	March 11, 2016	(6) 50,000	42,000	LIBOR+3.00%	March 11, 2016	(6)	
CNB Facility	75,000	73,900	LIBOR+3.00%	July 31, 2016	(7) 75,000	75,000	LIBOR+3.00%	July 31, 2015	(7)	
MetLife Facility April 2014	180,000	104,756	LIBOR+2.35%	August 12, 2017	(8) 180,000	144,673	LIBOR+2.35%	August 12, 2017	(8)	
UBS Facility December 2014	140,000	49,444	LIBOR+1.88%	April 7, 2017	(9) 140,000	19,685	LIBOR+1.88%	April 7, 2017	(9)	
UBS Facility	57,243	57,243	LIBOR+2.74%	July 6, 2016	(10) 57,243	57,243	LIBOR+2.74%	January 6, 2016		
Total	\$ 1,027,243	\$ 521,676			\$ 1,077,243	\$ 552,799				
Warehouse lines of credit:										
ASAP Line of Credit	\$ 80,000 (11)	\$ 17,550	LIBOR+1.40 to 1.75%	No expiration	\$ 80,000 (11)	\$ 58,469	LIBOR+1.40 to 1.75%	No expiration		
BAML Line of Credit	135,000 (12)	65,961	LIBOR+1.60%	June 30, 2016	(12) 180,000	134,696	LIBOR+1.60%	April 15, 2015		
Total	\$ 215,000	\$ 83,511			\$ 260,000	\$ 193,165				

(1) The master repurchase funding facility arranged by Wells Fargo, National Association (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.

(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) The secured revolving funding facility with Capital One, National Association (as amended, the Capital One Facility) matured on May 18, 2015. The Capital One Facility had been repaid in full and its term was not extended.

(4) The maturity date of each individual loan is the same as the maturity date of the underlying loan that secures such individual loan.

(5) We may request individual loans under the Bridge Loan Warehousing Credit and Security Agreement with Bank of America, N.A. (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.

(6) The secured revolving facility with City National Bank (the March 2014 CNB Facility) is subject to one 12-month extension at our option provided that certain conditions are met and applicable extension fees are paid.

(7) During the three months ended September 30, 2015, we exercised a 12-month extension option on the July 2014 CNB Facility (together with the March 2014 CNB Facility, the CNB Facilities) which extended the maturity date to July 31, 2016. The July 2014 CNB Facility's interest rate of LIBOR + 3.00% is comprised of LIBOR + 1.50% and a credit support fee of 1.50% payable to Ares Management.

(8) 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.

(9) The revolving master repurchase facility with UBS Real Estate Securities, Inc (the April 2014 UBS Facility) is subject to annual 12-month extensions at the discretion of the lender, provided that certain conditions are met and applicable extension fees are paid. See Note 18 to our consolidated financial statements included in this quarterly report on Form 10-Q for information on a subsequent event relating to the April 2014 UBS Facility.

(10) During the three months ended September 30, 2015, the maturity date on the December 2014 UBS Facility (together with the April 2014 UBS Facility, the UBS Facilities) was extended to July 6, 2016.

Table of Contents

(11) 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.

(12) During the three months ended December 31, 2014, the BAML Line of Credit's commitment size temporarily increased from \$80.0 million to \$180.0 million for the period November 25, 2014 through January 26, 2015. During the nine months ended September 30, 2015, the BAML Line of Credit's commitment size increased from \$80.0 million to \$135.0 million and the maturity date was extended to June 30, 2016. In addition, the BAML Line of Credit's commitment size temporarily increased from \$135.0 million to \$185.0 million for the period April 15, 2015 to June 1, 2015.

Our Financing Facilities contain various affirmative and negative covenants. As of September 30, 2015, we are in compliance in all material respects with the terms of each respective Financing Facility. See Note 5 to our consolidated financial statements included in this quarterly report on Form 10-Q for more information on our Financing Facilities.

During the three months ended September 30, 2015, the following activities occurred with respect to our sources of financing:

July 2014 CNB Facility

On July 21, 2015, the Company exercised a 12-month extension option on the July 2014 CNB Facility. The extended maturity date of the July 2014 CNB Facility is July 31, 2016.

December 2014 UBS Facility

On August 6, 2015, the Company extended the scheduled repurchase date of the purchased securities under the December 2014 UBS Facility. The extended maturity date of the December 2014 UBS Facility is July 6, 2016.

Commercial Mortgage-Backed Securities and Collateralized Loan Obligations

We may seek to enhance the returns on our senior commercial 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.

