Ares Commercial Real Estate Corp
Form 10-Q
November 13, 2013
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period to

Commission File No. 001-35517

ARES COMMERCIAL REAL ESTATE CORPORATION

(Exact name of Registrant as specified in its charter)

Maryland	**45-3148087**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

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

(Address of principal executive office) (Zip Code)

(312) 252-7500

(Registrant s telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company o

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

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 November 12, 2013
Common stock, $0.01 par value	28,476,596

Table of Contents

ARES COMMERCIAL REAL ESTATE CORPORATION

INDEX

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

	As of September 30, 2013 (unaudited)	As of December 31, 2012
ASSETS		
Cash and cash equivalents	$ 12,553	$ 23,390
Restricted cash	21,894	3,210
Loans held for investment	692,325	353,500
Loans held for sale, at fair value	24,465	-
Mortgage servicing rights	60,878	-
Other assets	27,691	7,759
Total assets	$ 839,806	$ 387,859
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Secured funding agreements	$ 294,019	$ 144,256
Warehouse lines of credit	13,821	-
Convertible notes	67,674	67,289
Allowance for loss sharing	19,530	-
Due to affiliate	2,958	1,320
Dividends payable	7,119	2,316
Other liabilities	24,038	7,240
Total liabilities	429,159	222,421
Commitments and contingencies (Note 8)		
STOCKHOLDERS EQUITY		
Preferred stock, par value $0.01 per share, 50,000,000 shares authorized at September 30, 2013 and December 31, 2012, no shares issued and outstanding at September 30, 2013 and December 31, 2012	-	-
Common stock, par value $0.01 per share, 450,000,000 shares authorized at September 30, 2013 and December 31, 2012, 28,476,596 and 9,267,162 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	284	92
Additional paid in capital	419,251	169,200
Accumulated deficit	(8,888)	(3,854)
Total stockholders equity	410,647	165,438
Total liabilities and stockholders equity	$ 839,806	$ 387,859

See accompanying notes to consolidated financial statements.

Table of Contents

ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except share and per share data)

	For the three months ended September 30, 2013 (unaudited)	For the three months ended September 30, 2012 (unaudited)	For the nine months ended September 30, 2013 (unaudited)	For the nine months ended September 30, 2012 (unaudited)
Net interest margin:				
Interest income from loans held for investment	$ 10,695	$ 1,889	$ 25,494	$ 4,397
Interest expense (from secured funding agreements)	(1,995)	(398)	(5,260)	(1,090)
Net interest margin	8,700	1,491	20,234	3,307
Mortgage banking revenue:				
Servicing fees, net	503	-	503	-
Gains from mortgage banking activities	3,842	-	3,842	-
Provision for loss sharing	32	-	32	-
Total revenue	13,077	1,491	24,611	3,307
Expenses:				
Other interest expense	1,646	-	4,696	-
Management fees to affiliate	1,487	625	2,744	1,044
Professional fees	675	292	1,741	706
Compensation and benefits	2,281	-	2,281	-
Acquisition and investment pursuit costs	2,052	-	3,813	-
General and administrative expenses	994	496	1,930	827
General and administrative expenses reimbursed to affiliate	1,000	632	2,610	951
Total expenses	10,135	2,045	19,815	3,528
Changes in fair value of derivatives	-	-	1,739	-
Income from operations before gain on acquisition and income taxes	2,942	(554)	6,535	(221)
Gain on acquisition	5,185	-	5,185	-
Income before income taxes	8,127	(554)	11,720	(221)
Income tax expense	496	-	496	-
Net income	7,631	(554)	11,224	(221)
Less income (loss) attributable to Series A Convertible Preferred Stock:				
Preferred dividends	-	-	-	(102)
Accretion of redemption premium	-	-	-	(572)
Net income (loss) attributable to common stockholders	$ 7,631	$ (554)	$ 11,224	$ (895)
Net income (loss) per common share:				
Basic and diluted earnings (loss) per common share	$ 0.27	$ (0.06)	$ 0.71	$ (0.16)
Weighted average number of common shares outstanding:				
Basic weighted average shares of common stock outstanding	27,976,562	9,205,480	15,806,777	5,606,840
Diluted weighted average shares of common stock outstanding	28,027,719	9,205,480	15,853,425	5,606,840
Dividends declared per share of common stock	$ 0.25	$ 0.06	$ 0.75	$ 0.17

See accompanying notes to consolidated financial statements.

Table of Contents

ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(in thousands, except share and per share data)

(unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders Equity
Balance at December 31, 2012	9,267,162	$ 92	$ 169,200	$ (3,854)	$ 165,438
Sale of common stock	18,601,590	186	250,501	-	250,687
Issuance of common stock-acquisition of ACRE Capital	588,235	6	7,506	-	7,512
Offering costs	-	-	(8,416)	-	(8,416)
Stock-based compensation	19,609	-	374	-	374
Net income	-	-	-	11,224	11,224
2015 Convertible Notes	-	-	86	-	86
Dividends declared	-	-	-	(16,258)	(16,258)
Balance at September 30, 2013	28,476,596	$ 284	$ 419,251	$ (8,888)	$ 410,647

See accompanying notes to consolidated financial statements.

Table of Contents

ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the nine months ended September 30, 2013 (unaudited)	For the nine months ended September 30, 2012 (unaudited)
Operating activities:		
Net income (loss)	$ 11,224	$ (221)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Amortization of deferred financing costs	818	469
Gains attributable to fair value of future servicing rights	(1,430)	-
Change in fair value of interest rate lock commitments	(3,580)	-
Change in fair value of forward sale commitments	2,148	-
Accretion of deferred loan origination fees and costs	(1,854)	(171)
Provision for loss sharing	(32)	-
Originations of mortgage loans held for sale	(22,845)	-
Sale of loans to third parties	21,324	-
Stock based compensation	374	202
Changes in fair value of derivatives	(1,739)	-
Amortization of convertible notes issuance costs	597	-
Accretion of convertible notes	385	-
Gain on acquisition	(5,185)	-
Depreciation expense	9	-
Deferred tax expense	301	-
Changes in operating assets and liabilities:		
Restricted cash	1,862	-
Other assets	(3,068)	(1,382)
Due to affiliate	1,638	1,053
Other liabilities	216	(25)
Accounts payable and accrued expenses	4,123	386
Net cash provided by (used in) operating activities	5,286	311
Investing activities:		
Issuance of and fundings on loans held for investment	(388,885)	(185,555)
Principal repayment of loans held for investment	48,220	132
Receipt of origination fees	3,694	-
Acquisition of ACRE Capital, net of cash acquired	(58,258)	-
Purchases of property and equipment	(10)	-
Net cash used in investing activities	(395,239)	(185,423)
Financing activities:		
Proceeds from secured funding arrangements	326,899	113,067
Repayments of secured funding arrangements	(177,137)	(64,277)
Secured funding costs	(1,029)	(2,090)
Proceeds from warehouse lines of credit	24,058	-
Repayments of warehouse lines of credit	(24,708)	-
Proceeds from issuance of Series A convertible preferred stock	-	5,723
Proceeds from sale of common stock	250,687	165,850
Redemption of Series A convertible preferred stock	-	(6,295)
Payment of offering costs	(8,198)	(3,016)
Common dividend payment	(11,456)	(1,005)
Series A preferred dividend	-	(102)
Net cash provided by financing activities	379,116	207,855
Change in cash and cash equivalents	(10,837)	22,743
Cash and cash equivalents, beginning of period	23,390	1,240
Cash and cash equivalents, end of period	$ 12,553	$ 23,983

Supplemental Information:				
Interest paid during the period	$	6,531	$	589
Supplemental disclosure of noncash investing and financing activities:				
Dividends payable	$	7,119	$	556
Deferred financing and offering costs	$	731	$	334
Issuance of common stock for acquisition of ACRE Capital	$	7,512	$	-
Fair value of assets acquired from ACRE Capital	$	111,341	$	-
Fair value of liabilities assumed from ACRE Capital	$	(46,386)	$	-

See accompanying notes to consolidated financial statements.

Table of Contents

ARES COMMERCIAL REAL ESTATE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As of September 30, 2013

(unaudited)

1. ORGANIZATION

Ares Commercial Real Estate Corporation (together with its consolidated subsidiaries, the Company and ACRE) is a Maryland corporation that was initially funded and commenced investment operations on December 9, 2011 and completed its initial public offering (the IPO) of common stock on May 1, 2012. The Company is primarily focused on two business segments involving commercial real estate (CRE) loans. First, in its principal lending business, the Company originates, invests in, manages and services middle-market CRE loans and other CRE-related investments for its own account. These loans are generally held for investment and are secured, directly or indirectly, by office, multi-family, retail, industrial and other commercial real estate properties, or by ownership interests therein. Second, in its mortgage banking and servicing business, conducted through a recently acquired subsidiary, ACRE Capital LLC, the Company originates, sells and retains servicing of primarily multifamily and other housing-related CRE loans. These loans are generally available for sale.

The Company is externally managed by Ares Commercial Real Estate Management LLC (ACREM or the Company s Manager), a Securities and Exchange Commission (SEC) registered investment adviser and a wholly owned subsidiary of Ares Management LLC, a global alternative asset manager and also a SEC registered investment adviser.

