

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

Ares Commercial Real Estate Corp
Form 10-Q
October 30, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2018

OR

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

For the transition period from _____ to _____

Commission File No. 001-35517

ARES COMMERCIAL REAL ESTATE CORPORATION

(Exact name of Registrant as specified in its charter)

Maryland 45-3148087

(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification Number)

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

(Address of principal executive offices) (Zip Code)

(212) 750-7300

(Registrant's telephone number, including area code)

N/A

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act.

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.

Class	Outstanding at October 26, 2018
Common stock, \$0.01 par value	28,698,600

ARES COMMERCIAL REAL ESTATE CORPORATION

INDEX

Part I. Financial Information

Item 1. Consolidated Financial Statements

Consolidated Balance Sheets as of September 30, 2018 (unaudited) and December 31, 2017 2

Consolidated Statements of Operations for the three and nine months ended September 30, 2018 and 2017 (unaudited) 3

Consolidated Statement of Stockholders' Equity for the nine months ended September 30, 2018 (unaudited) 4

Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and 2017 (unaudited) 5

Notes to Consolidated Financial Statements (unaudited) 6

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations 25

Item 3. Quantitative and Qualitative Disclosures About Market Risk 34

Item 4. Controls and Procedures 36

Part II. Other Information

Item 1. Legal Proceedings 36

Item 1A. Risk Factors 37

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds 37

Item 3. Defaults Upon Senior Securities 37

Item 4. Mine Safety Disclosures 37

Item 5. Other Information 37

Item 6. Exhibits 38

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)

	As of	
	September 30, 2018	December 31, 2017
	(unaudited)	
ASSETS		
Cash and cash equivalents	\$5,034	\$28,343
Restricted cash	379	379
Loans held for investment (\$286,265 and \$341,158 related to consolidated VIEs, respectively)	1,658,862	1,726,283
Other assets (\$750 and \$945 of interest receivable related to consolidated VIEs, respectively; \$54,893 of other receivables related to consolidated VIEs as of September 30, 2018)	67,237	15,214
Total assets	\$1,731,512	\$1,770,219
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Secured funding agreements	\$912,410	\$957,960
Secured term loan	108,151	107,595
Collateralized loan obligation securitization debt (consolidated VIE)	271,335	271,211
Due to affiliate	2,512	2,628
Dividends payable	8,323	7,722
Other liabilities (\$480 and \$414 of interest payable related to consolidated VIEs, respectively)	4,623	3,933
Total liabilities	1,307,354	1,351,049
Commitments and contingencies (Note 5)		
STOCKHOLDERS' EQUITY		
Common stock, par value \$0.01 per share, 450,000,000 shares authorized at September 30, 2018 and December 31, 2017, and 28,698,600 and 28,598,916 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	283	283
Additional paid-in capital	421,415	420,637
Accumulated earnings (deficit)	2,460	(1,750)
Total stockholders' equity	424,158	419,170
Total liabilities and stockholders' equity	\$1,731,512	\$1,770,219

See accompanying notes to consolidated financial statements.

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, 2018		For the nine months ended September 30, 2018	
	2017	2018	2017	2018
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net interest margin:				
Interest income from loans held for investment	\$30,362	\$28,551	\$87,401	\$72,321
Interest expense	(16,378)	(13,825)	(46,645)	(36,845)
Net interest margin	13,984	14,726	40,756	35,476
Expenses:				
Management and incentive fees to affiliate	1,571	1,554	5,302	5,020
Professional fees	498	350	1,435	1,169
General and administrative expenses	852	724	2,415	2,006
General and administrative expenses reimbursed to affiliate	870	986	2,624	2,883
Total expenses	3,791	3,614	11,776	11,078
Income before income taxes	10,193	11,112	28,980	24,398
Income tax expense, including excise tax	236	54	403	149
Net income attributable to ACRE	9,957	11,058	28,577	24,249
Less: Net income attributable to non-controlling interests	—	—	—	(25)
Net income attributable to common stockholders	\$9,957	\$11,058	\$28,577	\$24,224
Earnings per common share:				
Basic and diluted earnings per common share	\$0.35	\$0.39	\$1.00	\$0.85
Weighted average number of common shares outstanding:				
Basic weighted average shares of common stock outstanding	28,542,822	28,481,298	28,521,317	28,475,369
Diluted weighted average shares of common stock outstanding	28,698,600	28,582,690	28,638,973	28,537,723
Dividends declared per share of common stock	\$0.29	\$0.27	\$0.85	\$0.81

See accompanying notes to consolidated financial statements.

ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES
 CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(in thousands, except share and per share data)

(unaudited)

	Common Stock		Additional	Accumulated	Total
	Shares	Amount	Paid-in Capital	Earnings (Deficit)	Stockholders' Equity
Balance at December 31, 2017	28,598,916	\$ 283	\$ 420,637	\$ (1,750)	\$ 419,170
Stock based compensation	99,684	—	778	—	778
Net income	—	—	—	28,577	28,577
Dividends declared	—	—	—	(24,367)	(24,367)
Balance at September 30, 2018	28,698,600	\$ 283	\$ 421,415	\$ 2,460	\$ 424,158

See accompanying notes to consolidated financial statements.

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

	For the nine months ended September 30,	
	2018	2017
	(unaudited)	(unaudited)
Operating activities:		
Net income	\$28,577	\$ 24,249
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of deferred financing costs	4,317	5,596
Accretion of deferred loan origination fees and costs	(5,542)	(4,893)
Stock-based compensation	778	372
Changes in operating assets and liabilities:		
Other assets	(197)	(1,988)
Due to affiliate	(116)	(132)
Other liabilities	471	692
Net cash provided by (used in) operating activities	28,288	23,896
Investing activities:		
Issuance of and fundings on loans held for investment	(366,839)	(504,554)
Principal repayment of loans held for investment	381,477	273,985
Receipt of origination fees	4,004	6,138
Net cash provided by (used in) investing activities	18,642	(224,431)
Financing activities:		
Proceeds from secured funding agreements	465,696	533,880
Repayments of secured funding agreements	(511,246)	(584,365)
Payment of secured funding costs	(924)	(7,445)
Proceeds from issuance of debt of consolidated VIEs	—	272,927
Dividends paid	(23,765)	(22,814)
Contributions from non-controlling interests	—	12
Distributions to non-controlling interests	—	(10,681)
Net cash provided by (used in) financing activities	(70,239)	181,514
Change in cash, cash equivalents and restricted cash	(23,309)	(19,021)
Cash, cash equivalents and restricted cash, beginning of period	28,722	47,645
Cash, cash equivalents and restricted cash, end of period	\$5,413	\$ 28,624

See accompanying notes to consolidated financial statements.

ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As of September 30, 2018

(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 primarily engaged in originating and investing in commercial real estate loans and related investments. 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” or “Ares”), 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”).

The Company is primarily focused on directly originating and managing a diversified portfolio of CRE debt-related investments for the Company’s own account. The Company’s target investments include senior mortgage loans, subordinated debt, preferred equity, mezzanine loans and other CRE investments, including commercial mortgage backed securities. These investments are generally held for investment and are secured, directly or indirectly, by office, multifamily, retail, industrial, lodging, senior-living, self storage, student housing and other commercial real estate properties, or by ownership interests therein.

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 (the “Code”), 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, and Amendment No. 1 thereto on Form 10-K/A for the fiscal year ended December 31, 2017 (collectively, the “Company’s Annual Report on Form 10-K”) filed with the SEC.

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

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

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

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, 2018.

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 12 included in these consolidated financial statements for further discussion of the Company's VIEs.

Cash, Cash Equivalents and Restricted Cash

Cash and cash equivalents include funds on deposit with financial institutions, including demand deposits with financial institutions. Cash and short term investments with an original maturity of three months or less when acquired are considered cash and cash equivalents for the purpose of the consolidated balance sheets and statements of cash flows.

Restricted cash includes deposits required under certain Secured Funding Agreements (each individually defined in Note 4 included in these consolidated financial statements).

The following table provides a reconciliation of cash, cash equivalents and restricted cash in the consolidated balance sheets to the total amount shown in the consolidated statements of cash flows (\$ in thousands):

	As of	
	September 30,	September 30,
	2018	2017
Cash and cash equivalents	\$5,034	\$ 28,245
Restricted cash	379	379
Total cash, cash equivalents and restricted cash shown in the Company's consolidated statements of cash flows	\$5,413	\$ 28,624

7

Loans Held for Investment

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

Each loan classified as held for investment is evaluated for impairment on a quarterly basis. Loans are generally 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, 2018 and December 31, 2017, the Company did not recognize any impairment charges with respect to its loans held for investment.

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

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

Debt Issuance Costs

Debt issuance costs under the Company's indebtedness are capitalized and amortized over the term of the respective debt instrument. Unamortized debt issuance costs are expensed when the associated debt is repaid prior to maturity. Debt issuance costs related to debt securitizations are capitalized and amortized over the term of the underlying loans using the effective interest method. When an underlying loan is prepaid in a debt securitization and the outstanding

principal balance of the securitization debt is reduced, the related unamortized debt issuance costs are charged to expense based on a pro rata share of the debt issuance costs being allocated to the specific loans that were prepaid. Amortization of debt issuance costs is included within interest expense in the Company's consolidated statements of operations while the unamortized balance on (i) Secured Funding Agreements (each individually defined in Note 4 included in these consolidated financial statements) is included within other assets and (ii) the Secured Term Loan (defined in Note 4 included in these consolidated financial statements) and debt securitizations are both included as a reduction to the carrying amount of the liability, in the Company's consolidated balance sheets.

The original issue discount ("OID") on amounts drawn under the Company's Secured Term Loan represents a discount to the face amount of the drawn debt obligations. The OID is amortized over the term of the Secured Term Loan using the effective interest method and is included within interest expense in the Company's consolidated statements of operations while the unamortized balance is included as a reduction to the carrying amount of the Secured Term Loan in the Company's consolidated balance sheets.

