January 8, 2024

Ernst & Young
**ATT: Mr. Robert Franklin Hatch**
One Manhattan West, 395 9th Avenue
New York 10001

By email: robert.hatch@ey.com

Dear Mr. Hatch,

**Arbor Realty Trust, Inc.**

We write to you in your capacity as Auditor of Arbor Realty Trust, Inc. ("**Arbor**"), a position you have held since 2003.As you may be aware, Viceroy Researc[ published its findings from a lengthy investigation into Arbor Realty Trust on November 16, 2023. A full copy of our report, Slumlord Millionaires, and subsequent updates/reports ("**Reports**") can be found in the link below:

https://viceroyresearch.org/arbor-realty-research/

Viceroy Research is of the opinion that Arbor's financial statements and credit impairment models are fundamentally flawed. Arbor has made miniscule provisions for what we believe is an obvious wave of delinquencies which will significantly impair its book.

This is not a radical opinion. The circumstances that have led to this conclusion are wholly laid out in Arbor's risk profile in its own 10-K and prospectuses. Indeed, this opinion has been echoed by almost every reputable business journal in the country.

- Arbor's multifamily residential loan portfolio appears to be materially distressed. A review of Arbor's CLO-14 through CLO-19 data, which represents $7.5b of balance sheet assets, shows the following:
  - Approximately 17% of Arbor's CLO loans are delinquent. Many appear to have defaulted.
  - 92% of Arbor's CLO assets by loan value have a debt service coverage ratio ("**DSCR**") of less than 1.0x.
  - 20% of Arbor's CLO assets by loan value have a DSCR of less than 0.4x.
  - The underlying LTV of Arbor's CLO assets ~77%[1]. These underlying assets are valued at implied cap rates of 3.8%, the same as the 10-year risk free treasury bill market rate. They are inflated.
- There does not appear to be a viable rehabilitation strategy to refinance Arbor's loan book. The loans do not qualify for agency loans, and will not feasibly qualify for refinancing elsewhere in the absence of large equity capital injections.
  - A review of underlying CLO data shows rate caps has substantially expired. According to trustee data, only 11 of over 360 loans have lifetime rate caps.
- An empirical review of Arbor's internal controls indicates they have failed.
  - All loans are approved by a 3-person executive committee comprised of the CEO, COO, and Executive VP of Structured Finance, who concurrently appear to also transact with Arbor as borrowers (directly and/or indirectly).
  - Substantially all of Arbor's properties underlying CLO assets which we have investigated, at a high level, have not been rehabilitated and have foregone/cut down on maintenance as their ability to service interest costs has inflated.
  - Tenants have advised that properties have not been inspected for over 5 years.
  - A review of Arbor's borrowers, particularly syndicate sponsors, indicates that a vast number of debtors are unsophisticated investors with limited or no history of investing or managing capital.

[1] Adjusted for incomplete data (i.e. non-reported appraisal denominator values) and duplicate data (i.e. removal of duplicate appraisal value denominator from underlying properties with multiple loans) from CLO sample source.

In the course of our investigations, it is rare that Viceroy has access to monthly, granular, publicly available surveillance reports into the performance of a research target.

In the case of Arbor: monthly trustee data into the performance of Arbor CLOs have given us the ability to track and witness objectively radical and unfavorable moves in delinquencies, defaults, and quality of Arbor's loans.

Given that this data is so easily and readily available, we were surprised to find how vastly different a distressed and non-performing portfolio was portrayed by Arbor. We highlight your responsibilities as auditors to obtain reasonable assurance that Arbor Realty Trust's financial statements are free of material misstatements.

## Multifamily Residential Overview

Multifamily Residential deal flow exploded over the last 3 years given favorable rate cycles. Valuations at ~0% rates were exaggerated, and the free-money opportunity was widely promoted to unsophisticated investors by real estate gurus and YouTube experts.

- Geographically, sunbelt population growth has exploded due to a blend of favorable economic policies, affordability, and maybe better weather. This area has drawn in the perfect renter demographic and created opportunity for tens of billions of dollars in residential real estate investment.
- The multifamily residential investment is effectively to buy dilapidated, low-yielding units, rehabilitate them, increase the rent, and then refinance the investment via government agency loans.
- Non-bank financiers have entered the space to effectively "bridge" the financing of these investments from purchase, rehabilitation, to refinancing with the government (agency loans).
  - Agency loans are serviced by these underwriters, who can also effectively build a long-term "book" of cash flows.