In its principal lending business, the Company s target investments include: transitional senior mortgage loans, stretch senior mortgage loans, subordinated debt mortgage loans such as B-notes and mezzanine loans and other select CRE debt and preferred equity investments. Transitional senior mortgage loans provide strategic, flexible, short-term financing solutions for owners of transitional CRE middle-market assets that are the subject of a business plan that is expected to enhance the value of the property. Stretch senior mortgage loans provide flexible one stop financing for owners of higher quality CRE middle-market assets that are typically stabilized or near-stabilized properties with healthy balance sheets and steady cash flows. These mortgage loans typically have higher leverage (and thus higher loan-to-value ratios) than conventional mortgage loans provided by banks, insurance companies and other traditional CRE lenders, are typically fully funded at closing and generally non-recourse to the borrower (as compared to conventional mortgage loans, which are often with partial or full recourse to the borrower).

On August 30, 2013, the Company commenced its mortgage banking business with the acquisition (the Acquisition) of all of the outstanding common units of EF&A Funding, L.L.C., d/b/a Alliant Capital LLC, a Michigan limited liability company (Alliant), from Alliant, Inc., a Florida corporation, and The Alliant Company, LLC, a Florida limited liability company (together with Alliant, Inc., the Sellers). The Company paid approximately $53.4 million in cash, subject to adjustment, and issued 588,235 shares of its common stock in a private placement exempt from registration under Section 4(2) of the Securities Act of 1933 as consideration for the Acquisition. The transaction was accounted for as a business combination under the acquisition method of accounting as discussed in Note 2 and 17. Immediately following the Acquisition, Alliant changed its name to ACRE Capital LLC (ACRE Capital) and is a consolidated subsidiary of the Company.

Through ACRE Capital, the Company operates a mortgage banking and servicing business with a focus on multi-family lending. ACRE Capital primarily originates, sells and services multifamily and other housing-related CRE loans under programs offered by the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (Ginnie Mae) and the Federal Housing Administration, a division of the U.S. Department of Housing and Urban Development (together with Ginnie Mae, HUD). ACRE Capital is approved as a Delegated Underwriting and Servicing (DUS) lender to Fannie Mae, a Multifamily Accelerated Processing (MAP) and Section 232 LEAN lender for HUD, and a Ginnie Mae issuer.

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

In connection with the Acquisition, the Company contributed the common units of ACRE Capital to ACRE Capital Holdings LLC (TRS Holdings), a newly formed wholly-owned subsidiary of the Company. An entity classification election to be taxed as a corporation and a taxable REIT subsidiary (TRS) election were made with respect to TRS Holdings. A TRS is an entity taxed as a corporation other than a REIT in which a REIT directly or indirectly holds equity, and that has made a joint election with such REIT to be treated as a TRS. Other than some activities relating to lodging and health care facilities, a TRS generally may engage in any business, including investing in assets and engaging in activities that could not be held or conducted directly by the Company without jeopardizing its qualification as a REIT. A TRS is subject to applicable U.S. federal, state, local and foreign income tax on its taxable income. In addition, as a REIT, the Company also may be subject to a 100% excise tax on certain transactions between it and its TRS that are not conducted on an arm s-length basis.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting in conformity with generally accepted accounting principles (GAAP) and include the accounts of the Company and its wholly owned subsidiaries, including the results of operations of ACRE Capital from September 1, 2013 (the Accounting Effective Date) to September 30, 2013. 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 significant intercompany balances and transactions have been eliminated.

Table of Contents

Interim financial statements are prepared in accordance with United States GAAP for interim financial information 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 fiscal year ending December 31, 2013.

Segment Reporting

Prior to the Acquisition, the Company focused primarily on originating, investing in and managing middle-market CRE loans and other CRE-related investments and operated in one reportable business segment. As a result of the Acquisition, the Company now has two reportable business segments: principal lending, and through ACRE Capital, mortgage banking & servicing of multifamily CRE loans. ACRE Capital is included in the consolidated financial statements for the one month period ended September 30, 2013. See Note 18 for further discussion of the Company s reportable business segments.

Cash and Cash Equivalents

Cash and cash equivalents include funds on deposit with financial institutions, including demand deposits with financial institutions.

Restricted Cash

Restricted cash includes escrow deposits for taxes, insurance, leasing outlays, capital expenditures, tenant security deposits and payments required under certain loan agreements. These escrow deposits are held on behalf of the respective borrowers and are offset by escrow liabilities included in Other liabilities in the consolidated balance sheets. As of September 30, 2013, ACRE Capital s restricted cash consisted of reserves that are a requirement of the DUS program and borrower deposits, which represent funds that were collected for the processing of the borrowers loan applications and interest rate lock commitments (IRLCs).

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, loans held for investment, mortgage servicing rights (MSR), loans held for sale, interest receivable, derivative financial instruments and allowance for loss sharing. The Company places its cash and cash equivalents with financial institutions and, at times, cash held may exceed the FDIC-insured limit. The Company has exposure to credit risk on its loans held for investment and through its subsidiary ACRE Capital, the Company has exposure on credit risk on loans held for sale and the servicing portfolio whereby ACRE Capital shares in the risk of loss (see Note 7). The Company s Manager will seek to manage credit risk by performing credit fundamental analysis of potential collateral assets.

Loans Held for Investment

The Company originates CRE debt and related instruments generally to be held for investment and to maturity. Loans that are held for investment are carried at cost, net of unamortized loan fees and origination costs, unless the loans are deemed impaired.

Impairment occurs when it is deemed probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan. If a loan is considered to be impaired, the Company will record an allowance to reduce the carrying value of the loan to the present value of expected future cash flows discounted at the loan s contractual effective rate.

Each loan classified as held for investment is evaluated for impairment on a periodic basis. Loans are collateralized by real estate and as a result, the extent and impact of any credit deterioration associated with the performance and/or value of the underlying collateral property, as well as the financial and operating capability of the borrower could impact the expected amounts received and as a result are regularly evaluated. 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.

Table of Contents

In addition, the Company evaluates the entire portfolio to determine whether the portfolio has any impairment that requires a general valuation allowance on the remainder of the loan portfolio. As of September 30, 2013 and December 31, 2012, there are no impairments on the Company s loan portfolio.

Loans held for sale

Through its subsidiary, ACRE Capital, the Company originates multifamily mortgage loans, which are recorded at fair value. The holding period for these loans is approximately 30 days. The carrying value of the mortgage loans sold is reduced by the cost allocated to the associated MSRs based on relative fair value at the time of the sale. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the adjusted value of the related mortgage loans sold.

Mortgage Servicing Rights

When a mortgage loan is sold, ACRE Capital retains the right to service the loan and initially recognizes the MSR at fair value. The initial fair value represents expected net cash flows from servicing, as well as borrower prepayment penalties, interest earnings on escrows and interim cash balances, along with ancillary fees that are discounted at a rate that reflects the credit and liquidity risk of the MSR over the estimated life of the underlying loan.

Intangible Assets

Intangible assets consist of ACRE Capital s licenses permitting it to participate in programs offered by Fannie Mae & HUD. These licenses are intangible assets with indefinite lives and were acquired in connection with the Acquisition. As of the date of the Acquisition, these assets are recorded at fair value. The Company evaluates identified intangibles for impairment annually or if other events or circumstances indicate that the carrying value may be impaired.

Deferred Financing Costs

Deferred financing costs are capitalized and amortized over the terms of the respective debt instrument.

Derivative Financial Instruments

The Company does not hold or issue derivative instruments for trading purposes. The Company recognizes derivatives on its balance sheet, measures them at their estimated fair value and recognizes changes in their estimated fair value in the Company s results of operations for the period in which the change occurs.

On December 19, 2012, the Company issued $69.0 million aggregate principal amount of unsecured 7.000% Convertible Senior Notes due 2015 (the 2015 Convertible Notes). The conversion features of the 2015 Convertible Notes were deemed to be an embedded derivative under Accounting Standards Codification (ASC) Topic 815, Derivatives and Hedging (ASC 815). In accordance with ASC 815, the Company was required to bifurcate the embedded derivative related to the conversion features of the 2015 Convertible Notes. Prior to June 26, 2013, the Company recognized the embedded derivative as a liability on its balance sheet, measured at its estimated fair value and recognized changes in its estimated fair value in Changes in fair value of derivatives in the Company s consolidated statements of operations for the period in which the change occurs. See Note 6 for information on the derivative liability reclassification.

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

Fair Value Measurements

The Company determines the estimated fair value of financial assets and liabilities using the three-tier fair value hierarchy established by GAAP, which prioritizes the inputs used in measuring fair value. GAAP establishes market-based or observable inputs as the preferred source of values, followed by valuation models using management assumptions in the absence of market inputs. The financial instruments recorded at fair value on a recurring basis in the Company s consolidated financial statements are derivative financial instruments and loans held for sale. The Company has not elected the fair value option for certain other financial instruments, including loans held for investment, secured funding agreements and other debt instruments. Such financial instruments are carried at cost. Fair value is separately disclosed (see Note 14). The three levels of inputs that may be used to measure fair value are as follows:

Table of Contents

Level I Quoted prices in active markets for identical assets or liabilities.

