ARBOR REALTY TRUST INC
Form 10-K
February 28, 2007

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

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number: 001-32136

Arbor Realty Trust, Inc.
(Exact name of registrant as specified in its charter)

Maryland *(State or other jurisdiction of incorporation)*	**20-0057959** *(I.R.S. Employer Identification No.)*
333 Earle Ovington Boulevard, Suite 900 **Uniondale, NY** *(Address of principal executive offices)*	**11553** *Zip Code*

(516) 832-8002
(Registrant s telephone number, including area code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common stock, par value $0.01 per share	The New York Stock Exchange

Indicate by check mark if the registrant is a well-known, seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. o

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 proceeding 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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of the registrant s knowledge, in the definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer 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 þ

The aggregate market value of the registrant s voting common stock held by non-affiliates of the registrant as of June 30, 2006 (computed based on the closing price on such date as reported on the NYSE) was $392.9 million. As of February 16, 2007, the registrant had 17,230,375 shares of common stock outstanding (excluding 279,400 shares held in the treasury).

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the registrant s 2007 Annual Meeting of Stockholders (the 2007 Proxy Statement), to be filed within 120 days after the end of the registrant s fiscal year ended December 31, 2006, are incorporated by reference into Part III of this Annual Report on Form 10-K.

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FORWARD LOOKING STATEMENTS

The information contained in this annual report on Form 10-K is not a complete description of our business or the risks associated with an investment in Arbor Realty Trust, Inc. We urge you to carefully review and consider the various disclosures made by us in this report.

This report contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements relate to, among other things, the operating performance of our investments and financing needs. Forward-looking statements are generally identifiable by use of forward-looking terminology such as may, will, should, potential, intend, expect, endeavor, seek, anticipate, estimat underestimate, believe, could, project, predict, continue or other similar words or expressions. Forward-looki statements are based on certain assumptions, discuss future expectations, describe future plans and strategies, contain projections of results of operations or of financial condition or state other forward-looking information. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, our actual results and performance could differ materially from those set forth in the forward-looking statements. These forward-looking statements involve risks, uncertainties and other factors that may cause our actual results in future periods to differ materially from forecasted results. Factors that could have a material adverse effect on our operations and future prospects include, but are not limited to, changes in economic conditions generally and the real estate market specifically; adverse changes in the financing markets we access affecting our ability to finance our loan and investment portfolio; changes in interest rates; the quality and size of the investment pipeline and the rate at which we can invest our cash; impairments in the value of the collateral underlying our loans and investments; changes in the markets; legislative/regulatory changes; completion of pending investments; the availability and cost of capital for future investments; competition within the finance and real estate industries; and other risks detailed from time to time in our SEC reports. Readers are cautioned not to place undue reliance on any of these forward-looking statements, which reflect our management s views as of the date of this report. The factors noted above could cause our actual results to differ significantly from those contained in any forward-looking statement. For a discussion of our critical accounting policies, see Management s Discussion and Analysis of Financial Condition and Results of Operations of Arbor Realty Trust, Inc. and Subsidiaries Significant Accounting Estimates and Critical Accounting Policies under Item 7 of this report.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We are under no duty to update any of the forward-looking statements after the date of this report to conform these statements to actual results.

PART I

ITEM 1. *BUSINESS*

Overview

We are a specialized real estate finance company which invests in a diversified portfolio of structured finance assets in the multi-family and commercial real estate markets. We invest primarily in real estate-related bridge and mezzanine loans, including junior participating interests in first mortgages, preferred and direct equity, and in limited cases, discounted mortgage notes and other real estate-related assets, which we refer to collectively as structured finance investments. We also invest in mortgage-related securities. Our principal business objective is to maximize the difference between the yield on our investments and the cost of financing these investments to generate cash available for distribution, facilitate capital appreciation and maximize total return to our stockholders.

We are organized to qualify as a real estate investment trust (REIT) for federal income tax purposes. We commenced operations in July 2003 and conduct substantially all of our operations and investing activities through our operating partnership, Arbor Realty Limited Partnership, and its wholly-owned subsidiaries. We serve as the general partner of our operating partnership, and own an approximately 82% partnership interest in our operating partnership as of December 31, 2006.

We are externally managed and advised by Arbor Commercial Mortgage, LLC (ACM), a national commercial real estate finance company which specializes in debt and equity financing for multi-family and commercial real estate, pursuant to the terms of a management agreement described below. We believe ACM s experience and reputation positions it to originate attractive investment opportunities for us. Our management agreement with ACM was developed to capitalize on synergies with ACM s origination infrastructure, existing business relationships and management expertise.