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

The following table summarizes our securitized debt as of September 30, 2015 and December 31, 2014 (\$ in thousands):

	September 30, 2015	As of	December 31, 2014
Commercial mortgage-backed securitization debt (consolidated VIE)	\$ 61,856	\$	219,043
Collateralized loan obligation securitization debt (consolidated VIE)	222,187		308,703
Securitized debt	\$ 284,043	\$	527,746

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.

Table of Contents

Other Sources of Financing

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 Facilities, 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 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. 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 Facilities 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 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

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

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 October 21, 2015, we extended the maturity of the April 2014 UBS Facility to October 21, 2018, which is subject to annual extensions in UBS' sole discretion.

Table of Contents

As of November 3, 2015, ACRE Capital had originated \$32.6 million quarter to date in Fannie Mae, Freddie Mac or HUD loan commitments.

As of November 3, 2015, the Company had approximately \$70 million in capital, either in cash or in approved but undrawn capacity under the Company's secured funding agreements.

As of November 3, 2015, the total unfunded commitments for our existing loans held for investment were approximately \$106 million. In addition, borrowings under our Financing Facilities were approximately \$481 million (excluding Warehouse Lines of Credit in connection with our Mortgage Banking segment), debt issued in the form of CMBS was approximately \$62 million, debt issued in the form of CLOs was approximately \$221 million and debt issued in the form of convertible senior notes was approximately \$69 million.

On November 5, 2015, we declared a cash dividend of \$0.25 per common share for the fourth quarter of 2015. The fourth quarter 2015 dividend is payable on January 19, 2016 to common stockholders of record as of December 31, 2015.

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 and inflation 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 ACRE Capital's servicer and our Manager's servicer, which is a Standard & Poor's-rated commercial special servicer that is included on Standard & Poor's Select Servicer List and through ACRE Capital LLC as primary servicer. 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

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

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

Table of Contents

Facilities. 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 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.

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 and nine months ended September 30, 2015, the following fluctuations in the average 30-day LIBOR would have had the following impact on our net interest margin on our loans held for investment (\$ in millions):

Change in Average 30-Day LIBOR	Increase in Net Interest Margin	
	For the three months ended September 30, 2015	For the nine months ended September 30, 2015
Up 300 basis points	\$2.0	\$5.6
Up 200 basis points	\$1.3	\$3.5
Up 100 basis points	\$0.6	\$1.5
Down to 0 basis points	\$0.2	\$0.8

The severity of any such decline 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.

Table of Contents

Market Risk

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 our MSR 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 MSR by approximately \$1.9 million and \$1.8 million as of September 30, 2015 and December 31, 2014, respectively.

Prepayment Risk

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

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; 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

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

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Co-Chief Executive Officers and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15 of the Exchange Act). Based on that evaluation, our Co-Chief Executive Officers and our Chief Financial Officer have concluded that our disclosure controls and procedures as of September 30, 2015 are effective in timely alerting them of material information relating to us that is required to be disclosed by us in the reports we file or submit under the Exchange Act. During the three months ended September 30, 2015, there 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 September 30, 2015, we were not subject to any material pending legal proceedings.

Table of Contents

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, 2014. 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, 2014, 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.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Stock Buyback Program

In May 2015, we announced that the Board of Directors authorized us to repurchase up to \$20 million of our outstanding common stock over a period of one year. Purchases made pursuant to the 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. We did not repurchase any shares of our common stock during the three months ended September 30, 2015.

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

Exhibit Number	Exhibit Description
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. (1)
4.1*	Indenture dated as of December 19, 2012, between Ares Commercial Real Estate Corporation and U.S. Bank National Association, as Trustee. (2)
4.2*	Form of 7.000% Convertible Senior Note Due 2015 (included as part of Exhibit 4.1). (2)
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 and 3.2, as applicable, to the Company's Form S-8 (File No. 333-181077), filed on May 1, 2012.

(2) Incorporated by reference to Exhibits 4.1 and 4.2, as applicable, to the Company's Form 8-K (File No. 001-35517), filed on December 19, 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: November 5, 2015	By	/s/ John Jardine John Jardine Co-Chief Executive Officer (Principal Executive Officer)
Date: November 5, 2015	By	/s/ Robert L. Rosen Robert L. Rosen Interim Co-Chief Executive Officer (Principal Executive Officer)
Date: November 5, 2015	By	/s/ Tae-Sik Yoon Tae-Sik Yoon Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)