Level II Prices are determined using other significant observable inputs. Observable inputs are inputs that other market participants would use in pricing a security. These may include quoted prices for similar securities, interest rates, prepayment speeds, credit risk and others.

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

Allowance for loss sharing

When a loan is sold under the Fannie Mae DUS program, ACRE Capital undertakes an obligation to partially guarantee the performance of the loan. The date ACRE Capital commits to make a loan to a borrower, a liability for the fair value of the obligation undertaken in issuing the guaranty is recognized. The Company monitors the performance of each loan for events or circumstances which may signal a liability to be recognized if there is a probable and estimable loss. The general reserve was estimated by examining historical loss share experienced in the ACRE Capital portfolio since inception. These historical loss share served as a basis to derive a loss share rate which was then applied to the current ACRE Capital portfolio (net of specifically identified impaired loans that are subject to a separate loss share reserve analysis).

Servicing fee payable

ACRE Capital provides additional payments to certain personnel by providing them with a percentage of the servicing fee revenue that is earned by ACRE Capital, which is initially recorded as a liability when the MSR is obtained and expensed as the servicing fee is earned over the life of the related mortgage loan (servicing fee payable). ACRE Capital incurs an expense over the life of each loan as long as the related loan is performing. If a particular loan is not performing, the recipient will not receive the additional compensation on that loan, and if a loss sharing event is triggered, the recipient will not receive a portion of the additional compensation on other loans. The servicing fee payable is recorded in Other liabilities in the consolidated balance sheets and the related expense is recorded in Servicing fee revenue on a net basis in the consolidated statements of operations.

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. Fees earned on loans held for sale are included in mortgage banking activities below.

Servicing fees are earned for servicing mortgage loans, including all activities related to servicing the loans, and are recognized as services are provided over the life of the related mortgage loan. Also included in servicing fees are the fees earned on borrower prepayment penalties and interest earned on borrowers escrow payments and interim cash balances, along with other ancillary fees.

Gains from mortgage banking activities includes the initial fair value of MSRs, loan origination fees, gain on the sale of loans, interest income on loans held for sale and changes to the fair value of derivative financial instruments, including IRLCs and forward sale commitments. The initial fair value of MSRs, loan origination fees, gain on the sale of loans, and certain direct loan origination costs for loans held for sale are recognized when ACRE Capital commits to make a loan to a borrower. When the Company enters into a sale agreement and transfers the mortgage loan to the seller, the Company recognizes a MSR asset equal to the present value of the cash flows associated with the servicing of loans sold.

Stock Based Compensation

The Company recognizes the cost of stock-based compensation and payment transactions , which is included in General and administrative expenses in the consolidated statements of operations. The fair value of the restricted stock or restricted stock units granted is recorded to expense on a straight-line basis over the vesting period for the award, with an offsetting increase in stockholders equity. For grants to directors and officers, the fair value is determined based upon the market price of the stock on the grant date.

Table of Contents

Underwriting Commissions and Offering Costs

Underwriting commissions and offering costs incurred in connection with common stock offerings are reflected as a reduction of additional paid-in capital. Costs incurred that are not directly associated with the completion of a common stock offering are expensed. Underwriting commissions that are the responsibility of and paid by a related party, such as the Company s Manager, are reflected as a contribution of additional paid in capital from a sponsor in the consolidated financial statements.

Income Taxes

The Company has elected and qualified for taxation as a REIT commencing with its taxable year ended December 31, 2012. As a result of the Company s REIT qualification and its distribution policy, the Company does not generally pay U.S. federal corporate level income taxes. Many of the REIT requirements, however, are highly technical and complex. To continue to qualify as a REIT, the Company must meet a number of organizational and operational requirements, including a requirement that the Company distribute annually at least 90% of the Company s REIT taxable income to the Company s stockholders. If the Company fails to qualify as a REIT in any subsequent taxable year and does not qualify for certain statutory relief provisions, the Company will be subject to U.S. federal and state income taxes at regular corporate rates (including any applicable alternative minimum tax) and may be precluded from qualifying as a REIT for the Company s four subsequent taxable years. Even though the Company currently qualifies for taxation as a REIT, the Company may be subject to certain U.S. federal, state, local and foreign taxes on the Company s income and property and to U.S. federal income and excise taxes on the Company s undistributed REIT taxable income.

The Company currently owns 100% of the equity of TRS Holdings, a TRS. A TRS is subject to applicable U.S. federal, state, local and foreign income tax on its taxable income. In addition, as a REIT, the Company also may be subject to a 100% excise tax on certain transactions between it and its TRS that are not conducted on an arm s-length basis. For financial reporting purposes, a provision for current and deferred taxes has been established for the portion of the Company s GAAP consolidated earnings recognized by TRS Holdings.

ASC 740, Income Taxes, (ASC 740) prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company has analyzed its various federal and state filing positions and believes that its income tax filing positions and deductions are well documented and supported. As of September 30, 2013 and December 31, 2012, the Company has not recorded a reserve for any uncertain income tax positions; as a result, there are no ASC 740 disclosures in this quarterly report.

Comprehensive Income

For the three and nine months ended September 30, 2013 and 2012, comprehensive income equaled net income; therefore, a separate consolidated statement of comprehensive income is not included in the accompanying consolidated financial statements.

Earnings per Share

The Company calculates basic earnings (loss) per share by dividing net income (loss) allocable to common stockholders for the period by the weighted-average shares of common stock outstanding for that period after consideration of the earnings (loss) allocated to the Company s restricted stock and restricted stock units, which are participating securities as defined in GAAP. Diluted earnings (loss) per share takes into effect any dilutive instruments, such as restricted stock, restricted stock units and convertible debt, except when doing so would be anti-dilutive. With respect to the 2015 Convertible Notes (as defined above), the Company has the ability and intention to settle the principal in cash and to settle any amount above par in shares of the Company s common stock if the conversion options were exercised. As such, the Company is applying the treasury stock method of determining the dilutive impact on earnings per share.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Actual results could differ from those estimates.

Table of Contents

Business Combinations

The Company accounts for business combinations using the acquisition method of accounting, under which the purchase price of the acquisition is allocated to the assets acquired and liabilities assumed using the fair values determined by management as of the acquisition date. The Company recognizes identifiable assets acquired and liabilities (both specific and contingent) assumed at their fair values at the acquisition date. Furthermore, acquisition-related costs, such as due diligence, legal and accounting fees, are not capitalized or applied in determining the fair value of the acquired assets. The excess of the assets acquired, identifiable intangible assets and liabilities assumed over the purchase price is recognized as a gain on acquisition. During the measurement period, the Company records adjustments to the assets acquired and liabilities assumed with corresponding adjustments to the gain on acquisition. After the measurement period, which could be up to one year after the transaction date, subsequent adjustments are recorded through earnings.

3. LOANS HELD FOR INVESTMENT

As of September 30, 2013, the Company has originated or co-originated 24 loans secured by CRE middle market properties, excluding two loans that were repaid during the nine months ended September 30, 2013. The aggregate originated commitment under these loans at closing was approximately $759.8 million and outstanding principal was $697.4 million as of September 30, 2013. During the nine months ended September 30, 2013, the Company funded approximately $388.9 million and received repayments of $48.2 million on its net $697.4 million of outstanding principal at closing as described in more detail in the tables below. Such investments are referred to herein as the Company s investment portfolio. References to LIBOR or L are to 30-day LIBOR (unless otherwise specifically stated).

The Company s investments in mortgages and loans held for investment are accounted for at amortized cost. The following tables summarize the Company s loans held for investment as of September 30, 2013:

	September 30, 2013				
$ in thousands	**Carrying Amount (1)**	**Outstanding Principal (1)**	**Weighted Average Interest Rate**	**Weighted Average Unleveraged Effective Yield**	**Weighted Average Remaining Life (Years)**
[redacted]					

(1) The difference between the carrying amount and the outstanding principal face amount of the loans held for investment consists of unamortized purchase discount, deferred loan fees and loan origination costs.