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 for the three and nine months ended September 30, 2018 and 2017 is as follows (\$ in thousands):

	For the three months ended September 30, 2018		For the nine months ended September 30, 2017	
Interest income from loans held for investment, excluding non-controlling interests	\$ 30,362	\$ 28,551	\$ 87,401	\$ 72,286
Interest income from non-controlling interest investment held by third parties	—	—	—	35
Interest income from loans held for investment	\$ 30,362	\$ 28,551	\$ 87,401	\$ 72,321

Net Interest Margin and Interest Expense

Net interest margin in the Company's consolidated statements of operations serves to measure the performance of the Company'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 expense related to its Secured Funding Agreements, securitizations debt and the Secured Term Loan (individually defined in Note 4 included in these consolidated financial statements) in net interest margin. For the three and nine months ended September 30, 2018 and 2017, interest expense is comprised of the following (\$ in thousands):

	For the three months ended September 30, 2018		For the nine months ended September 30, 2017	
Secured funding agreements and securitizations debt	\$ 14,200	\$ 10,312	\$ 40,361	\$ 26,635
Secured term loan	2,178	3,513	6,284	10,210
Interest expense	\$ 16,378	\$ 13,825	\$ 46,645	\$ 36,845

Comprehensive Income

For the three and nine months ended September 30, 2018 and 2017, comprehensive income equaled net income; therefore, a separate consolidated statement of comprehensive income is not included in the accompanying consolidated financial statements.

Recent Accounting Pronouncements

In June 2016, the FASB issued Accounting Standards Update ("ASU") No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The standard will replace the incurred loss impairment methodology pursuant to GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. ASU No. 2016-13 is effective for annual reporting periods beginning after December 15, 2019, including interim periods within that reporting period, with early adoption permitted after December 15, 2018, including interim periods within that reporting period. The Company is currently evaluating the impact of adopting this ASU on its consolidated financial statements.

SEC Disclosure Update and Simplification

In August 2018, the SEC adopted the final rule under SEC Release No. 33-10532, Disclosure Update and Simplification, amending certain disclosure requirements that were redundant, duplicative, overlapping, outdated or superseded. In addition, the amendments expanded the disclosure requirements on the analysis of stockholders' equity for interim financial statements. Under the amendments, an analysis of changes in each caption of stockholders' equity and noncontrolling interests

9

presented in the balance sheet must be provided in a note or separate statement. The analysis should present a reconciliation of the beginning balance to the ending balance of each period for which a statement of comprehensive income is required to be filed. The Company plans to use the new presentation of consolidated statement of stockholders' equity beginning in 2019. The final rule is effective on November 5, 2018.

3. LOANS HELD FOR INVESTMENT

As of September 30, 2018, the Company's portfolio included 44 loans held for investment, excluding 69 loans that were repaid or sold since inception. The aggregate originated commitment under these loans at closing was approximately \$1.9 billion and outstanding principal was \$1.7 billion as of September 30, 2018. During the nine months ended September 30, 2018, the Company funded approximately \$367.4 million of outstanding principal and received repayments of \$436.4 million of outstanding principal, 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, 2018, 90.4% of the Company's loans have London Interbank Offered Rate ("LIBOR") floors, with a weighted average floor of 1.11%, 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 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, 2018 and December 31, 2017 (\$ in thousands):

	As of September 30, 2018						
	Carrying Amount (1)	Outstanding Principal (1)	Weighted Average Minimum Loan Borrowing Spread (2)	Weighted Average Unleveraged Effective Yield (3)	Weighted Average Remaining Life (Years)		
Senior mortgage loans	\$1,636,884	\$1,645,387	5.1 %	6.8 %	1.6		
Subordinated debt and preferred equity investments	21,978	22,937	12.0 %	13.4 %	5.8		
Total loans held for investment portfolio	\$1,658,862	\$1,668,324	5.2 %	6.9 %	1.7		
	As of December 31, 2017						
	Carrying Amount (1)	Outstanding Principal (1)	Weighted Average Minimum Loan Borrowing Spread (2)	Weighted Average Unleveraged Effective Yield (3)	Weighted Average Remaining Life (Years)		
Senior mortgage loans	\$1,674,169	\$1,684,439	4.8 %	6.2 %	1.9		
Subordinated debt and preferred equity investments	52,114	52,847	9.5 %	10.8 %	3.4		
Total loans held for investment portfolio	\$1,726,283	\$1,737,286	5.0 %	6.3 %	2.0		

(1)

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

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.

Minimum Loan Borrowing Spread is equal to (a) for floating rate loans, the margin above the applicable index rate (2) (e.g., LIBOR) plus floors, if any, on such applicable index rates, and (b) for fixed rate loans, the applicable interest rate.

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, premiums or discounts) (3) 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, 2018 and December 31, 2017 as weighted by the Outstanding Principal balance of each loan.

A more detailed listing of the Company's investment portfolio based on information available as of September 30, 2018 is as follows (\$ in millions, except percentages):

10

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

Loan Type	Location	Outstanding Principal (1)	Carrying Amount (1)	Interest Rate	Unleveraged Effective Yield (2)	Maturity Date (3)	Payment Terms (4)
Senior Mortgage Loans:							
Self Storage	(5)Diversified	\$116.7	\$116.7	L+4.35%	7.4%	Oct 2018	I/O
Multifamily	FL	89.7	89.5	L+4.75%	7.6%	Sep 2019	I/O
Various	(6)Diversified	82.3	82.3	L+4.75%	7.7%	Oct 2018	I/O
Hotel	Diversified	68.0	67.3	L+3.60%	6.3%	Sep 2021	I/O
Office	TX	67.2	66.7	L+3.60%	6.4%	July 2020	I/O
Multifamily	UT	63.3	63.0	L+3.25%	5.8%	Dec 2020	I/O
Hotel	OR/WA	62.4	61.8	L+3.45%	6.2%	May 2021	I/O
Office	IL	60.4	59.9	L+3.75%	6.6%	Dec 2020	I/O
Office	IL	59.9	59.7	L+3.99%	6.7%	Aug 2019	I/O
Office	IL	54.1	53.8	L+3.95%	6.6%	June 2021	I/O
Office	NJ	53.1	52.7	L+4.65%	7.5%	July 2020	I/O
Industrial	MN	51.6	51.2	L+3.15%	5.9%	Dec 2020	I/O
Mixed-use	CA	49.0	48.7	L+4.00%	6.7%	Apr 2021	I/O
Multifamily	FL	45.4	45.3	L+4.75%	7.6%	Sep 2019	I/O
Multifamily	TX	42.7	42.5	L+3.30%	5.9%	Dec 2020	I/O
Student Housing	CA	41.8	41.5	L+3.95%	6.8%	July 2020	I/O
Student Housing	TX	40.6	40.3	L+4.75%	7.6%	Jan 2021	I/O
Hotel	CA	40.0	39.7	L+4.12%	6.7%	Jan 2021	I/O
Multifamily	SC	38.9	38.7	L+3.36%	6.1%	May 2021	I/O
Student Housing	NC	38.7	38.6	L+4.00%	7.3%	Feb 2019	I/O
Hotel	NY	38.6	38.6	L+4.75%	7.0%	Dec 2018(7)	I/O
Hotel	MI	35.2	35.2	L+4.15%	6.4%	July 2019(8)	I/O
Hotel	MN	31.5	31.2	L+3.55%	6.2%	Aug 2021	I/O
Multifamily	NY	30.1	29.9	L+3.20%	5.8%	Dec 2020	I/O
Multifamily	NY	29.5	29.5	L+3.75%	6.3%	Oct 2018	P/I (9)
Multifamily	TX	27.5	27.4	L+3.20%	6.0%	Oct 2020	I/O
Industrial	OH	27.3	27.2	L+4.20%	6.7%	May 2019	(10)P/I (9)
Office	CO	26.7	26.5	L+4.15%	6.9%	June 2021	I/O
Multifamily	CA	26.4	26.3	L+3.85%	6.6%	July 2020	I/O
Student Housing	AL	24.1	24.0	L+4.45%	7.3%	Feb 2020	I/O
Student Housing	TX	24.0	23.8	L+4.10%	6.9%	Jan 2021	I/O
Multifamily	CA	23.0	22.9	L+3.90%	6.5%	Mar 2021	I/O
Hotel	IL	19.7	19.4	L+4.40%	7.3%	May 2021	I/O

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

Office	PA	19.6	19.5	L+4.70%	7.5%	Mar 2020	I/O	
Multifamily	CA	19.1	18.9	L+3.30%	5.9%	Feb 2021	I/O	
Multifamily	FL	19.0	18.9	L+4.00%	6.6%	Nov 2020	I/O	
Office	FL	18.4	18.3	L+4.30%	7.1%	Apr 2020	I/O	
Multifamily	NY	16.3	16.3	L+4.35%	6.9%	Nov 2018	I/O	
Multifamily	CA	15.0	14.9	L+3.80%	6.5%	July 2020	I/O	
Residential	CA	8.6	8.3	12.00%	14.8%	Feb 2020	I/O	
Subordinated Debt and Preferred								
Equity Investments:								
Office	NJ	17.0	16.4	12.00%	12.8%	Jan 2026	I/O	(9)
Residential	HI	3.3	3.2	14.00%	18.6%	Apr 2019	I/O	
Office	CA	2.6	2.6	L+8.25%	10.6%	Nov 2021	I/O	
Mixed-use	IL	—	(0.2)	L+12.25%	—	Nov 2021	I/O	
Total/Weighted Average		\$1,668.3	\$1,658.9		6.9%			

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. For the loans (1) held for investment that represent co-investments with other investment vehicles managed by Ares Management (See Note 10 included in these consolidated financial statements for additional information on co-investments), only the portion of Carrying Amount and Outstanding Principal held by the Company is reflected.

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, premiums or discounts) and assumes no dispositions, early prepayments or defaults. Unleveraged Effective Yield for each loan is (2) calculated based on LIBOR as of September 30, 2018 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, 2018 as weighted by the Outstanding Principal balance of each loan.

Certain loans are subject to contractual extension options that generally 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 (3) 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 and amend other terms of the loans in connection with loan modifications.

