

Sunstone Hotel Investors, Inc.
Form 10-Q
November 01, 2006
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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, 2006

OR

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

Commission file number 001-32319

Sunstone Hotel Investors, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Maryland
(State or Other Jurisdiction of
Incorporation or Organization)

903 Calle Amanecer, Suite 100
San Clemente, California
(Address of Principal Executive Offices)

Registrant's telephone number, including area code: (949) 369-4000

20-1296886
(I.R.S. Employer
Identification Number)

92673
(Zip Code)

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

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 "

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.

Large accelerated filer Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

57,708,279 shares, of Common Stock, \$0.01 par value, as of October 25, 2006

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SUNSTONE HOTEL INVESTORS, INC.

QUARTERLY REPORT ON

FORM 10-Q

For the Quarterly Period Ended September 30, 2006

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****SUNSTONE HOTEL INVESTORS, INC.****CONSOLIDATED BALANCE SHEETS***(In thousands, except per share data)*

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|--------------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 125,189 | \$ 17,538 |
| Restricted cash | 66,229 | 54,305 |
| Accounts receivable, net | 40,889 | 42,879 |
| Due from affiliates | 1,302 | 1,994 |
| Inventories | 3,005 | 2,814 |
| Prepaid expenses | 7,374 | 4,187 |
| Current assets of discontinued operations | | 359 |
| Total current assets | 243,988 | 124,076 |
| Investment in hotel properties, net | 2,470,950 | 2,054,001 |
| Investment in hotel properties held for sale, net | | 9,111 |
| Other real estate, net | 14,807 | 7,545 |
| Deferred financing costs, net | 7,610 | 8,299 |
| Goodwill | 22,436 | 27,169 |
| Other assets, net | 11,583 | 18,780 |
| Other assets of discontinued operations, net | | 208 |
| Total assets | \$ 2,771,374 | \$ 2,249,189 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 30,897 | \$ 22,293 |
| Accrued payroll and employee benefits | 11,888 | 8,960 |
| Due to Management Company | 18,141 | 19,404 |
| Dividends payable | 22,673 | 19,831 |
| Other current liabilities | 32,903 | 29,414 |
| Current portion of notes payable | 16,959 | 4,387 |
| Current liabilities of discontinued operations | | 302 |
| Total current liabilities | 133,461 | 104,591 |
| Notes payable, less current portion | 1,483,534 | 1,176,791 |
| Other liabilities | 6,177 | 8,782 |
| Total liabilities | 1,623,172 | 1,290,164 |
| Commitments and contingencies <i>(Note 12)</i> | | |
| Preferred stock, Series C Cumulative Convertible Redeemable Preferred Stock, \$0.01 par value 4,102,564 shares authorized, issued and outstanding at September 30, 2006 and December 31, 2005, liquidation preference of \$24.375 per share | 99,246 | 99,096 |

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Stockholders' equity:

| | | |
|--|--------------|--------------|
| Preferred stock, \$0.01 par value, 100,000,000 shares authorized. 8.0% Series A Cumulative Redeemable Preferred Stock, 7,050,000 issued and outstanding at September 30, 2006 and 4,850,000 issued and outstanding at December 31, 2005, stated at liquidation preference of \$25.00 per share | 176,250 | 121,250 |
| Common stock, \$0.01 par value, 500,000,000 shares authorized, 57,708,279 shares issued and outstanding at September 30, 2006 and 52,190,649 shares issued and outstanding at December 31, 2005 | 577 | 522 |
| Additional paid in capital | 958,009 | 798,400 |
| Retained earnings | 53,721 | 12,308 |
| Cumulative dividends | (139,601) | (72,551) |
| | | |
| Total stockholders' equity | 1,048,956 | 859,929 |
| | | |
| Total liabilities and stockholders' equity | \$ 2,771,374 | \$ 2,249,189 |

See accompanying notes to consolidated financial statements.