Table of Contents

A more detailed listing of the Company s current investment portfolio, based on information available as of September 30, 2013 is as follows:

(amounts in millions, except percentages)

Loan Type	**Location**	**Total Commitment (at closing)**	**Outstanding Principal (1)**	**Carrying Amount (1)**	**Interest Rate**	**LIBOR Floor**	**Unleveraged Effective Yield (2)**	**Maturity Date (3)**	**Payment Terms (4)**
Transitional Senior Mortgage Loans									
Retail	Chicago, IL	$ 75.9	$ 70.0	$ 69.3	L+4.25%	0.3%	4.9%	Aug 2017	I/O
Office	Orange County, CA	75.0	75.0	74.3	L+3.75%	0.2%	4.2%	Aug 2017	I/O
Apartment	Brandon, FL	49.6	46.7	46.3	L+4.80%	0.5%	5.9%	Jan 2016	I/O
Apartment	McKinney, TX	45.3	39.4	39.1	L+3.75%		4.5%	Jul 2016	I/O
Office	Austin, TX	38.0	31.7	31.5	L+5.75%-L+5.25%(5)	1.0%	7.6%	Mar 2015	I/O
Apartment	New York, NY	38.4 (6)	36.6	36.3	L+5.00%	0.8%	6.1%	Oct 2017	I/O
Apartment	Houston, TX	35.5	32.8	32.5	L+3.75%		4.5%	Jul 2016	I/O
Office	Cincinnati, OH	35.5	27.3	27.2	L+5.35%-L+5.00%(7)	0.3%	6.1%	Nov 2015	I/O
Apartment	New York, NY	26.3	25.1	25.0	L+5.75%-L+5.00%(8)	0.2%	6.5%	Dec 2015	I/O
Office	Overland Park, KS	25.5	24.4	24.1	L+5.00%	0.3%	5.8%	Mar 2016	I/O
Apartment	Avondale, AZ	22.1	21.3	21.2	L+4.25%	1.0%	5.9%	Sep 2015	I/O
Apartment	New York, NY	21.9	20.1	20.0	L+5.75%-L+5.00%(8)	0.2%	6.5%	Dec 2015	I/O
Apartment	New York, NY	21.8	19.6	19.6	L+5.75%-L+5.00%(8)	0.2%	6.5%	Dec 2015	I/O
Flex/Warehouse	Springfield, VA	19.7	19.0	18.8	L+5.25%	0.3%	6.4%	Dec 2015	I/O
Office	San Diego, CA	17.1	14.8	14.6	L+3.75%	0.3%	4.5%	Jul 2016	I/O
Office	Irvine, CA	15.2	14.7	14.6	L+4.50%	0.3%	5.3%	Jul 2016	I/O
Office	Denver, CO	11.0	10.3	10.2	L+5.50%	1.0%	7.9%	Jan 2015	I/O
Stretch Senior Mortgage Loans									

Office	Miami, FL	47.0	47.0(9)	47.0	L+5.25%	1.0%	6.6%	Apr 2014	I/O
Office	Mountain View, CA	15.0	14.5	14.3	L+4.75%	0.5%	5.7%	Feb 2016	I/O
Subordinated Debt Investments									
Apartment	Atlanta, GA	39.0	29.1	29.0	L+10.70%(10)	0.5%	12.8%	Apr 2016	I/O
Office	Chicago, IL	37.0	37.0	36.6	8.75%		9.1%	Aug 2016	I/O
Apartment	Rocklin, CA	18.7	18.7	18.7	L+6.40%(11)	1.0%	10.0%	Dec 2013	I/O
Office	Fort Lauderdale, FL	15.0(12)	8.0	7.9	L+10.75%-L+8.18%(12)	0.8%	12.0%	Feb 2015	I/O
Office	Atlanta, GA	14.3	14.3	14.2	10.50%(13)		11.0%	Aug 2017	I/O
Total/Average		$ 759.8	$ 697.4	$ 692.3			6.4%		

(1) The difference between the carrying amount and the outstanding principal face amount of the loans held for investment consists of unamortized purchase discount, deferred loan fees and loan origination costs.

(2) Unleveraged Effective Yield is the compounded effective rate of return that would be earned over the life of the investment based on the contractual interest rate (adjusted for any deferred loan fees, costs, premium or discount) and assumes no dispositions, early prepayments or defaults. Unleveraged Effective Yield for each loan is calculated based on LIBOR as of September 30, 2013 or the LIBOR floor, as applicable. The Total/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, 2013 as weighted by the Outstanding Principal balance of each loan.

(3) The Miami, Mountain View and Orange County loans are subject to one 12-month extension option. The Atlanta loan with a Maturity Date of April 2016, Austin, Avondale, Brandon, Cincinnati, McKinney, Houston, San Diego, New York loans with a Maturity Date of December 2015, Fort Lauderdale, Irvine and Chicago loans are subject to two 12-month extension options. The Rocklin loan is subject to one 6-month extension option. Certain extension options may be subject to performance based or other conditions as stipulated in the loan agreement.

Table of Contents

(4) I/O = interest only.

(5) The initial interest rate for this loan of L+5.75% steps down based on performance hurdles to L+5.25%.

(6) On August 9, 2013, the Company entered into a loan modification that increased the loan by $2.3 million (loan commitment increased from $36.1 million to $38.4 million) in order to pay for more rent stabilized conversions and pay other miscellaneous costs.

(7) The initial interest rate for this loan of L+5.35% steps down based on performance hurdles to L+5.00%.

(8) The initial interest rate for this loan of L+5.75% steps down based on performance hurdles to L+5.00%.

(9) On March 8, 2013, the Company entered into a loan assumption transaction with a new sponsor group to facilitate the purchase of a Class B office building in Miami, FL that was collateralized by the Company s existing $47.0 million first mortgage loan.

(10) This loan was co-originated with a third party using an A/B structure, with the whole loan interest rate of L + 4.95% and a LIBOR Floor of 0.50%. The A-Note (held by a third party) has an interest rate of L + 2.70% with no LIBOR Floor and the Company s B-Note receives the full benefit of the LIBOR Floor on the full combined balance of the A-Note and B-Note. On March 28, 2013, at the initial respective funded amounts of the A-Note and B-Note, the interest rate on the Company s B-Note is L + 10.70% subject to a 0.50% LIBOR Floor (with the benefit of any difference between actual LIBOR and the LIBOR Floor on the A-Note and B-Note accruing to the B-Note). Accordingly, the interest rate on the Company s B-Note would be 12.50% if LIBOR is equal to 0.0% and L + 10.70% if LIBOR is equal to or greater than 0.50%. As the Company funds additional proceeds on the loan under the B-Note up to the full $39 million level, the interest rate will decrease and the B-Note will have an interest rate of L +8.90% subject to a 0.50% LIBOR Floor (with the benefit of any difference between actual LIBOR and the LIBOR Floor on the A-Note and B-Note accruing to the B-Note). Accordingly, the interest rate on the Company s fully funded loan under the B-Note would be 10.30% if LIBOR is equal to 0.0% and L + 8.90% if LIBOR is equal to or greater than 0.50%.

(11) This loan was co-originated with a third party using an A/B structure, with a cumulative interest rate of L + 4.10% and a LIBOR Floor of 1.00%. The fully funded A-Note (held by a third party) has an interest rate of L + 2.75% with no LIBOR Floor and the Company s B-Note receives the full benefit of the LIBOR Floor on the full $50.5 million balance of the loan. The interest rate on the Company s B-Note is L + 6.40% subject to a 1.00% LIBOR Floor (with the benefit of any difference between actual LIBOR and the LIBOR Floor on the A-Note and B-Note accruing to the B-Note). Accordingly, the interest rate on the Company s B-Note would be 9.10% if LIBOR is equal to 0.0% and L + 6.40% if LIBOR is equal to or greater than 1.00%. This loan has an exit fee associated with it, which is waived under certain circumstances. As a result, the exit fee is not included in determining Unleveraged Effective Yield.

(12) The total commitment the Company co-originated was a $37.0 million first mortgage, of which a $22.0 million A-Note was fully funded by a third party, with a cumulative interest rate of L + 5.25% and a LIBOR Floor of 0.75%. The Company committed to a $15.0 million

B-Note. The fully funded A-Note (held by a third party) has an interest rate of L + 3.25% with the LIBOR Floor, resulting in an initial interest rate on the Company s B-Note of L + 10.75% with the LIBOR Floor. As the Company funds additional proceeds on the B-Note, the interest rate will decrease and the fully committed B-Note ($15.0 million) will have an interest rate of LIBOR + 8.18% with the LIBOR Floor.

(13) The interest rate for this loan increases to 11.0% on September 1, 2014.

Table of Contents

For the nine months ended September 30, 2013, the activity in the Company s loan portfolio was as follows ($ in thousands):

Balance at December 31, 2012	$	353,500
Initial funding		368,116
Receipt of origination fee, net of costs		(3,694)
Additional funding		20,769
Amortizing payments		(150)
Origination fee accretion		1,854
Loan payoffs (1)		(48,070)
Balance at September 30, 2013	$	692,325

(1) On June 27, 2013, the stretch senior mortgage loan on the apartment building in Arlington, VA was paid off in the amount of $13.4 million. There was no gain (loss) with respect to the repayment of this loan; however, included in interest income from loans held for investment for the nine months ended September 30, 2013 is $146 thousand of accelerated loan origination fees and costs. Additionally, on August 21, 2013, the stretch senior mortgage loan on the office building in Boston, MA was paid off in the amount of $34.7 million. There was no gain (loss) with respect to the repayment of this loan; however, included in interest income from loans held for investment for the three and nine months ended September 30, 2013 is $298 thousand of accelerated loan origination fees and costs.

No impairment charges have been recognized as of September 30, 2013 or as of December 31, 2012.

4. MORTGAGE SERVICING RIGHTS

MSRs represent servicing rights retained by ACRE Capital for loans it originates and sells. The initial fair value of MSRs is determined based on the cash flows associated with the servicing contracts on loans sold. The servicing fees are collected from the monthly payments made by the borrowers. ACRE Capital generally receives other remuneration including rights to various loan fees such as late charges, collateral re-conveyance charges, loan prepayment penalties, and other ancillary fees. In addition, ACRE Capital is also generally entitled to retain the interest earned on funds held pending remittance related to its collection of loan principal and escrow balances. The initial fair value of MSRs purchased in the Acquisition was $61.2 million. As of September 30, 2013, the carrying value of MSRs was approximately $60.9 million.