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

Prior to December 2017, the \$116.7 million senior mortgage loan collateralized by a portfolio of self storage properties was in payment default due to the failure of the borrower to repay an amount equal to \$42.5 million with respect to the retail and office properties (which included \$37.0 million of allocated loan amount and \$5.5 million of release premium). This payment amount was due in September 2017, which was prior to the initial maturity date of the loan in October 2018. In December 2017, the borrower repaid \$25.1 million with respect to the office property (which included \$21.8 million of allocated loan amount and \$3.3 million of release premium). In (5) conjunction with the repayment with respect to the office property, the senior mortgage loan was modified to, among other things, waive the payment default on the loan and extend the repayment obligation with respect to the retail property to January 2018. On January 31, 2018, the Company received a repayment of outstanding principal of \$17.4 million (which included \$15.1 million of allocated loan amount and \$2.3 million of release premium). The principal repayments related to the retail and office properties resulted in the release of the retail and office properties from the collateral pool. Subsequent to the principal repayments, the outstanding principal balance of the senior mortgage loan was \$116.7 million and was collateralized by a portfolio of self storage properties. See Note 13 included in these consolidated financial statements for a subsequent event related to this loan.

Prior to December 2017, the \$82.3 million senior mortgage loan collateralized by a portfolio of self storage properties and one retail property was in payment default due to the failure of the borrower to repay an amount equal to \$13.9 million with respect to the retail property (which included \$12.1 million of allocated loan amount and \$1.8 million of release premium). This payment amount was due in September 2017, which was prior to the (6) initial maturity date of the loan in October 2018. In December 2017, the senior mortgage loan was modified to, among other things, waive the payment default on the loan and extend the repayment obligation with respect to the retail property to the maturity date of the loan in October 2018. The senior mortgage loan continues to have a recourse payment guarantee of up to \$12.1 million from an individual who is the indirect owner of the underlying collateral and an affiliate of the borrower. See Note 13 included in these consolidated financial statements for a subsequent event related to this loan.

Prior to September 2018, the \$38.6 million senior mortgage loan, which is collateralized by a hotel property located in New York, was in maturity default due to the failure of the borrower to repay the outstanding principal (7) balance of the loan by the June 2018 maturity date. In September 2018, the senior mortgage loan was modified to, among other things, extend the repayment obligation to December 2018. As of September 30, 2018, the senior mortgage loan was not in maturity default.

(8) In June 2018, the borrower exercised a one-year extension option in accordance with the loan agreement, which extended the maturity date on the senior Michigan loan to July 2019.

In May 2017, amortization began on the senior Ohio loan, which had an outstanding principal balance of \$27.3 million as of September 30, 2018. In October 2017, amortization began on the senior New York loan, which had an (9) outstanding principal balance of \$29.5 million as of September 30, 2018. In February 2021, amortization will begin on the subordinated New Jersey loan, which had an outstanding principal balance of \$17.0 million as of September 30, 2018. The remainder of the loans in the Company's portfolio are non-amortizing through their primary terms.

(10) In February 2018, the borrower exercised a one-year extension option in accordance with the loan agreement, which extended the maturity date on the senior Ohio loan to May 2019.

The Company has made, and may continue to make, modifications to loans, including loans that are in default. Loan terms that may be modified include interest rates, required prepayments, asset release prices, maturity dates, covenants, principal amounts and other loan terms. The terms and conditions of each modification vary based on

individual circumstances and will be determined on a case by case basis.

For the nine months ended September 30, 2018, the activity in the Company's loan portfolio was as follows (\$ in thousands):

12

Balance at December 31, 2017	\$1,726,283
Initial funding	349,524
Origination fees and discounts, net of costs	(4,002)
Additional funding	17,885
Amortizing payments	(565)
Loan payoffs	(435,805)
Origination fee accretion	5,542
Balance at September 30, 2018	\$1,658,862

As of September 30, 2018, all loans were paying in accordance with their contractual terms. No impairment charges have been recognized during the three and nine months ended September 30, 2018 and 2017.

4. DEBT

Financing Agreements

The Company borrows funds, as applicable in a given period, under the Wells Fargo Facility, the Citibank Facility, the BAML Facility, the CNB Facility, the MetLife Facility, the UBS Facility and the U.S. Bank Facility (individually defined below and collectively, the “Secured Funding Agreements”) and the Secured Term Loan (as defined below). The Company refers to the Secured Funding Agreements and the Secured Term Loan as the “Financing Agreements.” The outstanding balance of the Financing Agreements in the table below are presented gross of debt issuance costs. As of September 30, 2018 and December 31, 2017, the outstanding balances and total commitments under the Financing Agreements consisted of the following (\$ in thousands):

	September 30, 2018		December 31, 2017		
	Balance	Commitment	Balance	Commitment	
Wells Fargo Facility	\$ 334,825	\$ 500,000	\$ 407,853	\$ 500,000	
Citibank Facility	238,571	250,000	(1) 175,651	250,000	(1)
BAML Facility	65,311	125,000	78,320	125,000	
CNB Facility	600	50,000	—	50,000	
MetLife Facility	131,132	180,000	101,131	180,000	
UBS Facility	—	140,000	34,000	140,000	
U.S. Bank Facility	141,971	185,989	161,005	185,989	
Secured Term Loan	110,000	110,000	110,000	110,000	
Total	\$ 1,022,410	\$ 1,540,989	\$ 1,067,960	\$ 1,540,989	

(1) The Citibank Facility (as defined below) has an accordion feature that provides for an increase in the \$250.0 million commitment amount with respect to approved assets, as determined by Citibank, N.A. in its sole discretion.

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

Wells Fargo Facility

The Company is party to a master repurchase funding facility with Wells Fargo Bank, National Association (“Wells Fargo”) (the “Wells Fargo Facility”), which allows the Company to borrow up to \$500.0 million. Under the Wells Fargo Facility, the Company is permitted to sell, and later repurchase, certain qualifying senior commercial mortgage loans, A-Notes, pari-passu participations in commercial mortgage loans and mezzanine loans under certain circumstances, subject to available collateral approved by Wells Fargo in its sole discretion. The initial maturity date of the Wells Fargo Facility is December 14, 2018, subject to two 12-month extensions, each of which may be exercised at the Company’s option, subject to the satisfaction of certain conditions, including payment of an extension fee, which, if both were exercised, would extend the maturity date of the Wells Fargo Facility to December 14, 2020. Advances under the Wells Fargo Facility accrue interest at a per annum rate equal to the sum of (i) one-month LIBOR plus (ii) a pricing margin range of 1.75% to 2.35%. The Company incurs a non-utilization fee of 25 basis points per annum on the average 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, 2018, the Company incurred a non-utilization fee of \$29 thousand and \$35 thousand, respectively. For the three and nine months ended September 30, 2017, the Company incurred a non-utilization fee of \$148 thousand and \$240 thousand, respectively. The non-utilization fee is included within interest expense in the Company’s consolidated statements of operations.

Citibank Facility

The Company is party to a \$250.0 million master repurchase facility with Citibank, N.A. (“Citibank”) (the “Citibank Facility”). 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 in its sole discretion. The Citibank Facility has an accordion feature that provides for an increase in the \$250.0 million commitment amount with respect to approved assets, as determined by Citibank in its sole discretion. The initial maturity date of the Citibank Facility is December 10, 2018, subject to three 12-month extensions, each of which may be exercised at the Company’s option assuming no existing defaults under the Citibank Facility and applicable extension fees being paid, which, if all three were exercised, would extend the maturity date of the Citibank Facility to December 8, 2021. Advances under the Citibank Facility accrue interest at a per annum rate equal to one-month LIBOR plus a pricing margin range of 2.25% to 2.50%, subject to certain exceptions. The Company incurs a non-utilization fee of 25 basis points per annum on the average daily available balance of the Citibank Facility. For the three and nine months ended September 30, 2018, the Company incurred a non-utilization fee of \$31 thousand and \$109 thousand, respectively. For the three and nine months ended September 30, 2017, the Company incurred a non-utilization fee of \$36 thousand and \$118 thousand, respectively. The non-utilization fee is included within interest expense in the Company’s consolidated statements of operations.

BAML Facility

The Company is party to a \$125.0 million Bridge Loan Warehousing Credit and Security Agreement with Bank of America, N.A. (“Bank of America”) (the “BAML Facility”). Under the BAML Facility, the Company may obtain advances secured by eligible commercial mortgage loans collateralized by multifamily properties. Bank of America may approve the loans on which advances are made under the BAML Facility in its sole discretion. In May 2018, the Company amended the BAML Facility to extend the period during which the Company may request individual loans under the facility to May 23, 2019. 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. In addition, in May 2018, the final maturity date of individual loans under the BAML Facility was extended to May 23, 2022. Since October 2, 2017, advances under the BAML Facility accrue interest at a per annum rate equal to one-month LIBOR plus a spread of 2.00%, subject to certain exceptions. Prior to and including October 1, 2017, advances under the BAML Facility accrued interest at a per annum rate equal to

one-month LIBOR plus a spread ranging from 2.25% to 2.75% depending upon the type of asset securing such advance. The Company incurs a non-utilization fee of 12.5 basis points per annum on the average daily available balance of the BAML Facility to the extent less than 50% of the BAML Facility is utilized. For the three months ended September 30, 2018, the Company did not incur a non-utilization fee. For the nine months ended September 30, 2018, the Company incurred a non-utilization fee of \$17 thousand. For the three and nine months ended September 30, 2017, the Company incurred a non-utilization fee of \$11 thousand and \$42 thousand, respectively. The non-utilization fee is included within interest expense in the Company's consolidated statements of operations.

CNB Facility

The Company is party to a \$50.0 million secured revolving funding facility with City National Bank (the "CNB Facility"). The Company is permitted to borrow funds under the CNB Facility to finance investments and for other working capital and general corporate needs. In February 2018, the Company exercised a 12-month extension option on the CNB

Facility to extend the initial maturity date to March 10, 2019. The Company has one additional 12-month extension, which may be exercised at the Company's option, subject to the satisfaction of certain conditions, including payment of an extension fee, which, if exercised, would extend the maturity date of the CNB Facility to March 10, 2020.

Advances under the 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 CNB Facility is used on average, unused commitments under the CNB Facility accrue non-utilization fees at the rate of 0.375% per annum. For the three and nine months ended September 30, 2018, the Company incurred a non-utilization fee of \$48 thousand and \$123 thousand, respectively. For the three and nine months ended September 30, 2017, the Company incurred a non-utilization fee of \$46 thousand and \$140 thousand, respectively. The non-utilization fee is included within interest expense in the Company's consolidated statements of operations.