We believe the financing of multi-family and commercial real estate offers significant growth opportunities that demand customized financing solutions. ACM has granted us a right of first refusal to pursue all domestic structured finance investment opportunities identified by ACM. ACM continues to originate and service multi-family and commercial mortgage loans under Fannie Mae, Federal Housing Administration and conduit commercial lending programs. We believe that the customer relationships established from these lines of business may generate additional real estate investment opportunities for our business.

Our Corporate History

On July 1, 2003, ACM contributed a portfolio of structured finance investments to our operating partnership. Concurrently with this contribution, we and our operating partnership entered into a management agreement with ACM pursuant to which ACM manages our investments for a base management fee and incentive compensation, and the nine person asset management group of ACM became our employees.

In exchange for ACM s contribution of structured finance investments, our operating partnership issued approximately 3.1 million units of limited partnership interest, or operating partnership units, and approximately 0.6 million warrants to purchase additional operating partnership units at an initial exercise price of $15.00 per operating partnership unit to ACM. Concurrently, we, our operating partnership and ACM entered into a pairing agreement. Pursuant to the pairing agreement, each operating partnership unit issued to ACM and issuable to ACM upon exercise of its warrants for additional operating partnership units in connection with the contribution of initial assets was paired with one share of the Company s special voting preferred stock. In October 2004, ACM exercised these warrants and currently holds approximately 3.8 million operating partnership units, constituting an approximately 18% limited partnership interest in our operating partnership. ACM may redeem each of these operating partnership units for cash or, at our election, one share of our common stock. We granted ACM certain demand and other registration rights with respect to the shares of common stock that may be issued upon redemption of these operating partnership units. Each of these operating partnership units is also paired with one share of our special voting preferred stock entitling ACM to one vote on all matters submitted to a vote of our stockholders. ACM currently holds approximately 18% of the voting power of our outstanding stock. If ACM redeems these operating partnership units, an equivalent number of shares of our special voting preferred stock will be redeemed and cancelled.

Concurrently with ACM s contribution of investments to our operating partnership, we sold approximately 1.6 million of our units, each consisting of five shares of our common stock and one warrant to purchase an additional share of common stock at an initial exercise price of $15.00 per share, for $75.00 per unit in a private placement and agreed to register the shares of common stock underlying these units and warrants for resale under the Securities Act of 1933. In July 2004, we registered approximately 9.6 million shares of common stock underlying these units and warrants. As of December 31, 2005, approximately 1.6 million warrants were exercised, of which 0.5 million were exercised cashless , for a total of 1.3 million common shares issued pursuant to their exercise.

In April 2004, we closed our initial public offering in which we issued and sold 6.3 million shares of common stock and a selling stockholder sold 22,500 shares of common stock, each at $20.00 per share. Concurrently with the initial public offering, we sold 0.5 million shares of common stock at the initial public offering price directly to an entity wholly-owned by one of our directors. The underwriters of our initial public offering exercised their overallotment option and, in May 2004, we issued and sold an additional 0.5 million shares of our common stock pursuant to such exercise.

Since January 2005, we completed three non-recourse collateralized debt obligation (CDO) transactions, wherby $1.44 billion of real estate related and other assets were contributed to three newly-formed consolidated subsidiaries, which issued $1.21 billion of investment grade-rated floating-rate notes in three separate private placements. These proceeds were used to repay outstanding debt and resulted in a decreased cost of funds relating to the CDO assets.

Our Investment Strategy

Our principal business objectives are to invest in bridge and mezzanine loans, including junior participating interests in first mortgages, preferred and direct equity and other real estate related assets in the multifamily and commercial real estate markets and actively manage our investment portfolio in order to generate cash available for distribution, facilitate capital appreciation and maximize total return to our stockholders. We believe we can achieve these objectives through the following business and growth strategies:

Provide Customized Financing. We provide financing customized to the needs of our borrowers. We target borrowers who have demonstrated a history of enhancing the value of the properties they operate, but whose options may be limited by conventional bank financing and who may benefit from the sophisticated structured finance products we offer.

Execute Transactions Rapidly. We act quickly and decisively on proposals, provide commitments and close transactions within a few weeks and sometimes days, if required. We believe that rapid execution attracts opportunities from both borrowers and other lenders that would not otherwise be available. We believe our ability to structure flexible terms and close loans in a timely manner gives us a competitive advantage over lending firms that also primarily serve this market.