5. INTANGIBLE ASSETS

As of September 30, 2013, the carrying values of the Company s intangible assets were $5.0 million, which are included in Other assets within the Company s consolidated balance sheets as of September 30, 2013. The identified intangible assets have indefinite lives and are not subject to amortization. The Company performs an annual assessment of impairment of its intangible assets in the fourth quarter of each year or whenever events or circumstances make it more likely than not that impairment may have occurred. As of September 30, 2013, there has been no impairment charges recognized.

6. DEBT

Secured Funding Agreements

	As of September 30, 2013		As of December 31, 2012	
$ in thousands	**Outstanding Balances**	**Total Commitment**	**Outstanding Balances**	**Total Commitment**
Wells Fargo Facility	$ 129,883	$ 225,000	$ 98,196	$ 172,500
Citibank Facility	81,215	125,000	13,900	86,225
Capital One Facility	82,921	100,000	32,160	50,000
Total	$ 294,019	$ 450,000	$ 144,256	$ 308,725

The secured funding agreements are generally collateralized by assignments of specific loans held for investment owned by the Company. The secured funding arrangements are guaranteed by the Company. Generally, the Company partially offsets interest rate risk by matching the interest index of loans held for investment with the secured funding agreement used to fund them.

Table of Contents

Wells Fargo Facility

On December 14, 2011, the Company entered into a $75.0 million secured revolving funding facility arranged by Wells Fargo Bank, National Association (the Wells Fargo Facility), pursuant to which the Company borrows funds to finance qualifying senior commercial mortgage loans and A-Notes, subject to available collateral. On May 22, 2012 and June 27, 2013, the agreements governing the Wells Fargo Facility were amended to, among other things, increase the total commitment under the Wells Fargo Facility from $75.0 million to $172.5 million and from $172.5 million to $225.0 million, respectively. Prior to June 27, 2013, advances under the Wells Fargo Facility accrued interest at a per annum rate equal to the sum of (i) 30 day LIBOR plus (ii) a pricing margin range of 2.50%-2.75%. On June 27, 2013, the pricing was reduced such that advances under the Wells Fargo Facility accrue interest at a per annum rate equal to the sum of (i) 30 day LIBOR plus (ii) a pricing margin range of 2.00%-2.50%. On May 15, 2012, the Company started to incur a non-utilization fee of 25 basis points on the average available balance of the Wells Fargo Facility. For the three and nine months ended September 30, 2013, the Company incurred a non-utilization fee of $62 thousand and $136 thousand, respectively. For the three and nine months ended September 30, 2012, the Company incurred a non-utilization fee of $108 thousand and $157 thousand, respectively. The initial maturity date of the Wells Fargo Facility is December 14, 2014 and, provided that certain conditions are met and applicable extension fees are paid, is subject to two 12-month extension options. As of September 30, 2013 and December 31, 2012, the outstanding balance on the Wells Fargo Facility was $129.9 million and $98.2 million, respectively.

The Wells Fargo Facility contains various affirmative and negative covenants applicable to the Company and certain of the Company s subsidiaries, including the following: (a) limitations on the incurrence of additional indebtedness or liens, (b) limitations on how borrowed funds may be used, (c) limitations on certain distributions and dividend payments in excess of the minimum amount necessary to continue to qualify as a REIT and avoid the payment of income and excise taxes, (d) maintenance of adequate capital, (e) limitations on change of control, (f) maintaining a ratio of total debt to total assets of not more than 75%, (g) maintaining a fixed charge coverage ratio (expressed as the ratio of EBITDA (net income before net interest expense, income tax expense, depreciation and amortization), as defined, to fixed charges) for the immediately preceding 12 month period ending on the last date of the applicable reporting period to be at least than 1.25 to 1.00, and (h) maintaining a tangible net worth of at least the sum of (1) $135.5 million, plus (2) 80% of the net proceeds raised in all future equity issuances by the Company. As of September 30, 2013, the Company was in compliance in all material respects with the terms of the Wells Fargo Facility.

Citibank Facility

On December 8, 2011, the Company entered into a $50.0 million secured revolving funding facility arranged by Citibank, N.A. (the Citibank Facility) pursuant to which the Company borrows funds to finance qualifying senior commercial mortgage loans and A-Notes, subject to available collateral. On April 16, 2012 and May 1, 2012, the agreements governing the Citibank Facility were amended to, among other things, increase the total commitment under the Citibank Facility from $50.0 million to $86.2 million. On July 12, 2013, the agreements governing the Citibank Facility were amended to, among other things, increase the total commitment under the Citibank Facility from $86.2 million to $125.0 million. Under the Citibank Facility, the Company borrows funds on a revolving basis in the form of individual loans. Each individual loan is secured by an underlying loan originated by the Company. Advances under the Citibank Facility accrue interest at a per annum rate based on LIBOR. From December 8, 2011 to July 11, 2013, the margin varied between 2.50% and 3.50% over the greater of LIBOR and 0.5%, based on the debt yield of the assets contributed into ACRC Lender C LLC, one of the Company s wholly owned subsidiaries and the borrower under the Citibank Facility. On July 12, 2013, the agreements governing the Citibank Facility were amended to reduce the pricing from a range of LIBOR plus a pricing margin of 2.50 % to 3.50 % to a range of LIBOR plus a pricing margin of 2.25% to 2.75%.

On March 3, 2012, the Company started to incur a non-utilization fee of 25 basis points on the average available balance of the Citibank Facility. For the three and nine months ended September 30, 2013, the Company incurred a non-utilization fee of $43 thousand and $121 thousand, respectively. For the three and nine months ended September 30, 2012, the Company incurred a non-utilization fee of $55 thousand and $111 thousand, respectively. The end of the funding period is December 8, 2013, and may be extended for an additional 12 months upon the payment of the applicable extension fee and provided that no event of default is then occurring. On July 12, 2013, the agreements governing the Citibank Facility were amended to change the final repayment date from the latest date on which a payment of principal is contractually obligated to be made in respect of each mortgage loan pledged under the Citibank Facility to the earlier of that date or July 2, 2018. As of September 30, 2013 and December 31, 2012, the outstanding balance on the Citibank Facility was $81.2 million and $13.9 million, respectively.

The Citibank Facility contains various affirmative and negative covenants applicable to the Company and certain of the Company s subsidiaries, including the following: (a) maintaining tangible net worth of at least the sum of (1) 80% of the Company s tangible net worth as of May 1, 2012, plus (2) 80% of the total net capital raised in all future equity issuances by the Company, (b) maintaining liquidity in an amount not less than the greater of (1) $5.0 million or (2) 5% of the Company s recourse indebtedness, not to exceed $10.0 million (provided that in the event the Company s total liquidity equals or exceeds $5.0 million, the Company may satisfy the difference between the minimum total liquidity requirement and the Company s total liquidity with available borrowing capacity), (c) maintaining a fixed charge coverage ratio (expressed as the ratio of EBITDA (net income before net interest expense, income tax expense, depreciation and amortization), as defined, to fixed charges) for the immediately preceding twelve month period ending on the last date of the applicable reporting period to be at least than 1.25 to 1.00, and (d) if the Company s average debt yield across the portfolio of assets that are financed with the Citibank Facility falls below certain thresholds, the Company may be required to repay certain amounts under the Citibank Facility. The Citibank Facility also prohibits the Company from amending the management agreement with its Manager in a material respect without the prior consent of the lender. As of September 30, 2013, the Company was in compliance in all material respects with the terms of the Citibank Facility.

Table of Contents

Capital One Facility

On May 18, 2012, the Company entered into a $50.0 million secured revolving funding facility with Capital One, National Association (the Capital One Facility), pursuant to which the Company borrows funds to finance qualifying senior commercial mortgage loans, subject to available collateral. On July 26, 2013, the agreements governing the Capital One Facility were amended to, among other things, increase the size of the Capital One Facility from $50.0 million to $100.0 million.

Under the Capital One Facility, the Company borrows funds on a revolving basis in the form of individual loans evidenced by individual notes. Each individual loan is secured by an underlying loan originated by the Company. Amounts outstanding under each individual loan committed prior to July 26, 2013 accrue interest at a per annum rate equal to LIBOR plus a spread ranging between 2.50% and 4.00%. On July 26, 2013, the agreements governing the Capital One Facility were amended to reduce the pricing from a range of LIBOR plus a pricing margin of 2.50% to 4.00% to a range of LIBOR plus a pricing margin of 2.00% to 3.50%. The Company may request individual loans under the Capital One Facility through and including May 18, 2015, subject to successive 12-month extension options at the lender s discretion. The maturity date of each individual loan is the same as the maturity date of the underlying loan that secures such individual loan. As of September 30, 2013 and December 31, 2012, the outstanding balance on the Capital One Facility was $82.9 million and $32.2 million, respectively. The Company does not incur a non-utilization fee under the terms of the Capital One Facility.