MetLife Facility

The Company and certain of its subsidiaries are party to a \$180.0 million revolving master repurchase facility with Metropolitan Life Insurance Company ("MetLife") (the "MetLife Facility"), pursuant to which the Company may sell, and later repurchase, commercial mortgage loans meeting defined eligibility criteria which are approved by MetLife in its sole discretion. The initial maturity date of the MetLife Facility is August 12, 2020, subject to two 12-month extensions, each of which may be exercised at the Company's option, subject to the satisfaction of certain conditions, including payment of an extension fee, which, if both were exercised, would extend the maturity date of the MetLife Facility to August 12, 2022. Since August 4, 2017, advances under the MetLife Facility accrue interest at a per annum rate equal to one-month LIBOR plus a spread of 2.30%. Prior to and including August 3, 2017, advances under the MetLife Facility accrued interest at a per annum rate equal to one-month LIBOR plus a spread of 2.35%. Effective in February 2018, the Company began incurring a non-utilization fee of 25 basis points per annum on the average daily available balance of the MetLife Facility to the extent less than 65% of the MetLife Facility is utilized. For the three months ended September 30, 2018, the Company did not incur a non-utilization fee. For the nine months ended September 30, 2018, the Company incurred a non-utilization fee of \$7 thousand. The non-utilization fee is included within interest expense in the Company's consolidated statements of operations.

UBS Facility

The Company and certain of its subsidiaries are party to a \$140.0 million revolving master repurchase facility with UBS Real Estate Securities Inc. ("UBS") (the "UBS Facility"), pursuant to which the Company may sell, and later repurchase, commercial mortgage loans and, under certain circumstances, other assets meeting defined eligibility criteria that are approved by UBS in its sole discretion. The maturity date of the UBS Facility is October 21, 2018, subject to annual extensions in UBS' sole discretion. The interest rate on advances under the UBS Facility is one-month LIBOR plus (a) 1.88% per annum, for assets that are subject to an advance for one year or less, (b) 2.08% per annum, for assets that are subject to an advance in excess of one year but less than two years and (c) 2.28% per annum, for assets that are subject to an advance for greater than two years. See Note 13 included in these consolidated financial statements for a subsequent event related to the UBS Facility.

U.S. Bank Facility

The Company and certain of its subsidiaries are party to a \$186.0 million master repurchase and securities contract with U.S. Bank National Association ("U.S. Bank") (the "U.S. Bank Facility"). Pursuant to the U.S. Bank Facility, the Company is permitted to sell, and later repurchase, eligible commercial mortgage loans collateralized by retail, office, mixed-use, multifamily, industrial, hospitality, student housing, manufactured housing or self storage properties. U.S. Bank may approve the mortgage loans that are subject to the U.S. Bank Facility in its sole discretion. The initial

maturity date of the U.S. Bank Facility is July 31, 2020, subject to two 12-month extensions, each of which may be exercised at the Company's option, subject to the satisfaction of certain conditions, including payment of an extension fee, which, if both were exercised, would extend the maturity date of the U.S. Bank Facility to July 31, 2022.

Advances under the U.S. Bank Facility generally accrue interest at a per annum rate equal to one-month LIBOR plus a spread of 2.25%, unless otherwise agreed between U.S. Bank and the Company, depending upon the mortgage loan sold to U.S. Bank in the applicable transaction. The Company incurs a non-utilization fee of 25 basis points per annum on the average daily available balance of the U.S. Bank Facility to the extent less than 50% of the U.S. Bank Facility is utilized. For both the three and nine months ended September 30, 2018, the Company did not incur a non-utilization fee. For the three months ended September 30, 2017, the Company did not incur a non-utilization fee. For the nine months ended September 30, 2017, the Company incurred a non-utilization fee of \$83 thousand. The non-utilization fee is included within interest expense in the Company's consolidated statements of operations.

Secured Term Loan

The Company and certain of its subsidiaries are party to a \$110.0 million Credit and Guaranty Agreement with the lenders referred to therein and Cortland Capital Market Services LLC, as administrative agent and collateral agent for the lenders (the “Secured Term Loan”). The initial maturity date of the Secured Term Loan is December 22, 2020, subject to one 12-month extension, which may be exercised at the Company’s option, provided there are no existing events of default under the Secured Term Loan, which, if exercised, would extend the maturity date of the Secured Term Loan to December 22, 2021. During the extension period, the spread on advances under the Secured Term Loan increases every three months by 0.125%, 0.375% and 0.750% per annum, respectively, beginning after the third-month of the extension period. Since December 22, 2017, advances under the Secured Term Loan accrue interest at a per annum rate equal to the sum of, at the Company’s option, one, two, three or six-month LIBOR plus a spread of 5.00%. Prior to and including December 21, 2017, advances under the Secured Term Loan accrued interest at a per annum rate equal to one-month LIBOR plus a spread of 6.00% (with a 1.00% LIBOR floor). The total original issue discount on the Secured Term Loan draws was \$2.6 million, which represents a discount to the debt cost to be amortized into interest expense using the effective interest method over the term of the Secured Term Loan. For the three and nine months ended September 30, 2018, the estimated per annum effective interest rate of the Secured Term Loan, which is equal to LIBOR plus the spread plus the accretion of the original issue discount and associated costs, was 7.7% and 7.5%, respectively. For the three and nine months ended September 30, 2017, the estimated per annum effective interest rate was 8.7% and 8.6%, respectively.

5. COMMITMENTS AND CONTINGENCIES

As of September 30, 2018 and December 31, 2017, 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	December
	30, 2018	31, 2017
Total commitments	\$1,814,832	\$1,847,534
Less: funded commitments	(1,668,324)	(1,737,286)
Total unfunded commitments	\$146,508	\$110,248

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, 2018, the Company is not aware of any legal claims that could materially impact its business, financial condition or results of operations.

6. STOCKHOLDERS’ EQUITY

Common Stock

There were no shares issued in public or private offerings for the three and nine months ended September 30, 2018. See “Equity Incentive Plan” below for shares issued under the plan.

Equity Incentive Plan

On April 23, 2012, the Company adopted an equity incentive plan. In April 2018, the Company’s board of directors authorized, and in June 2018, the Company’s stockholders approved, an amendment to the equity incentive plan to increase the total amount of shares of common stock the Company may grant thereunder to 1,390,000 shares (the “Amended and Restated 2012 Equity Incentive Plan”). Pursuant to the Amended and Restated 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 of the Manager, officers, ACREM and other eligible awardees under the plan. 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 stock-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.

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

The following table details the restricted stock grants awarded as of September 30, 2018:

Grant Date	Vesting Start Date	Shares Granted
May 1, 2012	July 1, 2012	35,135
June 18, 2012	July 1, 2012	7,027
July 9, 2012	October 1, 2012	25,000
June 26, 2013	July 1, 2013	22,526
November 25, 2013	November 25, 2016	30,381
January 31, 2014	August 31, 2015	48,273
February 26, 2014	February 26, 2014	12,030
February 27, 2014	August 27, 2014	22,354
June 24, 2014	June 24, 2014	17,658
June 24, 2015	July 1, 2015	25,555
April 25, 2016	July 1, 2016	10,000
June 27, 2016	July 1, 2016	24,680
April 25, 2017	April 25, 2018	81,710
June 7, 2017	July 1, 2017	18,224
October 17, 2017	January 2, 2018	7,278
December 15, 2017	January 2, 2018	8,948
May 14, 2018	July 2, 2018	31,766
June 26, 2018	July 1, 2019	67,918
Total		496,463

The following tables summarize the (i) non-vested shares of restricted stock and (ii) the vesting schedule of shares of restricted stock for the Company's directors and officers as of September 30, 2018:

Schedule of Non-Vested Share and Share Equivalents

	Restricted Stock Grants—Directors	Restricted Stock Grants—Officers	Total
Balance at December 31, 2017	21,394	90,658	112,052
Granted	31,766	67,918	99,684
Vested	(22,248)	(33,946)	(56,194)
Forfeited	—	—	—
Balance at September 30, 2018	30,912	124,630	155,542

Future Anticipated Vesting Schedule

	Restricted Stock Grants—Directors	Restricted Stock Grants—Officers	Total
2018	8,358	2,239	10,597
2019	18,384	49,878	68,262
2020	3,336	49,875	53,211
2021	834	22,638	23,472
2022	—	—	—
Total	30,912	124,630	155,542

7. 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, 2018 and 2017 (\$ in thousands, except share and per share data):

	For the three months ended September 30, 2018		For the nine months ended September 30, 2017	
Net income attributable to common stockholders	\$9,957	\$ 11,058	\$28,577	\$ 24,224
Divided by:				
Basic weighted average shares of common stock outstanding:	28,542,828	28,481,298	28,521,317	28,475,369
Non-vested restricted stock	155,772	101,392	117,656	62,354
Diluted weighted average shares of common stock outstanding:	28,698,600	28,582,690	28,638,973	28,537,723
Basic and diluted earnings per common share	\$0.35	\$ 0.39	\$1.00	\$ 0.85

8. INCOME TAX

The Company wholly-owns ACRC Lender W TRS LLC and ACRC Lender U TRS LLC, which are taxable REIT subsidiaries (“TRS”) formed in order to issue and hold certain loans intended for sale. The Company also wholly-owns ACRC 2017-FL3 TRS LLC, which is a TRS formed in order to hold a portion of the CLO Securitization (as defined below) to the extent it generates excess inclusion income.

The income tax provision for the Company and the TRSs consisted of the following for the three and nine months ended September 30, 2018 and 2017 (\$ in thousands):

	For the three months ended September 30, 2018		For the nine months ended September 30, 2017	
Current	\$ 134	\$ 4	\$ 143	\$ 14
Deferred	7	—	—	—
Excise tax	95	50	260	135
Total income tax expense, including excise tax	\$ 236	\$ 54	\$ 403	\$ 149

For the three and nine months ended September 30, 2018, the Company incurred an expense of \$95 thousand and \$260 thousand, respectively, for U.S. federal excise tax. For the three and nine months ended September 30, 2017, the Company incurred an expense of \$50 thousand and \$135 thousand, respectively, for U.S. federal excise tax. Excise tax represents a 4% tax on a portion of the required amount of the Company’s ordinary income and net capital gains not distributed during the year. If it is determined that the Company’s estimated current year taxable income plus any undistributed shortfall from its prior calendar year will be in excess of estimated dividend distributions (including capital gain dividend) for the current year, the Company will accrue excise tax on estimated excess taxable income as such taxable income is earned. The quarterly expense is calculated in accordance with applicable tax regulations.