Manage and Maintain Credit Quality. A critical component of our success in the real estate finance sector is our ability to manage the real estate risk that is underwritten by our manager and us. We actively manage and maintain the credit quality of our portfolio by using the expertise of our asset management group, which has a proven track record of structuring and repositioning structured finance investments to improve credit quality and yield.

Use Arbor Commercial Mortgage s Relationships with Existing Borrowers. We capitalize on ACM s reputation in the commercial real estate finance industry. ACM has relationships with a large borrower base nationwide. Since ACM s originators offer senior mortgage loans as well as our structured finance products, we are able to benefit from its existing customer base and use its senior lending business as a potential refinance vehicle for our structured finance assets.

Offer Broader Products and Expand Customer Base. We have the ability to offer a larger number of financing alternatives than ACM has been able to offer to its customers in the past. Our potential borrowers are able to choose from products offering longer maturities and larger principal amounts than ACM could previously offer.

Leverage the Experience of Executive Officers and Arbor Commercial Mortgage and Our Employees. Our executive officers and employees, and those of ACM, have extensive experience originating and managing structured commercial real estate investments. Our senior management team has on average over 20 years experience in the financial services industry including prior experience in managing and operating a public company, the predecessor of ACM.

Our Targeted Investments

We actively pursue lending and investment opportunities with property owners and developers who need interim financing until permanent financing can be obtained. We primarily target transactions under $40 million where we believe we have competitive advantages, particularly our lower cost structure and in-house underwriting capabilities. Our structured finance investments generally have maturities of two to five years, depending on type, have extension options when appropriate, and generally require a balloon payment of principal at maturity. Borrowers in the market for these types of loans include, but are not limited to, owners or developers seeking either to acquire or refurbish real estate or to pay down debt and reposition a property for permanent financing.

Our investment program emphasizes the following general categories of real estate related activities:

Bridge Financing. We offer bridge financing products to borrowers who are typically seeking short term capital to be used in an acquisition of property. The borrower has usually identified an undervalued asset that has been under managed and/or is located in a recovering market. From the borrower s perspective, shorter term bridge financing is advantageous because it allows time to improve the property value through repositioning the property without encumbering it with restrictive long term debt.

The bridge loans we make typically range in size from $1 million to $60 million and are predominantly secured by first mortgage liens on the property. The term of these loans typically is up to five years. Historically, interest rates have typically ranged from 2.50% to 9.00% over 30-day LIBOR, with fixed rates ranging from 5.00% to 13.00%. In 2006, interest rates have typically ranged from 2.50% to 7.00% over 30-day LIBOR, with fixed rates ranging from 6.00% to 13.00%. Additional yield enhancements may include origination fees, deferred interest, yield look-backs, and participating interests, which are equity interests in the borrower that share in a percentage of the underlying cash flows of the property. Borrowers generally use the proceeds of a conventional mortgage to repay a bridge loan.

Mezzanine Financing. We offer mezzanine financing in the form of loans that are subordinate to a conventional first mortgage loan and senior to the borrower s equity in a transaction. These loans may be in the form of a junior participating interest in the senior debt. Mezzanine financing may take the form of loans secured by pledges of ownership interests in entities that directly or indirectly control the real property or subordinated loans secured by second mortgage liens on the property. We may also require additional collateral such as personal guarantees, letters of credit and/or additional collateral unrelated to the property.

Our mezzanine loans typically range in size from $1 million to $50 million and have terms of up to ten years. Historically, interest rates have typically ranged from 2.00% to 12.00% over 30-day LIBOR, with fixed rates ranging from 5.00% to 15.00%. In 2006, interest rates have typically ranged from 2.00% to 10.00% over 30-day LIBOR, with fixed rates ranging from 5.50% to 15.00%. As in the case with our bridge loans, the yield on these investments may be enhanced by prepaid and deferred interest payments, yield look-backs and participating interests.

We hold a majority of our mezzanine loans through subsidiaries of our operating partnership that are pass-through entities for tax purposes or taxable subsidiary corporations.

Preferred Equity Investments. We provide financing by making preferred equity investments in entities that directly or indirectly own real property. In cases where the terms of a first mortgage prohibit additional

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liens on the ownership entity, investments structured as preferred equity in the entity owning the property serve as viable financing substitutes. With preferred equity investments, we typically become a special limited partner or member in the ownership entity.

Real Property Acquisitions. We may purchase existing domestic real estate for repositioning and/or renovation and then disposition at an anticipated significant return. From time to time, we may identify real estate investment opportunities. In these situations, we may act solely on our own behalf or in partnership with other investors. Typically, these transactions are analyzed with the expectation that we will have the ability to sell the property within a one to three year time period, achieving a significant return on invested capital. In connection with these transactions, speed of execution is often the most critical component to success. We may seek to finance a portion of the acquisition price through short term financing. Repayment of the short term financing will either come from the sale of the property or conventional permanent debt.