The Capital One Facility contains various affirmative and negative covenants applicable to the Company and certain of the Company s subsidiaries, including the following: (a) maintaining a ratio of debt to tangible net worth of not more than 3.0 to 1, (b) maintaining a tangible net worth of at least the sum of (1) 80% of the Company s tangible net worth as of May 1, 2012, plus (2) 80% of the net proceeds received from all future equity issuances by the Company, and (c) maintaining a fixed charge coverage ratio (expressed as the ratio of EBITDA, as defined, to fixed charges) of at least 1.25 to 1. Effective September 27, 2012, the agreements governing the Capital One Facility were amended to provide that the required minimum fixed charge coverage ratio with respect to the Company as guarantor will start to be tested upon the earlier to occur of (a) the calendar quarter ending on June 30, 2013 and (b) the first full calendar quarter following the calendar quarter in which the Company reports Loans held for investment in excess of $200.0 million on the Company s quarterly consolidated balance sheet. As of December 31, 2012 the Company reported Loans held for investment in excess of $200.0 million. As a result, the Company tested the minimum fixed charge coverage ratio beginning with the three months ended March 31, 2013. As of September 30, 2013, the Company was in compliance in all material respects with the terms of the Capital One Facility.

Warehouse Lines of Credit

ASAP Line of Credit

On August 25, 2009, ACRE Capital entered into a multifamily as soon as pooled (ASAP) sale agreement with Fannie Mae, which was assumed as part of the Acquisition. As of September 30, 2013, the ASAP Line of Credit had a borrowing capacity of $105.0 million with no expiration date. Fannie Mae advances payment to ACRE Capital in two separate installments according to the terms as set forth in the ASAP sale agreement. The first installment is considered an advance to ACRE Capital from Fannie Mae and not a sale until the second advance and settlement is made. Installments received by ACRE Capital from Fannie Mae are financed on the Fannie Mae ASAP Line of Credit (the ASAP Line of Credit) which charges interest at a floating daily rate of LIBOR+140 with a floor of 1.75% and secured by the origination loan. As of September 30, 2013, there was no outstanding balance under the ASAP Line of Credit.

BAML Line of Credit

As of September 30, 2013, ACRE Capital maintained a line of credit with Bank of America, N.A. (the BAML Line of Credit) of $80.0 million with a stated interest rate of Bank of America LIBOR Daily Floating Rate plus 1.60%. The BAML Line of Credit was assumed as part of the Acquisition and expires on January 31, 2014. For the three and nine months ended September 30, 2013, the Company incurred a commitment fee of $8 thousand. As of September 30, 2013, outstanding borrowings under this line were $13.8 million.

Table of Contents

The BAML Line of Credit is collateralized by a first lien on ACRE Capital s interest in the mortgage loans that it originates. Advances from the BAML Line of Credit cannot exceed 100% of the principal amounts of the mortgage loans originated by ACRE Capital and must be repaid at the earlier of the sale or other disposition of the mortgage loans or at the expiration date of the warehouse line of credit. The terms of the BAML Line of Credit require ACRE Capital to comply with various covenants, including a minimum tangible net worth requirement. As of September 30, 2013, ACRE Capital was in compliance in all material respects with the terms of the BAML Line of Credit.

2015 Convertible Notes

On December 19, 2012, the Company issued $69.0 million aggregate principal amount of the 2015 Convertible Notes. Of this aggregate principal amount, $60.5 million aggregate principal amount of the 2015 Convertible Notes was sold to the initial purchasers (including $9.0 million pursuant to the initial purchasers exercise in full of their overallotment option) and $8.5 million aggregate principal amount of the 2015 Convertible Notes was sold directly to certain directors, officers and affiliates of the Company in a private placement. The 2015 Convertible Notes were issued pursuant to an Indenture, dated December 19, 2012 (the Indenture), between the Company and U.S. Bank National Association, as trustee. The sale of the 2015 Convertible Notes generated net proceeds of approximately $66.2 million. Aggregate estimated offering expenses in connection with the transaction, including the initial purchasers discount of approximately $2.1 million, were approximately $2.8 million. As of September 30, 2013 and December 31, 2012, the carrying value of the 2015 Convertible Notes was $67.7 million and $67.3 million, respectively.

The 2015 Convertible Notes bear interest at a rate of 7.000% per year, payable semiannually in arrears on June 15 and December 15 of each year, beginning on June 15, 2013. The estimated effective interest rate of the 2015 Convertible Notes, which is equal to the stated rate of 7.000% plus the accretion of the original issue discount and associated costs, was 9.4% for the three and nine months ended September 30, 2013. For the three and nine months ended September 30, 2013, the interest charged on this indebtedness was $1.2 million and $3.6 million, respectively. The 2015 Convertible Notes will mature on December 15, 2015 (the Maturity Date), unless previously converted or repurchased in accordance with their terms. The 2015 Convertible Notes are the Company s senior unsecured obligations and rank senior in right of payment to the Company s existing and future indebtedness that is expressly subordinated in right of payment to the 2015 Convertible Notes; equal in right of payment to the Company s existing and future unsecured indebtedness that is not so subordinated; effectively junior in right of payment to any of the Company s secured indebtedness (including existing unsecured indebtedness that the Company later secures) to the extent of the value of the assets securing such indebtedness; and structurally junior to all existing and future indebtedness (including trade payables) incurred by the Company s subsidiaries, financing vehicles or similar facilities.

Prior to the close of business on the business day immediately preceding June 15, 2015, holders may convert their 2015 Convertible Notes only under certain circumstances as set forth in the Indenture. On or after June 15, 2015 until the close of business on the scheduled trading day immediately preceding the Maturity Date, holders may convert their 2015 Convertible Notes at any time. Upon conversion, the Company will pay or deliver, as the case may be, at its election, cash, shares of its common stock or a combination of cash and shares of its common stock. The conversion rate is initially 53.6107 shares of common stock per $1,000 principal amount of 2015 Convertible Notes (equivalent to an initial conversion price of approximately $18.65 per share of common stock). The conversion rate will be subject to adjustment in some events, including for regular quarterly dividends in excess of $0.35 per share, but will not be adjusted for any accrued and unpaid interest. In addition, if certain corporate events occur prior to the Maturity Date, the conversion rate will be increased but will in no event exceed 61.6523 shares of common stock per $1,000 principal amount of 2015 Convertible Notes.

Prior to June 26, 2013, the Company could not elect to issue shares of common stock upon conversion of the 2015 Convertible Notes to the extent such election would result in the issuance of 20% or more of the common stock outstanding immediately prior to the issuance of the 2015 Convertible Notes until the Company received stockholder approval for issuances above this threshold. Until such stockholder approval was obtained, the Company could not share-settle the full conversion option. As a result, the embedded conversion option did not qualify for equity classification and instead was separately valued and accounted for as a derivative liability. The initial value allocated to the derivative liability was $1.7 million, which represented a discount to the debt cost to be amortized through other interest expense using the effective interest method through the maturity of the 2015 Convertible Notes. The effective interest rate used to amortize the debt discount on the 2015 Convertible Notes was 9.4%. During each reporting period, the derivative liability was marked to fair value through earnings. As of December 31, 2012, the derivative liability had a fair value of $1.8 million. There was no derivative liability as of September 30, 2013.

On June 26, 2013, stockholder approval was obtained for the issuance of shares in excess of 20% of the Company s common stock outstanding to satisfy any conversions of the 2015 Convertible Notes. As a result, the Company has the ability to fully settle in shares the conversion option and the embedded conversion option is no longer required to be separately valued and accounted for as a derivative liability on a prospective basis. As of June 26, 2013, the conversion option s cumulative value of $86 thousand was reclassified to additional paid in capital and will no longer be marked-to-market through earnings. The remaining debt discount of $1.5 million as of June 26, 2013, which arose at the date of debt issuance from the original bifurcation, will continue to be amortized through other interest expense.

Table of Contents

The Company does not have the right to redeem the 2015 Convertible Notes prior to the Maturity Date, except to the extent necessary to preserve its qualification as a REIT for U.S. federal income tax purposes. No sinking fund is provided for the 2015 Convertible Notes. In addition, if the Company undergoes certain corporate events that constitute a fundamental change, the holders of the 2015 Convertible Notes may require the Company to repurchase for cash all or part of their 2015 Convertible Notes at a repurchase price equal to 100% of the principal amount of the 2015 Convertible Notes to be repurchased, plus accrued and unpaid interest to, but excluding, the fundamental change repurchase date.

7. ALLOWANCE FOR LOSS SHARING

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

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

Losses on Loss Level I loans are shared 33.33% by ACRE Capital and 66.67% by Fannie Mae. The maximum amount of ACRE Capital s risk-sharing obligation with respect to any Loss Level I loan is 33.33% of the original principal amount of the loan. Losses incurred in connection with Loss Level II and Loss Level III loans are allocated disproportionately to ACRE Capital until ACRE Capital has absorbed the maximum level of its risk-sharing obligation with respect to the particular loan. The maximum loss allocable to ACRE Capital for Loss Level II loans is 30% of the original principal amount of the loan, and for Loss Level III loans is 40% of the original principal amount of the loan.