It would indeed be very difficult botch this investment in a 0% cash rate environment. Unfortunately for almost everyone involved, the US policy rate climbed from about 0% in 2020-2021, to almost 5% in 2023. This unprecedented and enormous rate hike has derailed even the most bullish projects in the Arbor portfolio.

| The MOST BLUE SKY multifamily residential investment scenario | | | |
|---|---|---|---|
| Cost value of property | 1,000,000 | **Loan-to-cost** | **75.00%** |
| NOI | 40,000 | Loan value | 825,000 |
| NOI % | 4.00% | Bridge rate ( | 3.50% |
| Expected rehab NOI p.a. * | 60,000 | Expected NO | 60,000 |
| CAPEX required to rehabilitate | 100,000 | Interest | 28,875 |
| Cost Base incl. rehab budget | 1,100,000 | | |
| Expected NOI yield | 5.45% | **DSCR** | **2.08** |

| Refinance | 2020 | 2023 |
|---|---|---|
| Fixed rate long-term rate | 3.00% | 8.00% |
| **DSCR** | **2.42** | **0.91** |
| Floating rate bridge | 3.50% | 10.00% |
| **DSCR** | **2.08** | **0.73** |

*Figures 1 & 2 – Viceroy Analysis*

- Not only have underlying cash rates exploded, but the spread on high-risk loans, such as multifamily bridge loans, has similarly ballooned from ~300bps to ~400bps.
- The required Debt Service Coverage Ratio (**DSCR** – Net Operating Income / Interest Expense) for a bridge loan at Arbor is ~1.2, as dictacted by the draft terms sheet on their website.
- The current underlying DSCR of Arbor's ~$7.6b CLOs is approximately 0.61x.

Even if these properties enjoyed bullish NOI increases post renovation (they're not) and moved to cheaper agency loans (which they can't), these investments would still be haemorrhaging cash and eating into equity.

There are no feasible rate cuts in the next 18 months that could salvage these projects.

## Arbor's Business Model

Arbor's business model is to finance bridge loans for multifamily residential unit investments, typically through renovation periods. After renovation, Arbor can then refinance these bridge loans into agency loans.

In order to access liquidity against these floating rate bridge loans, Arbor established Collateralized Loan Obligation facilities (**CLO**s), in which it retains a junior/residual tranche (which is to say, it gets paid last in the waterfall).

Viceroy have pulled data of every single loan in Arbor's CLOs 14 through 19. We note the following:

- The current underlying weighted average LTV of the CLOs is ~77%
- Appraised values of underlying CLOs properties are valued at cap rates of ~3.8%. This is ludicrous.
  - 1 year T-Bill rate: 4.84%
  - 2 Year T-Bill rate: 4.40%
  - 10 Year T-Bill rate: 4.05%
- A bullish revaluation of underlying property values at a cap rate of ~7% (which is more than reasonable given these properties have NOT been fully rehabilitated) wipes out the LTV buffer and all of Arbors residual claim.
- A default of Arbor's CLOs will revert collateral (properties) to secured lenders, wiping out Arbor's equity/residual tranche. This alone will destroy half of Arbor's book value.

| Residual Shortfall Analysis | |
|---|---|
| **Outstanding Debt ($m)** | **6,467.05** |
| Collateral ($m) | 8,314.65 |
| LTV | 77.78% |
| NOI | 317.96 |
| Implied Cap Rate | 3.82% |
| LTV buffer ($m) | 1,848 |
| **Collateral @ 7% cap rate** | **4,542** |
| Variance @ 7% cap rate | (3,772) |
| **Net shortfall to $ABR** | **(1,925)** |

| CLO | | ABR Residual | Value ($m) |
|---|---|---|---|
| CLO 14 | 2021-FL1 | Residual interest of $129.5m, of which $68.7m are below IG notes | 129.5 |
| CLO 15 | 2021-FL2 | Residual interest of $140.6m, of which $73.4m are below IG notes | 140.6 |
| CLO 16 | 2021-FL3 | Residual interest of $262.5m, of which $135.0m are below IG notes | 262.5 |
| CLO 17 | 2021-FL4 | Residual interest of $385.9m, of which $194.3m are below IG notes | 385.9 |
| CLO 18 | 2022-FL1 | Residual interest of $397.2m, of which $210.1m are below IG notes | 397.2 |
| CLO 19 | 2022-FL2 | $177.2 million were below investment grade notes retained by us | 177.2 |
| **Total** | | | **1,492.9** |

*Figures 3 & 5 – Viceroy Analysis*

We opine that that the residual tranche risk held by Arbor for its fully consolidated CLOs is not adequately disclosed in Arbor's financial statements.