The TRSs recognize interest and penalties related to unrecognized tax benefits within income tax expense in the Company’s consolidated statements of operations. Accrued interest and penalties, if any, are included within other

liabilities in the Company's consolidated balance sheets.

As of September 30, 2018, tax years 2015 through 2018 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 12 months.

9. 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

18

market participants on the measurement date. 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 1-Quoted prices in active markets for identical assets or liabilities.

Level 2-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 3-Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

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

As of September 30, 2018 and December 31, 2017, the Company did not have any assets or liabilities required to be recorded at fair value on a recurring or nonrecurring basis.

As of September 30, 2018 and December 31, 2017, 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, 2018		December 31, 2017	
		Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:					
Loans held for investment	3	\$1,658,862	\$1,668,324	\$1,726,283	\$1,737,286
Financial liabilities:					
Secured funding agreements	2	\$912,410	\$912,410	\$957,960	\$957,960
Secured term loan	2	108,151	110,000	107,595	110,000
Collateralized loan obligation securitization debt (consolidated VIE)	3	271,335	272,927	271,211	272,927

The carrying values of cash and cash equivalents, restricted cash, interest receivable, due to affiliate liability and accrued expenses, which are all categorized as Level 2 within the fair value hierarchy, approximate their fair values due to their short-term nature.

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

10. RELATED PARTY TRANSACTIONS

Management Agreement

The Company is party to a Management Agreement under which ACREM, subject to the supervision and oversight of the Company's board of directors, is responsible for, among other duties, (a) performing all of the Company's day-to-day functions, (b) determining the Company's 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 Amended and Restated 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 Amended and Restated 2012 Equity Incentive Plan (see Note 6 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. For the three months ended September 30, 2018, no incentive fees were incurred. For the nine months ended September 30, 2018, the Company incurred incentive fees of \$610 thousand. For the three

months ended September 30, 2017, no incentive fees were incurred. For the nine months ended September 30, 2017, the Company incurred incentive fees of \$381 thousand.

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

The Company will not reimburse ACREM for the salaries and other compensation of its personnel, except for the allocable share of the salaries and other compensation of the Company's (a) Chief Financial Officer, based on the percentage of his time spent on the Company's affairs and (b) other corporate finance, tax, accounting, internal audit, legal, risk management, operations, compliance and other non-investment professional personnel of ACREM or its affiliates who spend all or a portion of their time managing the Company's affairs based on the percentage of their time spent on the Company's affairs. The Company is also required to pay its pro-rata portion of rent, telephone, utilities, office furniture, equipment, machinery and other office, internal and overhead expenses of ACREM and its affiliates that are required for the Company's operations. The term of the Management Agreement ends on May 1, 2019, with automatic one-year renewal terms thereafter. Except under

limited circumstances, upon a termination of the Management Agreement, the Company will pay ACREM a termination fee equal to three times the average annual base management fee and incentive fee received by ACREM during the 24-month period immediately preceding the most recently completed fiscal quarter prior to the date of termination, each as described above.

Certain of the Company's subsidiaries, along with the Company's lenders under certain of the Company's Secured Funding Agreements, as well as under the CLO transaction have entered into various servicing agreements with ACREM's subsidiary servicer, Ares Commercial Real Estate Servicer LLC ("ACRES"). 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.

The following table summarizes the related party costs incurred by the Company for the three and nine months ended September 30, 2018 and 2017 and amounts payable to the Company's Manager as of September 30, 2018 and December 31, 2017 (\$ in thousands):

	Incurred		For the nine		Payable	
	For the three months ended September 30,	For the three months ended September 30,	For the nine months ended September 30,	For the nine months ended September 30,	As of September 30,	As of December 31, 2017
	2018	2017	2018	2017	2018	2017
Affiliate Payments						
Management fees	\$1,571	\$1,554	\$4,692	\$4,639	\$1,571	\$1,549
Incentive fees	—	—	610	381	—	—
General and administrative expenses	870	986	2,624	2,883	920	1,016
Direct costs (1)	30	89	172	177	21	63
Total	\$2,471	\$2,629	\$8,098	\$8,080	\$2,512	\$2,628

(1) For the three and nine months ended September 30, 2018 and 2017, direct costs incurred are included within general and administrative expenses in the Company's consolidated statements of operations.

Investments in Loans

From time to time, the Company may co-invest with other investment vehicles managed by Ares Management or its affiliates, including the Manager, and their portfolio companies, including by means of splitting investments, participating in investments or other means of syndication of investments. For such co-investments, the Company expects to act as the administrative agent for the holders of such investments provided that the Company maintains a majority of the aggregate investment. No fees will be received by the Company for performing such service. The Company's investment in such co-investments are made on a pari-passu basis with the other Ares managed investment vehicles and the Company is not obligated to provide, nor has it provided, any financial support to the other Ares managed investment vehicles. As such, the Company's risk is limited to the carrying value of its investment and the Company recognizes only the carrying value of its investment in its consolidated balance sheets.

In May 2018, the Company participated in originating a \$25.0 million mezzanine loan commitment on the construction of a mixed-use property located in Illinois, with a participation interest of \$15.3 million held by the Company and \$9.7 million held by other Ares managed investment vehicles. As of September 30, 2018, there was no outstanding principal balance on this mezzanine loan.

In August 2018, the Company participated in originating a \$12.0 million pre-construction mezzanine loan commitment on a property with in-place development rights for a residential project located in Hawaii. The mezzanine loan was split into separate notes with an \$8.0 million note held by the Company and \$4.0 million of notes held by other Ares managed investment vehicles. As of September 30, 2018, the total outstanding principal balance on the note held by the Company was \$3.3 million.

11. DIVIDENDS AND DISTRIBUTIONS

The following table summarizes the Company's dividends declared during the nine months ended September 30, 2018 and 2017 (\$ in thousands, except per share data):

Date Declared	Record Date	Payment Date	Per Share Amount	Total Amount
July 26, 2018	September 28, 2018	October 16, 2018	\$ 0.29	\$ 8,323
May 1, 2018	June 29, 2018	July 17, 2018	0.28	8,036
March 1, 2018	March 29, 2018	April 17, 2018	0.28	8,008
Total cash dividends declared for the nine months ended September 30, 2018			\$ 0.85	\$ 24,367
August 3, 2017	September 29, 2017	October 16, 2017	\$ 0.27	\$ 7,717
May 2, 2017	June 30, 2017	July 17, 2017	0.27	7,718
March 7, 2017	March 31, 2017	April 17, 2017	0.27	7,690
Total cash dividends declared for the nine months ended September 30, 2017			\$ 0.81	\$ 23,125

12. 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 investment in the CLO Securitization (as defined below), which is considered to be a variable interest in a VIE.

CLO Securitization

On March 2, 2017, ACRE Commercial Mortgage 2017-FL3 Ltd. (the "Issuer") and ACRE Commercial Mortgage 2017-FL3 LLC (the "Co-Issuer"), both wholly-owned indirect subsidiaries of the Company, entered into an indenture (the "Indenture") with Wells Fargo Bank, National Association, as advancing agent and note administrator, and Wilmington Trust, National Association as trustee, which governs the issuance of approximately \$308.8 million principal balance secured floating rate notes (the "Notes") and \$32.4 million of preferred equity in the Issuer (the "CLO Securitization").

As of September 30, 2018, the Notes were collateralized by interests in a pool of twelve mortgage assets having a total principal balance of approximately \$286.3 million (the "Mortgage Assets") that were originated by a subsidiary of the Company and approximately \$54.9 million of receivables related to repayments of outstanding principal on previous mortgage assets. As of December 31, 2017, the Notes were collateralized by interests in a pool of thirteen mortgage assets having a total principal balance of approximately \$341.2 million that were originated by a subsidiary of the Company. During the reinvestment period ending on March 15, 2019, the Company may direct the Issuer to acquire additional mortgage assets meeting applicable reinvestment criteria using the principal repayments from the Mortgage Assets, subject to the satisfaction of certain conditions, including receipt of a Rating Agency Confirmation and investor approval of the new mortgage assets.

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

The contribution of the Mortgage Assets to the Issuer is governed by a Mortgage Asset Purchase Agreement between ACRC Lender LLC (the “Seller”), a wholly-owned subsidiary of the Company, and the Issuer, and acknowledged by the Company solely for purposes of confirming its status as a REIT, in which the Seller made certain customary representations, warranties and covenants.

In connection with the securitization, the Issuer and Co-Issuer offered and issued the following classes of Notes: Class A, Class A-S, Class B, Class C and Class D Notes (collectively, the “Offered Notes”) to a third party. A wholly-owned subsidiary of the Company retained approximately \$35.8 million of the Notes and all of the \$32.4 million of preferred equity in the Issuer, which totaled \$68.2 million. 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.

After March 15, 2021, the Issuer may redeem the Offered Notes subject to paying a make whole prepayment fee of 1.0% of the then outstanding balance of the Offered Notes. In addition, once the Class A Notes, Class A-S Notes, Class B Notes and Class C Notes have been repaid in full, the Issuer has the right to redeem the Class D Notes, subject to paying a make whole prepayment fee of 1.0% on the Class D Notes.

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

The CLO Securitization is consolidated in accordance with FASB ASC Topic 810 and is structured as a pass through entity that receives principal and interest on the underlying collateral and distributes those payments to the note holders, as applicable. The assets and other instruments held by the CLO Securitization are restricted and can only be used to fulfill the obligations of the CLO Securitization. Additionally, the obligations of the CLO Securitization 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 the CLO Securitization of which the Company is deemed the primary beneficiary has no economic effect on the Company. The Company's exposure to the obligations of the CLO Securitization is generally limited to its investment in the entity. The Company is not obligated to provide, nor has it provided, any financial support for the consolidated structure. As such, the risk associated with the Company's involvement in the CLO Securitization is limited to the carrying value of its investment in the entity. As of September 30, 2018, the Company's maximum risk of loss was \$68.2 million, which represents the carrying value of its investment in the CLO Securitization. For the three and nine months ended September 30, 2018, the Company incurred interest expense related to the CLO Securitization of \$2.7 million and \$7.6 million, respectively. For the three and nine months ended September 30, 2017, the Company incurred interest expense related to the CLO Securitization of \$2.1 million and \$4.7 million, respectively. Interest expense related to the CLO Securitization is included within interest expense in the Company's consolidated statements of operations.