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

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

As part of the Acquisition, the Sellers are jointly and severally obligated to fund directly (if permitted) or to reimburse ACRE Capital for amounts due and owing after the closing date to Fannie Mae pursuant to ACRE Capital s allowance for loss sharing with respect to settlement of certain DUS program mortgage loans originated and serviced by ACRE Capital, subject to certain limitations. In addition, the Sellers are jointly and severally obligated to indemnify ACRE Capital for, among other things, certain losses arising from Sellers failure to fulfill the funding or reimbursement obligations described above. As of September 30, 2013, the preliminary estimate of the portion of such contributions towards such losses relating to the allowance for loss sharing of ACRE Capital is $4.2 million and is recorded in Other assets within the consolidated balance sheets. Additionally, with respect to the settlement of certain non-designated DUS program mortgage loans originated and serviced by ACRE Capital, the Sellers are jointly and severally obligated to fund directly (if permitted) or to reimburse ACRE Capital in each of the three 12 month periods following the closing date for eighty percent (80%) of amounts due and owing after the closing date to Fannie Mae pursuant to ACRE Capital s allowance for loss sharing in excess of $2,000,000 during such 12 month period; provided that in no event shall Sellers obligations exceed in the aggregate $3.0 million for the entire three year period.

Table of Contents

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

A summary of the Company s allowance for loss sharing for the three months ended September 30, 2013 is as follows (in thousands):

[redacted]

As of September 30, 2013, the maximum quantifiable allowance for loss sharing associated with the Company s guarantees under the Fannie Mae DUS agreement was $1.3 billion from a total recourse at risk pool of $3.8 billion. Additionally, the non-at risk pool was $5.5 million. The at risk pool is subject to Fannie Mae s Master Loss Sharing Agreement and the non-at risk pool is not subject to such agreement. The maximum quantifiable allowance for loss sharing is not representative of the actual loss the Company would incur. The Company would be liable for this amount only if all of the loans it services for Fannie Mae, for which the Company retains some risk of loss, were to default and all of the collateral underlying these loans was determined to be without value at the time of settlement.

8. COMMITMENTS AND CONTINGENCIES

The Company has various commitments to fund investments in its portfolio, extend credit and sell loans as described below.

As of September 30, 2013 and December 31, 2012, the Company had the following commitments to fund various stretch senior and transitional senior mortgage loans, as well as subordinated and mezzanine debt investments:

	As of	
$ in thousands	**September 30, 2013**	**December 31, 2012**
Total commitments	$ 759,750	$ 405,695
Less: funded commitments	(697,415)	(356,930)
Total unfunded commitments	$ 62,335	$ 48,765

Commitments to extend credit by ACRE Capital are generally agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Occasionally, the commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements. As of September 30, 2013, ACRE Capital had the following commitments to sell and fund loans:

$ in thousands		**As of September 30, 2013**
Commitments to sell loans	$	107,486
Commitments to fund loans	$	83,965

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, 2013, the Company is not aware of any legal claims that could materially impact its business, financial condition or results of operations.

Table of Contents

9. DERIVATIVES

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

Non-designated Hedges

Derivatives not designated as hedges are derivatives that do not meet the criteria for hedge accounting under GAAP or for which the Company has not elected to designate as hedges. Changes in the fair value of derivatives not designated as hedging relationships are recorded directly in Change in fair value of derivatives in the consolidated statements of operations.

For the month of September 2013, the Company entered into 12 IRLCs & 12 forward sale commitments.

As of September 30, 2013, the Company had seven IRLCs with a total notional amount of $84.0 million and thirteen forward sale commitments with a notional amount of $107.5 million, with maturities ranging from 25 to 90 days that were not designated as hedges in qualifying hedging relationships.

The table below presents the fair value of the Company s derivative financial instruments as well as their classification on the balance sheet as of September 30, 2013 ($ in thousands):

	As of September 30, 2013		
	Balance Sheet Location		**Fair Value**
Derivatives not designated as hedging instruments			
Interest rate lock commitments	Other assets	$	4,717
Forward sale commitments	Other liabilities		(2,136)
Total derivatives not designated as hedging instruments		$	2,581

10. SERIES A CONVERTIBLE PREFERRED STOCK

On February 8, 2012, the Company s board of directors adopted resolutions classifying and designating 600 shares of authorized preferred stock as shares of Series A Convertible Preferred Stock, par value $0.01 per share (Series A Preferred Stock). Holders of shares of Series A Preferred Stock were entitled to receive, when and as authorized by the Company s board of directors and declared by us out of funds legally available for that purpose, dividends at the Prevailing Dividend Rate, compounded quarterly. The Prevailing Dividend Rate means (a) beginning on the issue date through and including December 31, 2012, 10% per annum, (b) beginning on January 1, 2013 through and including December 31, 2013, 11% per annum, (c) beginning on January 1, 2014 through and including December 31, 2014, 12% per annum, and (d) beginning on January 1, 2015 and thereafter, 13% per annum; provided, however, that the Prevailing Dividend Rate may decrease by certain specified amounts if the Company achieves a certain coverage ratio.

Shares of Series A Preferred Stock were redeemable by the Company at any time, in whole or in part, beginning on September 30, 2012, at the applicable redemption price. Additionally, shares of Series A Preferred Stock were redeemable at the option of the holder upon an IPO, at the applicable redemption price. Holders of shares of the Series A Preferred Stock exercised this redemption in connection with the IPO.

During the year ended December 31, 2012, the Company issued 114.4578 shares of Series A Preferred Stock for an aggregate subscription price of approximately $5.7 million, paid a cash dividend of $102 thousand, and recognized the accretion of $572 thousand for the redemption premium for a total balance of approximately $6.3 million. The redemption price for redeemed shares of Series A Preferred Stock was equal to (i) the sum of (a) the subscription price, (b) any dividends per share added thereto pursuant to the terms of the Series A Preferred Stock and (c) any accrued and unpaid dividends per share plus (ii) an amount equal to a percentage of the subscription price of the Series A Preferred Stock and 10%.

Table of Contents

11. STOCKHOLDERS EQUITY

On May 9, 2013, the Company filed a registration statement on Form S-3 (the Shelf Registration Statement), with the SEC in order to permit the Company to offer, from time to time, in one or more offerings or series of offerings up to $1.5 billion of the Company s common stock, preferred stock, debt securities, subscription rights to purchase shares of the Company s common stock, warrants representing rights to purchase shares of the Company s common stock, preferred stock or debt securities, or units. On June 17, 2013, the registration statement was declared effective by the SEC.

On June 21, 2013, the Company priced a public offering of 18,000,000 shares of its common stock at a public offering price of $13.50 per share (the Offering), raising gross proceeds of approximately $243.0 million. The Company incurred approximately $8.4 million in offering expenses related to the public offering resulting in net proceeds of $234.6 million. In connection with the Offering, the Company also granted the underwriters an option to purchase up to an additional 2.7 million shares of common stock. On July 9, 2013, the Company sold 601,590 shares of its common stock to the underwriters, pursuant to the underwriters partial exercise of the option to purchase additional shares. The Company raised approximately $7.7 million in net proceeds from the sale of these additional shares of its common stock, which brought the total net proceeds of the offering to approximately $242.3 million. The Offering was made under the Company s Shelf Registration Statement. The net proceeds from the Offering are being used to invest in target investments, repay indebtedness, fund future funding commitments on existing loans and for other general corporate purposes.

On August 30, 2013, the Company issued 588,235 shares of its common stock in a private placement exempt from registration under Section 4(2) of the Securities Act of 1933 as part of the consideration for the Acquisition. See Note 17 for additional information on the Acquisition.

Equity Incentive Plan

On April 23, 2012, the Company adopted an equity incentive plan (the 2012 Equity Incentive Plan). Pursuant to the 2012 Equity Incentive Plan, the Company may grant awards consisting of restricted shares of the Company s common stock, restricted stock units and/or other equity-based awards to the Company s outside directors, the Company s Chief Financial Officer, ACREM and other eligible awardees under the plan, subject to an aggregate limitation of 690,000 shares of common stock (7.5% of the issued and outstanding shares of the Company s common stock immediately after giving effect to the issuance of the shares sold in the IPO). Any restricted shares of the Company s common stock and restricted stock units will be accounted for under ASC 718, Stock Compensation, resulting in share-based compensation expense equal to the grant date fair value of the underlying restricted shares of common stock or restricted stock units.

On May 1, 2012, in connection with the IPO, the Company granted 5,000 restricted shares of common stock to each of the Company s five independent directors. In addition, on June 18, 2012, Mr. Rosen, an outside director, was granted 5,000 restricted shares of common stock as an award granted pursuant to the 2012 Equity Incentive Plan. These awards of 5,000 restricted shares vest ratably on a quarterly basis over a three year period beginning on July 1, 2012. In addition, on May 1, 2012, each of the Company s five independent directors were granted 2,027 restricted shares of common stock as 2012 annual compensation awards granted pursuant to the 2012 Equity Incentive Plan. On June 18, 2012, Mr. Rosen was also granted 2,027 restricted shares of common stock as a 2012 annual compensation award granted pursuant to the 2012 Equity Incentive Plan. These awards of 2,027 restricted shares in respect of annual directors fees vest ratably on a quarterly basis over a one year period beginning on July 1, 2012. As of September 30, 2013, 12,508 shares of the total 30,000 restricted shares of common stock granted to Mr. Rosen and the Company s five independent directors, as initial grants in connection with the IPO have vested. As of September 30, 2013, all 12,162 restricted shares of common stock granted to Mr. Rosen and the Company s five independent directors in respect of 2012 annual compensation have vested.