Table of Contents**SUNSTONE HOTEL INVESTORS, INC.****UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS***(In thousands, except per share data)*

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|--|---|---|---|---|
| REVENUES | | | | |
| Room | \$ 155,477 | \$ 111,820 | \$ 433,896 | \$ 257,905 |
| Food and beverage | 49,703 | 38,687 | 165,697 | 88,148 |
| Other operating | 21,833 | 11,222 | 57,083 | 31,718 |
| Total revenues | 227,013 | 161,729 | 656,676 | 377,771 |
| OPERATING EXPENSES | | | | |
| Room | 34,755 | 24,491 | 95,849 | 55,301 |
| Food and beverage | 39,502 | 29,062 | 119,564 | 62,768 |
| Other operating | 10,073 | 7,557 | 29,308 | 20,994 |
| Advertising and promotion | 13,015 | 10,757 | 37,352 | 23,701 |
| Repairs and maintenance | 9,308 | 6,723 | 26,626 | 15,599 |
| Utilities | 10,129 | 7,233 | 26,094 | 15,357 |
| Franchise costs | 9,941 | 6,084 | 24,675 | 16,671 |
| Property tax, ground lease, and insurance | 13,389 | 9,339 | 37,287 | 19,900 |
| Property general and administrative | 24,301 | 19,088 | 74,063 | 44,448 |
| Corporate overhead | 3,116 | 3,534 | 13,495 | 10,278 |
| Depreciation and amortization | 26,078 | 18,771 | 71,213 | 43,824 |
| Total operating expenses | 193,607 | 142,639 | 555,526 | 328,841 |
| Operating income | 33,406 | 19,090 | 101,150 | 48,930 |
| Interest and other income | 616 | 910 | 2,227 | 2,614 |
| Interest expense | (23,996) | (14,717) | (73,668) | (39,349) |
| Income before minority interest and discontinued operations | 10,026 | 5,283 | 29,709 | 12,195 |
| Minority interest | | (321) | | (1,115) |
| Income from continuing operations | 10,026 | 4,962 | 29,709 | 11,080 |
| Income (loss) from discontinued operations | (8,490) | 2,923 | 11,704 | 7,134 |
| NET INCOME | 1,536 | 7,885 | 41,413 | 18,214 |
| Preferred stock dividends and accretion | (5,188) | (4,084) | (14,429) | (6,886) |
| INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDERS | \$ (3,652) | \$ 3,801 | \$ 26,984 | \$ 11,328 |
| Basic and diluted per share amounts: | | | | |
| Income from continuing operations available to common stockholders | \$ 0.08 | \$ 0.02 | \$ 0.27 | \$ 0.11 |
| Income (loss) from discontinued operations | (0.14) | 0.07 | 0.20 | 0.19 |

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| | | | | | | | | |
|---|----|--------|----|--------|----|--------|----|--------|
| Basic and diluted income (loss) available to common stockholders per common share | \$ | (0.06) | \$ | 0.09 | \$ | 0.47 | \$ | 0.30 |
| Weighted average common shares outstanding: | | | | | | | | |
| Basic | | 57,708 | | 42,594 | | 57,075 | | 37,600 |
| Diluted | | 58,193 | | 42,909 | | 57,523 | | 37,904 |
| Dividends paid per common share | \$ | 0.30 | \$ | 0.285 | \$ | 0.90 | \$ | 0.855 |

See accompanying notes to consolidated financial statements.

Table of Contents**SUNSTONE HOTEL INVESTORS, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY***(In thousands, except share and per share data)*

| | Preferred Stock | | Common Stock | | Additional Paid in Capital | Retained Earnings | Cumulative Dividends | Total |
|---|------------------------|------------|---------------------|--------|----------------------------------|----------------------|-------------------------|--------------|
| | Number of Shares | Amount | Number of Shares | Amount | | | | |
| Balance at December 31, 2005 (audited) | 4,850,000 | \$ 121,250 | 52,190,649 | \$ 522 | \$ 798,400 | \$ 12,308 | \$ (72,551) | \$ 859,929 |
| Net proceeds from sale of Series A preferred stock | 2,200,000 | 55,000 | | | (842) | | | 54,158 |
| Net proceeds from sale of common stock | | | 5,500,000 | 55 | 157,652 | | | 157,707 |
| Vesting of restricted common stock | | | 17,630 | | 2,799 | | | 2,799 |
| Common dividends declared and payable at \$0.90 per share | | | | | | | (52,588) | (52,588) |
| Series A preferred dividends declared and payable at \$1.50 per share | | | | | | | (9,475) | (9,475) |
| Series C preferred dividends declared and payable at \$1.18 per share | | | | | | | (4,837) | (4,837) |
| Accretion of discount on Series C preferred stock | | | | | | | (150) | (150) |
| Net income | | | | | | 41,413 | | 41,413 |
| Balance at September 30, 2006 (unaudited) | 7,050,000 | \$ 176,250 | 57,708,279 | \$ 577 | \$ 958,009 | \$ 53,721 | \$ (139,601) | \$ 1,048,956 |

See accompanying notes to consolidated financial statements.