13. 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, 2018, except as disclosed below.

On October 2, 2018, the Company originated and fully funded a \$17.5 million pre-construction senior mortgage loan on a property with in-place development rights for a residential project located in Florida. The loan has a per annum interest rate of LIBOR plus a spread of 8.00% (plus fees) and an initial term of 1.5 years.

On October 12, 2018, the \$116.7 million senior mortgage loan collateralized by a portfolio of self storage properties was modified to, among other things, extend the repayment obligation to November 2018. See Note 3 included in

these consolidated financial statements for more information on this senior mortgage loan.

On October 12, 2018, the \$82.3 million senior mortgage loan collateralized by a portfolio of self storage properties and one retail property was modified to, among other things, extend the repayment obligation to November 2018. See Note 3 included in these consolidated financial statements for more information on this senior mortgage loan.

On October 21, 2018, the UBS Facility matured. The UBS Facility had been repaid in full and its term was not extended.

On October 22, 2018, the Company originated a \$14.0 million mezzanine construction loan on a property with in-place development rights for a residential conversion project located in New York. At closing, the outstanding principal balance

23

was approximately \$10.6 million. The loan has a per annum interest rate of LIBOR plus a spread of 14.00% (plus fees) and an initial term of 2.5 years.

On October 26, 2018, the Company originated a \$13.5 million senior mortgage loan on an office property located in North Carolina. At closing, the outstanding principal balance was approximately \$8.0 million. The loan has a per annum interest rate of LIBOR plus a spread of 4.00% (plus fees) and an initial term of 4.0 years.

On October 30, 2018, the Company declared a cash dividend of \$0.31 per common share for the fourth quarter of 2018. The fourth quarter 2018 dividend is payable on January 15, 2019 to common stockholders of record as of December 28, 2018.

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, and Amendment No. 1 thereto on Form 10-K/A for the fiscal year ended December 31, 2017 (collectively, our "Annual Report on Form 10-K"). In addition, some of the statements in this quarterly report (including in the following discussion) constitute forward-looking statements, which relate to future events or the future performance or financial condition of Ares Commercial Real Estate Corporation ("ACRE" and, together with its consolidated subsidiaries, the "Company," "we," "us" and "our"). The forward-looking statements contained in this report involve a number of risks and uncertainties, including statements concerning:

- our business and investment strategy;
- our projected operating results;
- the return or impact of current and future investments;
- the timing of cash flows, if any, from our investments;
- estimates relating to our ability to make distributions to our stockholders in the future;
 - defaults by borrowers in paying amounts due on outstanding indebtedness and our ability to collect all amounts due according to the contractual terms of our investments;
- our ability to obtain and maintain financing arrangements, including securitizations;
- market conditions and our ability to access alternative debt markets and additional debt and equity capital;
- the amount of commercial mortgage loans requiring refinancing;
- our expected investment capacity and available capital;
- financing and advance rates for our target investments;
- our expected leverage;
- changes in interest rates, credit spreads and the market value of our investments;
- the impact of changes in London Interbank Offered Rate ("LIBOR") on our operating results;
- 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;

• availability of investment opportunities in mortgage-related and real estate-related investments and securities;

• the ability of Ares Commercial Real Estate Management LLC (“ACREM” or our “Manager”) to locate suitable investments for us, monitor, service and administer our investments and execute our investment strategy;

• allocation of investment opportunities to us by our Manager;

25

- our ability to successfully identify, complete and integrate any acquisitions;
- our ability to maintain our qualification as a real estate investment trust (“REIT”) for U.S. federal income tax purposes;
- our ability to maintain our exemption from registration under the Investment Company Act of 1940 (the “1940 Act”);
- our understanding of our competition;
- general volatility of the securities markets in which we may invest;
- adverse changes in the real estate, real estate capital and credit markets and the impact of a protracted decline in the liquidity of credit markets on our business;
- changes in governmental regulations, tax law and rates, and similar matters (including interpretation thereof);
- authoritative or policy changes from standard-setting bodies such as the Financial Accounting Standards Board, the Securities and Exchange Commission, the Internal Revenue Service, the stock exchange where we list our common stock, and other authorities that we are subject to, as well as their counterparts in any foreign jurisdictions where we might do business;
- actions and initiatives of the U.S. Government and changes to U.S. Government policies;
- the state of the United States, European Union and Asian economies generally or in specific geographic regions;
- global economic trends and economic recoveries; and
- market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy.

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 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 primarily engaged in originating and investing in commercial real estate (“CRE”) loans and related investments. We are externally managed by ACREM, a subsidiary of Ares Management, L.P. (NYSE: ARES) (“Ares Management”), a publicly traded, leading global alternative asset manager, pursuant to the terms of the management agreement dated April 25, 2012, as amended, between us and our Manager (the “Management Agreement”). From the commencement of our operations in late 2011, we have been primarily focused on directly originating and managing a diversified portfolio of CRE debt-related investments for our own account.

We were formed and commenced operations in late 2011. We are a Maryland corporation and completed our initial public offering in May 2012. We have elected and qualified to be taxed as a REIT for U.S. federal income tax purposes under the Internal Revenue Code of 1986, as amended, commencing with our taxable year ended December

31, 2012. We generally will not be subject to U.S. federal income taxes on our REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, to the extent that we annually distribute all of our REIT taxable income to stockholders and comply with various other requirements as a REIT. We also operate our business in a manner that is intended to permit us to maintain our exemption from registration under the 1940 Act.

26

Developments During the Third Quarter of 2018:

- ▲ACRE originated a \$31.5 million senior mortgage loan on a hotel property located in Minnesota.
- ACRE originated an \$8.0 million pre-construction mezzanine loan on a property with in-place development rights for a residential project located in Hawaii.
- ▲ACRE originated a \$78.0 million senior mortgage loan on a hotel portfolio located across multiple states.

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, creditworthiness 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.

Investment Portfolio

As of September 30, 2018, our portfolio included 44 loans held for investment, excluding 69 loans that were repaid or sold since inception. Such investments are referred to herein as our investment portfolio. As of September 30, 2018, the aggregate originated commitment under these loans at closing was approximately \$1.9 billion and outstanding principal was \$1.7 billion. During the nine months ended September 30, 2018, we funded approximately \$367.4 million of outstanding principal and received repayments of \$436.4 million of outstanding principal. As of September 30, 2018, 90.4% of our loans have LIBOR floors, with a weighted average floor of 1.11%, 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, 2018, all loans were paying in accordance with their contractual terms. During the nine months ended September 30, 2018, 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, 2018 (\$ in thousands):

	As of September 30, 2018					
	Carrying Amount (1)	Outstanding Principal (1)	Weighted Average Minimum Loan Borrowing Spread (2)	Weighted Average Unleveraged Effective Yield (3)	Weighted Average Remaining Life (Years)	
Senior mortgage loans	\$1,636,884	\$1,645,387	5.1 %	6.8 %	1.6	
Subordinated debt and preferred equity investments	21,978	22,937	12.0 %	13.4 %	5.8	
Total loans held for investment portfolio	\$1,658,862	\$1,668,324	5.2 %	6.9 %	1.7	

(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) Minimum Loan Borrowing Spread is equal to (a) for floating rate loans, the margin above the applicable index rate (e.g., LIBOR) plus floors, if any, on such applicable index rates, and (b) for fixed rate loans, the applicable interest rate.

(3) 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, premiums or discounts) 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, 2018 as weighted by the Outstanding Principal balance of each loan.

Critical Accounting Policies

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles, 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. See Note 2 to our consolidated financial statements included in this quarterly report on Form 10-Q, which describes the recently issued accounting pronouncements that were adopted or not yet required to be adopted by us.

RESULTS OF OPERATIONS

The following table sets forth a summary of our consolidated results of operations for the three and nine months ended September 30, 2018 and 2017 (\$ in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2018	2017	2018	2017
Net interest margin	\$13,984	\$14,726	\$40,756	\$35,476
Total expenses	3,791	3,614	11,776	11,078
Income before income taxes	10,193	11,112	28,980	24,398
Income tax expense, including excise tax	236	54	403	149
Net income attributable to ACRE	9,957	11,058	28,577	24,249
Less: Net income attributable to non-controlling interests	—	—	—	(25)
Net income attributable to common stockholders	\$9,957	\$11,058	\$28,577	\$24,224

The following tables set forth select details of our consolidated results of operations for the three and nine months ended September 30, 2018 and 2017 (\$ in thousands):

Net Interest Margin

	For the three months ended September 30,		For the nine months ended September 30,	
	2018	2017	2018	2017
Interest income from loans held for investment	\$30,362	\$28,551	\$87,401	\$72,321
Interest expense	(16,378)	(13,825)	(46,645)	(36,845)
Net interest margin	\$13,984	\$14,726	\$40,756	\$35,476

For the three months ended September 30, 2018 and 2017, net interest margin was approximately \$14.0 million and \$14.7 million, respectively. For the three months ended September 30, 2018 and 2017, interest income from loans held for investment of \$30.4 million and \$28.6 million, respectively, was generated by weighted average earning assets of \$1.7 billion and \$1.6 billion, respectively, offset by \$16.4 million and \$13.8 million, respectively, of interest expense, unused fees and amortization of deferred loan costs. For the three months ended September 30, 2018 and 2017, the weighted average borrowings under the Wells Fargo Facility, the Citibank Facility, the BAML Facility, the CNB Facility, the MetLife Facility, the UBS Facility and the U.S. Bank Facility (individually defined below and collectively, the "Secured Funding Agreements") and securitization debt and the Secured Term Loan (defined below) were \$1.3 billion and \$1.2 billion, respectively. The increase in interest income from loans held for investment and

interest expense for the three months ended September 30, 2018 compared to the three months ended September 30, 2017 primarily relates to an increase in our weighted average earning assets and weighted average borrowings as well as an increase in 30-day LIBOR for the three months ended September 30, 2018.