On July 9, 2012, in connection with his appointment as Chief Financial Officer of the Company, Tae-Sik Yoon was granted 25,000 restricted shares of the Company s common stock as an award granted pursuant to the 2012 Equity Incentive Plan. These shares of restricted stock vest ratably on a quarterly basis over a four-year period that began on October 1, 2012, subject to certain conditions. As of September 30, 2013, 6,250 shares of the total 25,000 restricted shares of the Company s common stock granted to Mr. Yoon have vested.

On June 26, 2013, the Company granted 2,921 restricted shares of common stock to each of the Company s five independent directors and Mr. Rosen, an outside director. These awards of 2,921 restricted shares of common stock each vest ratably on a quarterly basis in four equal installments on the first business day of each of the four consecutive fiscal quarters beginning on July 1, 2013. In addition, on June 26, 2013, Mr. White, an independent director, was granted 5,000 restricted shares of common stock as an award granted pursuant to the 2012 Equity Incentive Plan. These 5,000 restricted shares vest ratably in 12 equal installments on the first business day of each of the 12 consecutive fiscal quarters beginning on July 1, 2013. Mr. Schuster, the Company s Co-CEO, forfeited 2,917 shares of common stock during the quarter ended June 30, 2013. As of September 30, 2013, 4,799 shares of the total 22,526 restricted shares of common stock granted to the Company s directors in June 2013 have vested.

Table of Contents

The following tables summarize the non-vested shares of restricted stock and the vesting schedule of shares of restricted stock for directors and officers as of September 30, 2013.

Schedule of Non-Vested Share and Share Equivalents

	Restricted Stock Grants Directors	Restricted Stock Grants Officer	Total
Balance as of December 31, 2012	31,080	23,436	54,516
Granted	22,526	-	22,526
Vested	(18,387)	(4,686)	(23,073)
Forfeited	(2,917)	-	(2,917)
Balance as of September 30, 2013	32,302	18,750	51,052

Future Anticipated Vesting Schedule

	Restricted Stock Grants Directors	Restricted Stock Grants Officer	Total
Three-months ended December 31, 2013	6,882	1,564	8,446
2014	18,768	6,250	25,018
2015	5,818	6,250	12,068
2016	834	4,686	5,520
2017	-	-	-
Total	32,302	18,750	51,052

12. EARNINGS PER SHARE

The following information sets forth the computations of basic and diluted earnings (loss) per common share for the three and nine months ended September 30, 2013 and 2012:

	For the three months ended		For the nine months ended	
$ in thousands (except share and per share data)	**September 30, 2013**	**September 30, 2012**	**September 30, 2013**	**September 30, 2012**
Net income (loss) attributable to common stockholders:	$ 7,631	$ (554)	$ 11,224	$ (895)
Divided by:				
Basic weighted average shares of common stock outstanding:	27,976,562	9,205,480	15,806,777	5,606,840
Diluted weighted average shares of common stock outstanding:	28,027,719	9,205,480	15,853,425	5,606,840
Basic and diluted earnings (loss) per common share:	$ 0.27	$ (0.06)	$ 0.71	$ (0.16)

The Company has considered the impact of the 2015 Convertible Notes and the restricted shares on diluted earnings per common share. The number of shares of common stock that the 2015 Convertible Notes are convertible into were not included in the computation of diluted net income per common share because the inclusion of those shares would have been anti-dilutive for the three and nine months ended September 30, 2013 and 2012.

Table of Contents

13. INCOME TAX

As discussed in Note 1, the Company established a TRS, TRS Holdings, in connection with the Acquisition. As a result, the Company has an income tax provision beginning this quarter. The Company s income tax provision consisted of the following for the three months ended September 30, 2013 ($ in thousands):

		For the three months ended September 30, 2013
Current	$	195
Deferred		301
Total income tax provision	$	496

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of the assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Deferred tax assets and liabilities are presented net by tax jurisdiction and are reported in Other assets and Other liabilities on the consolidated balance sheets, respectively. At September 30, 2013, the Company s U.S. tax jurisdiction was in a net deferred tax liability position. The following table presents the U.S. tax jurisdiction and the tax effects of temporary differences on their respective net deferred tax assets and liabilities ($ in thousands). The Company is not currently subject to tax in any foreign tax jurisdictions.

		As of September 30, 2013
Deferred tax asset, net		
Change in carrying value	$	268
Other temporary differences		1
		269
Deferred tax liability, net		
Component of gains from mortgage banking activities	$	(558)
Reserves and accruals		(12)
Net deferred tax assets (liabilities)	$	(570)

Based on the Company s assessment, it is more likely than not that the deferred tax assets will be realized through future taxable income.

The following table is a reconciliation of the Company s effective tax rate to the Company s statutory federal income tax rate for the three months ended September 30, 2013:

	For the three months ended September 30, 2013

Federal statutory rate	35.0%
State income taxes	5.7%
Federal benefit of state tax deduction	(2.0%)
Effective tax rate	38.7%

14. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company follows 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 of fair value measurements. ASC 820-10 determines fair value to be the price that would be received for a financial instrument in a current sale, which assumes an orderly transaction between market participants on the measurement date. The financial instruments recorded at fair value on a recurring basis in the Company s consolidated financial statements are derivative instruments and loans held for sale. Such financial instruments are carried at cost. ASC 820-10 specifies a hierarchy of valuation techniques based on the inputs used in measuring fair value. In accordance with ASC 820-10, these inputs are summarized in the three broad levels listed below:

The three levels of inputs that may be used to measure fair value are as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

Level II Prices are determined using other significant observable inputs. Observable inputs are inputs that other market participants would use in pricing a security. These may include quoted prices for similar securities, interest rates, prepayment speeds, credit risk and others.

Table of Contents

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

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

Financial Instruments reported at fair value

The Company has certain assets and liabilities that are required to be recorded at fair value on a recurring basis in accordance with GAAP. Included in financial instruments reported at fair value in the Company s consolidated financial statements are IRLCs, forward sale commitments, loans held for sale and an embedded conversion option related to the Company s 2015 Convertible Notes. The carrying values of cash and cash equivalents, restricted cash, interest receivable and accrued expenses approximate their fair values due to their short-term nature.

The following table summarizes the levels in the fair value hierarchy into which the Company s financial instruments were categorized as of September 30, 2013 and December 31, 2012 ($ in thousands):

	Fair Value as of September 30, 2013			
	Level I	**Level II**	**Level III**	**Total**
Derivative assets:				
Interest rate lock commitments	$ -	$ -	$ 4,717	$ 4,717
Loans held for sale	$ -	$ 24,465	$ -	$ 24,465
Derivative liabilities:				
Forward sale commitments	$ -	$ -	$ (2,136)	$ (2,136)

	Fair Value as of December 31, 2012			
	Level I	**Level II**	**Level III**	**Total**
Embedded conversion option	$ -	$ -	$ 1,825(1)	$ 1,825

(1) On June 26, 2013, the Company obtained stockholder approval to issue shares in excess of 20% outstanding. This permitted the Company to issue, at its option, 100% common stock to settle any conversions of the 2015 Convertible Notes. As a result, the embedded conversion option was no longer separately valued and accounted for as a derivative liability. As of June 26, 2013, the conversion option s cumulative value of $86 thousand was reclassified to additional paid in capital and will no longer be marked-to-market through earnings. See Note 6 for information on the derivative liability reclassification.

There were no transfers between the levels as of September 30, 2013 and December 31, 2012. Transfers between levels are recognized based on the fair value of the financial instrument at the beginning of the period.

The valuation of derivative instruments are determined using widely accepted valuation techniques, including market yield analyses and discounted cash flow analysis on the expected cash flows of each derivative. The embedded conversion option fair value analysis as of December 31, 2012 reflected the contractual terms of the derivative, including the period to maturity, and used observable market-based inputs to the extent available, including interest rate curves, spot and market forward points. IRLCs and forward sale commitments are valued based on a discounted cash flow model that incorporates changes in interest rates during the period. The loans held for sale are valued based discounted cash flows models that incorporate quoted observable prices from market participants.

Table of Contents

The following table summarizes the significant unobservable inputs the Company used to value financial instruments categorized within Level III as of September 30, 2013 ($ in thousands):

Asset Category	Fair Value	Primary Valuation Technique	Unobservable Input: Input	Unobservable Input: Range	Weighted Average
Interest rate lock commitments	$ 4,717	Discounted cash flow	Discount rate	10-14%	12%
Forward sale commitments	$ (2,136)	Discounted cash flow	Discount rate	10-14%	12%

The following table summarizes the significant unobservable inputs the Company used to value financial instruments categorized within Level III as of December 31, 2012 ($ in thousands):

	Fair	Primary	Unobservable Input