Table of Contents**SUNSTONE HOTEL INVESTORS, INC.****UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS***(In thousands)*

| | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | \$ 41,413 | \$ 18,214 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Bad debt expense | 140 | 187 |
| Minority interest | | 1,115 |
| Gain on sale of hotel properties, net | (10,304) | (2,476) |
| Loss on early extinguishment of debt | 9,976 | |
| Depreciation | 76,343 | 49,969 |
| Amortization of deferred franchise fees | 79 | 106 |
| Amortization of deferred financing costs | 4,540 | 2,987 |
| Amortization of loan premiums | (2,420) | (304) |
| Amortization of deferred stock compensation | 2,799 | 1,480 |
| Loss on interest rate cap agreements | 3 | 1 |
| Goodwill impairment loss | 4,733 | |
| Changes in operating assets and liabilities: | | |
| Restricted cash | (11,322) | 1,786 |
| Accounts receivable | 2,109 | (8,866) |
| Due from affiliates | 692 | 60 |
| Inventories | (176) | 5 |
| Prepaid expenses and other assets | 1,754 | 894 |
| Accounts payable and other liabilities | 2,745 | 12,457 |
| Accrued payroll and employee benefits | 2,928 | 438 |
| Due to Management Company | (1,368) | 93 |
| Discontinued operations | 77 | |
| Net cash provided by operating activities | 124,741 | 78,146 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Net proceeds from sale of hotel properties | 152,856 | 27,864 |
| Restricted cash replacement reserve | (602) | (18,404) |
| Acquisitions of hotel properties | (438,974) | (623,830) |
| Additions to hotel properties and other real estate | (102,854) | (42,390) |
| Net cash used in investing activities | (389,574) | (656,760) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Proceeds from preferred securities offerings | 55,000 | 220,250 |
| Payment of preferred securities offering costs | (842) | (3,929) |
| Proceeds from common stock offerings | 158,400 | 306,684 |
| Payment of common stock offerings costs | (693) | (8,722) |
| Proceeds from notes payable | 440,542 | 526,207 |
| Payments on notes payable | (212,203) | (281,499) |
| Payments of deferred financing costs | (3,664) | (2,751) |
| Dividends and distributions paid | (64,056) | (37,968) |
| Net cash provided by financing activities | 372,484 | 718,272 |

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| | | |
|--|------------|------------|
| Net increase in cash and cash equivalents | 107,651 | 139,658 |
| Cash and cash equivalents, beginning of period | 17,538 | 5,966 |
| Cash and cash equivalents, end of period | \$ 125,189 | \$ 145,624 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION | | |
| Cash paid for interest | \$ 70,783 | \$ 39,009 |
| NONCASH FINANCING ACTIVITY | | |
| Assumption of debt in connection with acquisitions of hotel properties | \$ 81,000 | \$ 63,143 |
| Receipt of note receivable | \$ 5,600 | \$ |
| Dividends and distributions payable | \$ 22,673 | \$ 18,873 |

See accompanying notes to consolidated financial statements.

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SUNSTONE HOTEL INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Description of Business

Sunstone Hotel Investors, Inc. (the Company), through its 100.0% controlling interest in Sunstone Hotel Partnership, LLC (the Operating Partnership), of which the Company is the sole managing member, and the subsidiaries of the Operating Partnership, including Sunstone Hotel TRS Lessee, Inc. (the TRS Lessee) and its subsidiaries, is currently engaged in owning, acquiring, selling, and renovating hotel properties. The Company operates as a real estate investment trust (REIT) for federal income tax purposes.

The Company was formed to succeed to the businesses of Sunstone Hotel Investors, L.L.C. (SHI), WB Hotel Investors, LLC (WB), and Sunstone/WB Hotel Investors IV, LLC (WB IV) (collectively, the Sunstone Predecessor Companies or the Predecessor), which were engaged in owning, acquiring, selling, managing, and renovating hotel properties in the United States. The Company was incorporated in Maryland on June 28, 2004, in anticipation of an initial public offering of common stock (the IPO), which was consummated on October 26, 2004 concurrently with the consummation of various formation transactions. These transactions were designed to (i) enable the Company to raise the necessary capital to acquire properties from the Predecessor and repay certain mortgage debt relating thereto, (ii) provide a vehicle for future acquisitions, (iii) enable the Company to comply with certain requirements under the federal income tax laws and regulations relating to REITs, (iv) facilitate potential financings and (v) preserve certain tax advantages for the Predecessor. From June 28, 2004 through October 26, 2004, the Company did not have any operations.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements as of September 30, 2006 and December 31, 2005, and for the three and nine months ended September 30, 2006 and September 30, 2005, include the accounts of the Company, the Operating Partnership and the TRS Lessee and their subsidiaries. All significant intercompany balances and transactions have been eliminated.