Note Acquisitions. We may acquire real estate notes from lenders in situations where the borrower wishes to restructure and reposition its short term debt and the lender wishes, for a variety of reasons (such as risk mitigation, portfolio diversification or other strategic reasons), to divest certain assets from its portfolio. These notes may be acquired at a discount. In such cases, we intend to use our management resources to resolve any dispute concerning the note or the property securing it and to identify and resolve any existing operational or any other problems at the property. We will then either restructure the debt obligation for immediate resale or sale at a later date, or reposition it for permanent financing. In some instances, we may take title to the property underlying the real estate note.

Mortgage-Related Securities. We invest in certificates issued by the Government National Mortgage Association, or GNMA, Federal National Mortgage Association, or FNMA, or the Federal Home Loan Mortgage Association, or FHLMC that are collateralized by whole pools of fixed or adjustable rate residential or commercial mortgage loans. We refer to these mortgage-related securities as agency-sponsored whole loan pool certificates. The adjustable rate mortgage-related securities include adjustable-rate FHLMC ARM and FNMA ARM certificates, which are generally evidenced by pools of mortgage loans with a fixed rate of interest for the first three years with annual interest adjustments thereafter and GNMA ARM certificates, which have a fixed rate of interest for the first three years with annual adjustments in relation to the Treasury index thereafter. Unlike conventional fixed-income securities which provide for periodic fixed interest payments and principal payments at maturity and specified call dates, mortgage-related securities provide for monthly payments of interest and principal that, in effect, are a pass-through of the monthly payments made by the borrowers on the residential or commercial mortgage loans underlying such securities, net of any fees paid to the issuer or guarantor of such securities. Additional payments on the securities are made when repayments of principal are made due to the sale of the underlying property, refinancing or foreclosure, net of fees or costs that may be incurred. Some mortgage-related securities (such as securities issued by GNMA) are described as modified pass-through because they entitle the holder to receive all interest and principal payments owed on the mortgage pool, net of certain fees, at scheduled payment dates regardless of whether or not the mortgagor makes the payment.

The rate of prepayments on the underlying mortgage loans affect the price and volatility of mortgage-related securities and may have the effect of shortening or extending the effective maturity of the security beyond what was anticipated at the time of our investment in such securities. The yield and maturity characteristics of mortgage-related securities differ from conventional fixed-income securities in that the principal amount of mortgage-related securities may be prepaid at any time because the underlying mortgage loans may be prepaid at any time. Therefore, some mortgage-related securities may have less potential for growth in value than conventional fixed-income securities with comparable maturities. In addition, the rate of prepayments tends to increase in periods of falling interest rates. During such periods, the reinvestment of prepayment proceeds by us will generally be at lower rates than the rates that were carried by the obligations that have been prepaid. To the extent that we purchase mortgage-related securities at a premium, prepayments (which may be made without penalty) may result in loss of our principal investment to the extent of the premium paid.

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Our Structured Finance Investments

We own a diversified portfolio of structured finance investments consisting primarily of real estate-related bridge and mezzanine loans as well as preferred equity investments and mortgage-backed securities.

At December 31, 2006, we had 102 loans and investments in our portfolio, totaling $2.0 billion. These loans and investments were for 32 multi-family properties, 11 condominium properties, 26 office properties, 16 hotel properties, nine commercial properties, five land properties, two retail properties, and one other property. We have an $8.5 million loan in our portfolio that is non-performing and income recognition has been suspended. The principal amount of the loan is not deemed to be impaired and no loan loss reserve has been recorded at this time. Income recognition will resume when the loan becomes contractually current and performance has recommenced. We continue to actively manage all loans and investments in the portfolio and believe that our strict underwriting and active asset management enable us to maintain the credit quality of our portfolio.

The overall yield on our portfolio in 2006 was 10.50%, excluding the impact from a first quarter recognition of previously deferred revenue and a fourth quarter distribution that were recorded as interest income totaling approximately $10.4 million, on average assets of $1.5 billion. This yield was computed by dividing the interest income earned during the year by the average assets during the year. Our cost of funds in 2006 was 7.11% on average borrowings of $1.3 billion. This cost of funds was computed by dividing the interest expense incurred during the year by the average borrowings during the year.