For the nine months ended September 30, 2018 and 2017, net interest margin was approximately \$40.8 million and \$35.5 million, respectively. For the nine months ended September 30, 2018 and 2017, interest income from loans held for investment of \$87.4 million and \$72.3 million, respectively, was generated by weighted average earning assets of \$1.7 billion and \$1.5 billion, respectively, offset by \$46.6 million and \$36.8 million, respectively, of interest expense, unused fees and amortization of deferred loan costs. For the nine months ended September 30, 2018 and 2017, the weighted average borrowings

under the Secured Funding Agreements and securitization debt and the Secured Term Loan were \$1.3 billion and \$1.1 billion, respectively. The increase in interest income from loans held for investment and interest expense for the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017 primarily relates to an increase in our weighted average earning assets and weighted average borrowings as well as an increase in 30-day LIBOR for the nine months ended September 30, 2018.

Operating Expenses

	For the three months ended September 30, 2018		For the nine months ended September 30, 2017	
Management and incentive fees to affiliate	\$1,571	\$1,554	\$5,302	\$5,020
Professional fees	498	350	1,435	1,169
General and administrative expenses	852	724	2,415	2,006
General and administrative expenses reimbursed to affiliate	870	986	2,624	2,883
Total expenses	\$3,791	\$3,614	\$11,776	\$11,078

For the three months ended September 30, 2018 and 2017, we incurred operating expenses of \$3.8 million and \$3.6 million, respectively.

For the nine months ended September 30, 2018 and 2017, we incurred operating expenses of \$11.8 million and \$11.1 million, respectively.

Related Party Expenses

For the three months ended September 30, 2018, related party expenses included \$1.6 million in management fees due to our Manager pursuant to the Management Agreement. No incentive fees were incurred for the three months ended September 30, 2018. For the three months ended September 30, 2018, related party expenses also included \$0.9 million for our share of allocable general and administrative expenses for which we were required to reimburse our Manager pursuant to the Management Agreement. For the three months ended September 30, 2017, related party expenses included \$1.6 million in management fees due to our Manager pursuant to the Management Agreement. No incentive fees were incurred for the three months ended September 30, 2017. For the three months ended September 30, 2017, related party expenses also included \$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. The management fees and allocable general and administrative expenses due to our Manager were relatively consistent for both periods.

For the nine months ended September 30, 2018, related party expenses included \$5.3 million in management and incentive fees due to our Manager pursuant to the Management Agreement, which consisted of \$4.7 million in management fees and \$0.6 million in incentive fees. For the nine months ended September 30, 2018, related party expenses also included \$2.6 million for our share of allocable general and administrative expenses for which we were required to reimburse our Manager pursuant to the Management Agreement. For the nine months ended September 30, 2017, related party expenses included \$5.0 million in management and incentive fees due to our Manager pursuant to the Management Agreement, which consisted of \$4.6 million in management fees and \$0.4 million in incentive fees. For the nine months ended September 30, 2017, related party expenses also included \$2.9 million for our share of allocable general and administrative expenses for which we were required to reimburse our Manager pursuant to the Management Agreement. The management fees and allocable general and administrative expenses due to our Manager were relatively consistent for both periods. The increase in incentive fees due to our Manager for the nine

months ended September 30, 2018 compared to the nine months ended September 30, 2017 primarily relates to an increase in our Core Earnings (as defined below) for the twelve months ended September 30, 2018. “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 our target investments are structured as debt and we foreclose 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 our Manager and our independent directors and after approval by a majority of our independent directors.

Other Expenses

For the three months ended September 30, 2018 and 2017, professional fees were \$0.5 million and \$0.4 million, respectively. The increase in professional fees for the three months ended September 30, 2018 compared to the three months ended September 30, 2017 primarily relates to an increase in our use of third party professionals due to changes in transaction activity year over year. For the three months ended September 30, 2018 and 2017, general and administrative expenses were \$0.9 million and \$0.7 million, respectively. The increase in general and administrative expenses for the three months ended September 30, 2018 compared to the three months ended September 30, 2017 primarily relates to an increase in stock-based compensation expense due to new restricted stock grants awarded after September 30, 2017.

For the nine months ended September 30, 2018 and 2017, professional fees were \$1.4 million and \$1.2 million, respectively. The increase in professional fees for the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017 primarily relates to an increase in our use of third party professionals due to changes in transaction activity year over year. For the nine months ended September 30, 2018 and 2017, general and administrative expenses were \$2.4 million and \$2.0 million, respectively. The increase in general and administrative expenses for the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017 primarily relates to an increase in stock-based compensation expense due to new restricted stock grants awarded after September 30, 2017.

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 our Secured Funding Agreements, the net proceeds of future offerings, payments of principal and interest we receive on our portfolio of assets and cash generated from our operating activities. However, principal repayments from mortgage loans in securitizations where we retain the subordinate securities are applied sequentially, first used to pay down the senior notes, and accordingly, we will not receive any proceeds from repayment of loans in the securitizations until all senior notes are repaid in full. Subject to maintaining our qualification as a REIT and our exemption from the 1940 Act, we expect that our primary sources of financing will be, to the extent available to us, through (a) credit, secured funding and other lending facilities, (b) securitizations, (c) other sources of private financing, including warehouse and repurchase facilities, and (d) public or private offerings of our equity or debt securities. 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, cash equivalents and restricted cash for the nine months ended September 30, 2018 and 2017 (\$ in thousands):

	For the nine months ended September 30,	
	2018	2017
Net income	\$28,577	\$24,249
Adjustments to reconcile net income to net cash provided by (used in) operating activities:	(289)	(353)
Net cash provided by (used in) operating activities	28,288	23,896
Net cash provided by (used in) investing activities	18,642	(224,431)
Net cash provided by (used in) financing activities	(70,239)	181,514

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

Change in cash, cash equivalents and restricted cash \$(23,309) \$(19,021)

During the nine months ended September 30, 2018 and 2017, cash, cash equivalents and restricted cash decreased by \$23.3 million and \$19.0 million, respectively.

Operating Activities

For the nine months ended September 30, 2018 and 2017, net cash provided by operating activities totaled \$28.3 million and \$23.9 million, respectively. For the nine months ended September 30, 2018, adjustments to net income related to operating activities primarily included accretion of deferred loan origination fees and costs of \$5.5 million and amortization of

30

deferred financing costs of \$4.3 million. For the nine months ended September 30, 2017, adjustments to net income related to operating activities primarily included accretion of deferred loan origination fees and costs of \$4.9 million, amortization of deferred financing costs of \$5.6 million and change in other assets of \$2.0 million.

Investing Activities

For the nine months ended September 30, 2018 and 2017, net cash provided by (used in) investing activities totaled \$18.6 million and \$(224.4) million, respectively. This change in net cash provided by (used in) investing activities was primarily as a result of the cash received from 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, 2018.

Financing Activities

For the nine months ended September 30, 2018, net cash used in financing activities totaled \$70.2 million and primarily related to repayments of our Secured Funding Agreements of \$511.2 million, partially offset by proceeds from our Secured Funding Agreements of \$465.7 million. For the nine months ended September 30, 2017, net cash provided by financing activities totaled \$181.5 million and primarily related to proceeds from our Secured Funding Agreements of \$533.9 million and proceeds from the issuance of debt of consolidated variable interest entities ("VIEs") of \$272.9 million, partially offset by repayments of our Secured Funding Agreements of \$584.4 million.

Summary of Financing Agreements

The sources of financing, as applicable in a given period, under our Secured Funding Agreements and the Secured Term Loan (collectively, the "Financing Agreements") are described in the following table (\$ in thousands):

	As of September 30, 2018			Maturity Date	December 31, 2017			Maturity Date
	Total Commitment	Outstanding Balance	Interest Rate		Total Commitment	Outstanding Balance	Interest Rate	
Secured Funding Agreements:								
Wells Fargo Facility	\$ 500,000	\$ 334,825	LIBOR+1.75 to 2.35%	December 14, 2018	(1) \$ 500,000	\$ 407,853	LIBOR+1.75 to 2.35%	December 14, 2018
Citibank Facility	250,000	(2) 238,571	LIBOR+2.00 to 2.50%	December 10, 2018	(2) 250,000	(2) 175,651	LIBOR+2.25 to 2.50%	December 10, 2018
BAML Facility	125,000	65,311	LIBOR+1.75 to 2.00%	May 23, 2019	(3) 125,000	78,320	LIBOR+2.00%	May 24, 2018
CNB Facility	50,000	600	LIBOR+3.00%	March 10, 2019	(4) 50,000	—	LIBOR+3.00%	March 11, 2018
MetLife Facility	180,000	131,132	LIBOR+2.30%	August 12, 2020	(5) 180,000	101,131	LIBOR+2.30%	August 12, 2020
UBS Facility	140,000	—	LIBOR+1.88 to 2.28%	(6) October 21, 2018	(6) 140,000	34,000	LIBOR+1.88 to 2.28%	(6) October 21, 2018
U.S. Bank Facility	185,989	141,971	LIBOR+1.85 to 2.25%	July 31, 2020	(7) 185,989	161,005	LIBOR+1.85 to 2.25%	July 31, 2020
Subtotal	\$ 1,430,989	\$ 912,410			\$ 1,430,989	\$ 957,960		

Secured									
Term Loan	\$ 110,000	\$ 110,000	LIBOR+5.00%	December 22, 2020	(8) \$ 110,000	\$ 110,000	LIBOR+5.00%	December 22, 2020	(8)
Total	\$ 1,540,989	\$ 1,022,410			\$ 1,540,989	\$ 1,067,960			

The maturity date of the master repurchase funding facility with Wells Fargo Bank, National Association (the (1) “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.

The maturity date of 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.

(2) The Citibank Facility has an accordion feature that provides for an increase in the \$250.0 million commitment amount with respect to approved assets, as determined by Citibank, N.A. in its sole discretion.

(3) Individual advances on loans under the Bridge Loan Warehousing Credit and Security Agreement with Bank of America, N.A. (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. In May 2018, we amended the

BAML Facility to extend the period during which we may request individual loans under the facility to May 23, 2019. In addition, the final maturity date of individual loans under the BAML Facility was extended to May 23, 2022.

(4) The maturity date of the secured revolving funding facility with City National Bank (the “CNB Facility”) is subject to one 12-month extension at our option provided that certain conditions are met and applicable extension fees are paid. In February 2018, we exercised a 12-month extension option on the CNB Facility to extend the maturity date to March 10, 2019.

(5) The maturity date of 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.