## Internal Controls

Arbor's 10-K details underwriting due diligence checks for structured products, including inspections and borrower investment histories, which are written into a report to be approved by a committee consisting only of the CEO, the CCO and the EVP of structured products:

***Underwriting and Risk Management.*** Our underwriters perform due diligence on all proposed transactions prior to approval and commitment using several tools to manage and mitigate potential loan losses and risk sharing exposure. The underwriters analyze each loan application in accordance with the guidelines below to determine the loan's conformity with the guidelines. Key factors considered in credit decisions include, but are not limited to, debt service coverage, loan to value ratios and property financial and operating performance. In general, our underwriting guidelines require evaluation of the following:

- The borrower and each person directing a borrowing entity's activities (a "key principal"), including a review of their experience, credit, operating, bankruptcy and foreclosure history;
- Historic and current property revenues and expenses;
- Potential for near-term revenue growth and opportunity for expense reduction and increased operating efficiencies;
- Property location, its attributes and competitive position within its market;
- Proposed ownership structure, financial strength and real estate experience of the borrower and property management;
- Third-party appraisal, environmental review, flood certification, zoning and engineering studies;
- Market assessment, including property inspection, review of tenant lease files, surveys of comparable properties and an analysis of area economic and demographic trends;
- Review of an acceptable mortgagee's title policy and an "as built" survey;
- Construction quality of the property to determine future maintenance and capital expenditure requirements;
- The requirements for any reserves, including those for immediate repairs or rehabilitation, replacement reserves, tenant improvement and leasing commission costs, real estate taxes and property casualty and liability insurance; and
- For any application for one of our Agency products, we will underwrite the loan to the relevant agency or Company guidelines.

***Investment Approval Process.*** We apply an established investment approval process to all loans and other investments proposed for our Structured Business before submitting each proposal for final approval. A written report is generated for every loan or other investment that is submitted to our credit committee for approval, which consists of our chief executive officer, chief credit officer and executive vice president of structured finance. The report includes a description of the prospective borrower and any guarantors, the collateral, and the proposed use of investment proceeds, as well as borrower and property financial statements and analysis. The report also includes an analysis of borrower liquidity, net worth, cash investment, income, credit history and operating experience. All transactions require the approval of the majority of the members of our credit committee. Following the approval of a transaction, our underwriting and servicing departments, together with our asset management group, assure that all loan approval terms have been satisfied and conform to lending requirements established for that particular transaction.

*Figures 4 & 5 – Arbor 2022 10-K*

- A significant portion of the properties underlying the CLOs have atrocious reviews, including pictures, and have not been rehabilitated. Some properties have already been condemned and labelled as slums. We expand on this in Section 3 below, where we examine a sample of properties from the CLOs.
- Billions of dollars of loans in CLOs were made to finfluencers and real estate "guru" syndicates who have zero real estate investment backgrounds. Rudimentary news searches show many are experiencing financial distress in rising rate environments.
- Arbor has scrambled to insinuate that borrowers must establish interest rate caps for their loans. Various documented interviews on Tegus and Alphasense claim this is not the case.
- The equity and other guarantees backing these investments are naturally other multifamily residential projects and real estate, which will be subject to the same deterioration as the underlying debt collateral. Further the non-recourse nature of these loans makes cutting losses a viable strategy.

We also note that Arbor has hundreds of millions of dollars of exposure to related party loans to its executive team and staff, whether directly or indirectly. We believe it is a failure of internal controls and a mockery of their role as investment advisors for insiders to actively engage in untransparent, 8-9 figure transactions with Arbor.

## Auditor’s Responsibility

Given the above, we reiterate our belief that Arbor’s loans have been improperly impaired. If credit models provided by management do not reflect this, then you must further scrutinize this model. We note the following:

**ASC 310-10-35-16**

> A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement.

**ASC 310-10-35-22**

> When a loan is impaired (see paragraphs 310-10-35-16 through 35-17), a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is a collateral-dependent loan

## Data Room

We are happy to make available a data room containing our Arbor Reports and working documents; however we presume management would make these available to you.

We believe Arbor’s audit deserves great scrutiny. Our team are happy to field questions or provide documentation which may assist in your audit.

Please do not hesitate to contact us via email at viceroy@viceroyresearch.com.

Yours faithfully

Viceroy Research Team

cc. Mr. Cameron Darden
cameron.darden.ap@ey.com

info@ey.com