Our average net investment (average assets less average borrowings) in 2006 was $213.5 million, resulting in average leverage (average borrowings divided by average assets) of 86%. Including average trust preferred securities of $197.5 million as equity, our average leverage was 73%. The net interest income earned in 2006 yielded a 35.70% return on our average net investment during the year. This yield was computed by dividing the net interest (interest income less interest expense) earned in 2006 by the average equity (computed as average assets minus average borrowings) invested during the year.

Our business plan contemplates that our leverage ratio, including our trust preferred securities as equity, will be approximately 70% to 80% of our assets in the aggregate. However, including our trust preferred securities as equity, our leverage will not exceed 80% of the value of our assets in the aggregate unless approval to exceed the 80% limit is obtained from our board of directors. At December 31, 2006, our overall leverage ratio including the trust preferred securities as equity was 73%.

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STRUCTURED FINANCE INVESTMENT PORTFOLIO
As of December 31, 2006

The following tables set forth information regarding our bridge and mezzanine loans, preferred equity investments and other real estate-related assets as of December 31, 2006.

Type	Asset Class	Number	Unpaid Principal (Dollars in thousands)	Weighted Average Pay Rate	Weighted Average Remaining Maturity (Months)
Bridge Loans	MultiFamily	12	$ 133,075	8.2%	17.9
	Office	8	246,729	7.8%	31.4
	Hotel	4	124,096	8.1%	17.7
	Condo	6	261,328	9.0%	12.7
	Commercial	5	100,267	8.42%	17.8
	Land	3	95,118	10.41%	34.5
	Retail	1	2,802	9.9%	17.0
	Other	1	1,300	12.0%	3.0
		40	964,715	8.5%	21.5
Mezzanine Loans	MultiFamily	13	183,289	9.7%	33.2
	Office	17	345,765	9.1%	44.9
	Hotel	10	241,367	8.6%	17.8
	Condo	5	158,043	12.3%	14.4
	Commercial	2	60,000	10.0%	15.0
	Land	2	20,958	5.4%	38.4
	Retail	1	3,000	10.4%	21.0
		50	1,012,422	9.6%	29.6
Preferred Equity	MultiFamily	7	10,437	10.0%	111.2
	Office	1	11,000	10.9%	21.0
	Hotel	1	2,000	9.0%	3.0
		9	23,437	10.3%	59.6
Other	Hotel	1	1,846	7.4%	200.0
	Commercial	2	10,500	5.6%	15.0
		3	12,346	5.9%	42.7
Total		102	$ 2,012,920	9.1%	26.2

Geographic Location		Unpaid Principal (Dollars in thousands)	Percentage(1)	Asset Class		Unpaid Principal (Dollars in thousands)	Percentage(1)
New York	$	1,070,342	53.2%	MultiFamily	$	326,801	16.2%
Florida		210,965	10.5%	Office		603,494	30.0%
California		109,499	5.4%	Hotel		369,309	18.3%
Maryland		68,790	3.4%	Condo		419,371	20.8%
Other(2)		282,571	13.5%	Commercial		170,767	8.5%
Diversified		270,753	14.0%	Land		116,076	5.8%
				Retail		5,802	0.3%
				Other		1,300	0.1%
Total	$	2,012,920	100%	Total	$	2,012,920	100%

(1) Based on a percentage of the total unpaid principal balance of the underlying loans.

(2) No other individual state makes up more than 3% of the total.

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Our Investments in Mortgage-Related Securities

In 2004, we invested $57.4 million (including $0.1 million of purchased interest) in agency-sponsored whole pool certificates. $20.6 million of these securities were issued by FNMA and $36.7 million were issued by FHLMC. Pools of FNMA and FHLMC adjustable rate residential mortgage loans underlie these securities. The underlying mortgage loans bear interest at a weighted average fixed rate for three years and adjust annually thereafter and have a weighted average coupon rate of 3.8%. We receive monthly payments of interest and principal on these securities based on the monthly interest and principal payments that are made on the underlying mortgage loans. At December 31, 2006, these securities were financed under a $100.0 million repurchase agreement, maturing July 2007, at a rate of one-month LIBOR plus 0.20%. At December 31, 2006, the amortized cost of these securities was $22.2 million and the amount outstanding on the repurchase agreement related to the financing of these securities was $20.7 million. These investments had a weighted average balance of $26.4 million for the year with an average yield of 2.17%, net of amortization of premiums. These assets were financed by borrowings with a weighted average balance of $25.1 million and an average cost of funds of 5.28%.

The table below sets forth information regarding our investments in mortgage-related securities as of December 31, 2006. These securities have a fixed interest rate until March 2007, and adjust annually thereafter.

					Initial
	Amortized	**Unrealized**	**Market**		