(6) The interest rate on advances under the revolving master repurchase facility with UBS Real Estate Securities Inc. (the “UBS Facility”) is one-month LIBOR plus (i) 1.88% per annum, for assets that are subject to an advance for one year or less, (ii) 2.08% per annum, for assets that are subject to an advance in excess of one year but less than two years, and (iii) 2.28% per annum, for assets that are subject to an advance for more than two years. See “Recent Developments” and Note 13 to our consolidated financial statements included in this quarterly report on Form 10-Q for a subsequent event related to the UBS Facility.

(7) The maturity date of the master repurchase and securities contract with U.S. Bank National Association (the “U.S. Bank Facility”) is subject to two 12-month extensions at our option provided that certain conditions are met and applicable extension fees are paid.

(8) The maturity date of the Credit and Guaranty Agreement with the lenders referred to therein and Cortland Capital Market Services LLC, as administrative agent and collateral agent for the lenders (the “Secured Term Loan”), is subject to one 12-month extension at our option provided that certain conditions are met.

Our Financing Agreements contain various affirmative and negative covenants, including negative pledges, and provisions related to events of default that are normal and customary for similar financing agreements. As of September 30, 2018, we were in compliance with all financial covenants of each respective Financing Agreement. See Note 4 to our consolidated financial statements included in this quarterly report on Form 10-Q for more information on our Financing Agreements.

Securitizations

We may seek to enhance the returns on our senior mortgage loan investments through securitizations, if available. To the extent available, we intend to securitize the senior portion of some of our loans, while retaining the subordinate securities in our investment portfolio. The securitization of this senior portion will be accounted for as either a “sale” and the loans will be removed from our balance sheet or as a “financing” and will be classified as “loans held for investment” in our consolidated balance sheets, depending upon the structure of the securitization. As of September 30, 2018, the carrying amount and outstanding principal of our CLO Securitization was \$271.3 million and \$272.9 million, respectively. See Note 12 to our consolidated financial statements included in this quarterly report on Form 10-Q for additional terms and details of our CLO Securitization.

Capital Markets

We may periodically raise additional capital through public offerings of debt and equity securities to fund new investments. On June 6, 2016, we filed a registration statement on Form S-3 with the Securities and Exchange Commission (“SEC”), which became effective on August 29, 2016, in order to permit us to offer, from time to time, in one or more offerings or series of offerings up to \$1.25 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.

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 Agreements and securitizations, including other credit facilities, warehouse facilities, repurchase facilities, non-convertible or convertible debt, securitized financings and other public and private forms of borrowing. These financings may be issued by us or our subsidiaries, be collateralized or non-collateralized, accrue interest at either fixed or floating rates and may involve one or more lenders.

Leverage Policies

We intend to use prudent amounts of leverage to increase potential returns to our stockholders. To that end, subject to maintaining our qualification as a REIT and our exemption from registration under the 1940 Act, we intend to continue to use borrowings to fund the origination or acquisition of our target investments. Given current market conditions and our focus on first or senior mortgages, we currently expect that such leverage would not exceed, on a debt-to-equity basis, a 4-to-1 ratio. Our charter and bylaws do not restrict the amount of leverage that we may use. The amount of leverage we will deploy for particular investments in our target investments will depend upon our Manager's assessment of a variety of factors, which may include, among others, the anticipated liquidity and price volatility of the assets in our investment portfolio, the potential for losses and extension risk in our portfolio, the gap between the duration of our assets and liabilities, including hedges, the availability and cost of financing the assets, our opinion of the creditworthiness of our financing counterparties, the health of the U.S. economy generally or in specific geographic regions and commercial mortgage markets, our outlook for the level and 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 elected to be taxed as a REIT for U.S. federal income tax purposes and, as such, anticipate annually distributing to our stockholders at least 90% of our REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains. To the extent that we distribute less than 100% of our REIT taxable income in any tax year (taking into account any distributions made in a subsequent tax year under Sections 857(b)(9) or 858 of the Code), we will pay tax at regular corporate rates on that undistributed portion. Furthermore, if a REIT distributes less than the sum of 85% of its ordinary income for the calendar year, 95% of its capital gain net income for the calendar year plus any undistributed shortfall from its prior calendar year (the "Required Distribution") to its stockholders during any calendar year (including any distributions declared by the last day of the calendar year but paid in the subsequent year), then it is required to pay non-deductible excise tax equal to 4% of any shortfall between the Required Distribution and the amount that was actually distributed. Any of these taxes would decrease cash available for distribution to our stockholders. The 90% distribution requirement does not require the distribution of net capital gains. However, if a REIT elects to retain any of its net capital gain for any tax year, it must notify its stockholders and pay tax at regular corporate rates on the retained net capital gain. The stockholders must include their proportionate share of the retained net capital gain in their taxable income for the tax year, and they are deemed to have paid the REIT's tax on their proportionate share of the retained capital gain. Furthermore, such retained capital gain may be subject to the nondeductible 4% excise tax. If we determine that our estimated current year taxable income (including net capital gain) will be in excess of estimated dividend distributions (including capital gains dividends) for the current year from such income, we accrue excise tax on a portion of the estimated excess taxable income as such taxable income is earned.

Before we make any distributions, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our Financing Agreements and other debt payable. If our cash available for distribution is less than our REIT taxable income, we could be required to sell assets or borrow funds to make cash distributions or we may make a portion of the Required Distribution in the form of a taxable stock distribution or distribution of debt securities.

OFF-BALANCE SHEET ARRANGEMENTS

We have commitments to fund various senior mortgage loans, as well as subordinated debt and preferred equity investments in our portfolio.

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 2, 2018, we originated and fully funded a \$17.5 million pre-construction senior mortgage loan on a property with in-place development rights for a residential project located in Florida. The loan has a per annum interest rate of LIBOR plus a spread of 8.00% (plus fees) and an initial term of 1.5 years.

On October 22, 2018, we originated a \$14.0 million mezzanine construction loan on a property with in-place development rights for a residential conversion project located in New York. At closing, the outstanding principal balance was approximately \$10.6 million. The loan has a per annum interest rate of LIBOR plus a spread of 14.00% (plus fees) and an initial term of 2.5 years.

On October 26, 2018, we originated a \$13.5 million senior mortgage loan on an office property located in North Carolina. At closing, the outstanding principal balance was approximately \$8.0 million. The loan has a per annum interest rate of LIBOR plus a spread of 4.00% (plus fees) and an initial term of 4.0 years.

On October 30, 2018, we declared a cash dividend of \$0.31 per common share for the fourth quarter of 2018. The fourth quarter 2018 dividend is payable on January 15, 2019 to common stockholders of record as of December 28, 2018.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As part of our risk management strategy, our Manager closely monitors our portfolio and actively manages the credit, interest rate, market, prepayment, real estate inflation and financing risks associated with holding a portfolio of our target investments. We manage our portfolio through an interactive process with our Manager and Ares Management. 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 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 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.

Interest Rate Risk

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and our related financing obligations, including our borrowings under the Financing Agreements. We primarily originate or acquire floating rate mortgage assets and finance those assets with index-matched floating rate liabilities. As a result, we significantly reduce our exposure to changes in 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, 2018, the following fluctuations in the average 30-day LIBOR would have resulted in the following increases in net interest margin on our loans held for investment (\$ in millions):

Change in Average 30-Day LIBOR	For the	For the
	three	nine
	months	months
	ended	ended
	September	September
	30, 2018	30, 2018
Up 300 basis points	\$ 2.7	\$ 8.4
Up 200 basis points	\$ 1.8	\$ 5.6
Up 100 basis points	\$ 0.9	\$ 2.8
Down to 0 basis points	\$ 2.3	\$ 5.8

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

Interest Rate Cap and Floor Risk

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

Market Risk

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.

Prepayment and Securitizations Repayment Risk

Our net income and earnings may be affected by prepayment rates on our existing CRE loans. When we originate our CRE loans, we anticipate that we will generate an expected yield. When borrowers prepay their CRE loans faster than we expect, we may be unable to replace these CRE loans with new CRE loans that will generate yields which are as high as the prepaid CRE loans. Additionally, principal repayment proceeds from mortgage loans in the CLO Securitization are applied sequentially, first used to pay down the senior CLO Securitization notes. We will not receive any proceeds from the repayment of loans in the CLO Securitization until all senior notes are repaid in full.

35

Financing Risk

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

Real Estate Risk

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

Inflation Risk

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as that term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) that are designed to ensure that information required to be disclosed in our reports under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosures. Any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2018. Based upon that evaluation and subject to the foregoing, our principal executive officer and principal financial officer concluded that, as of September 30, 2018, the design and operation of our disclosure controls and procedures were effective to accomplish their objectives at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2018 that have materially affected, or that are 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, 2018, we were not subject to any material pending legal proceedings.

36

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K, and Amendment No. 1 thereto on Form 10-K/A for the year ended December 31, 2017 (collectively, our “Annual Report on Form 10-K”). You should carefully consider the risk factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K, 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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

37

Item 6. Exhibits

EXHIBIT INDEX

Exhibit Number	Exhibit Description
<u>2.1</u> *	Purchase and Sale Agreement, among Ares Commercial Real Estate Corporation and Cornerstone Real Estate Advisers LLC. (1) Waiver and Amendment to Purchase and Sale Agreement, dated as of September 29, 2016, among Ares Commercial Real Estate Corporation and Barings Real Estate Advisers LLC (formerly known as Cornerstone Real Estate Advisers LLC). (2)
<u>2.2</u> *	Articles of Amendment and Restatement of Ares Commercial Real Estate Corporation. (3)
<u>3.1</u> *	Amended and Restated Bylaws of Ares Commercial Real Estate Corporation. (4)
<u>3.2</u> *	Certification of 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
<u>31.1</u>	
<u>31.2</u>	

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

	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
	Certification of Chief Executive Officer 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
<u>32.1</u>	
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 Exhibit 2.1 to the Company's Form 8-K (File No. 001-35517), filed on June 29, 2016.

(2) Incorporated by reference to Exhibit 2.2 to the Company's Form 10-Q (File No. 001-35517), filed on August 3, 2017.

(3) Incorporated by reference to Exhibit 3.1 to the Company's Form 10-K (File No. 001-35517), filed on March 1, 2016.

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

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: October 30, 2018 By: /s/ James A. Henderson

James A. Henderson
Chief Executive Officer, Chief Investment Officer and President
(Principal Executive Officer)

Date: October 30, 2018 By: /s/ Tae-Sik Yoon

Tae-Sik Yoon
Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)