The accompanying interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States and in conformity with the rules and regulations of the Securities and Exchange Commission. In the Company's opinion, the interim financial statements presented herein reflect all adjustments, consisting solely of normal and recurring adjustments, which are necessary to fairly present the interim financial statements. These financial statements should be read in conjunction with the financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the Securities and Exchange Commission on February 15, 2006.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could materially differ from those estimates.

Reporting Periods

The results the Company reports in its consolidated statements of operations are based on results reported to the Company by its hotel managers. These hotel managers use different reporting periods. Sunstone Hotel Properties, Inc., a division of Interstate Hotels & Resorts, Inc. (the Management Company), the manager of 34 of the Company's properties as of September 30, 2006, as well as four of the Company's other managers, Hyatt Corporation, Fairmont Hotels & Resorts, Hilton Hotels Corporation, and Starwood Hotels & Resorts Worldwide, Inc., which manage a combined total of six of the Company's properties as of September 30, 2006, report results on a monthly basis. In contrast, Marriott International, Inc. (Marriott), the manager of ten of the Company's properties as of September 30, 2006, uses a fiscal year ending on the Friday closest to December 31, and reports twelve weeks of operations for each of the first three quarters of the year and sixteen or seventeen weeks of operations for the fourth quarter of the year. The Company has elected to adopt quarterly close periods of March 31, June 30 and September 30, and an annual year end of December 31. As a result, the Company's 2006 results of operations for the Marriott managed hotels include results from December 31 through March 24 for the first quarter, March 25 through June 16 for the second quarter, June 17 through September 8 for the third quarter, and September 9 through December 29 for the fourth quarter. The Company's 2005 results of operations for the Marriott managed

hotels

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include results from January 1 through March 25 for the first quarter, March 26 through June 17 for the third quarter, June 18 through September 9 for the third quarter, and September 10 through December 30 for the fourth quarter.

Accounts Receivable

Accounts receivable primarily represents receivables from hotel guests who occupy hotel rooms and utilize hotel services. Accounts receivable also includes receivables from customers who utilize the Company's laundry facilities in Salt Lake City, Utah, and Rochester, Minnesota. The Company maintains an allowance for doubtful accounts sufficient to cover potential credit losses. The Company's accounts receivable at September 30, 2006 and December 31, 2005 include an allowance for doubtful accounts of \$0.5 million and \$0.8 million, respectively.

At September 30, 2006 and December 31, 2005, the Company had approximately \$3.3 million and \$4.6 million, respectively, in accounts receivable with one customer who is operating under a contract with the United States government. The Company has specifically reserved a portion of this particular receivable in the amount of \$50,000 and \$100,000 at September 30, 2006 and December 31, 2005, respectively.

Deferred Financing Costs

Interest expense related to the amortization of deferred financing costs was \$1.6 million and \$0.5 million for the three months ended September 30, 2006 and 2005, respectively, and \$4.5 million and \$3.0 million for the nine months ended September 30, 2006 and 2005, respectively.

Minority Interest

Prior to November 2005, minority interests of the Company represented the common membership units in the Operating Partnership. The carrying value of the minority interest increased by the minority interests' share of earnings and decreased by cash distributions and the purchase of additional membership units by the Company. In November 2005, the membership units held by the minority interest owners were converted to shares of common stock of the Company, and were subsequently sold in a public offering eliminating the minority interests of the Company. As a result of such conversion, the Company beneficially owns all of the membership interests in the Operating Partnership.

Earnings Per Share

The following table sets forth the computation of basic and diluted earnings (loss) per common share (in thousands, except per share data):

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|--|--|---|---|
| Numerator: | | | | |
| Net income | \$ 1,536 | \$ 7,885 | \$ 41,413 | \$ 18,214 |
| Less preferred dividends and accretion | (5,188) | (4,084) | (14,429) | (6,886) |
| Numerator for basic and diluted earnings (loss) available to common stockholders | \$ (3,652) | \$ 3,801 | \$ 26,984 | \$ 11,328 |
| Denominator: | | | | |
| Weighted average basic common shares outstanding | 57,708 | 42,594 | 57,075 | 37,600 |
| Unvested restricted stock awards | 485 | 315 | 448 | 304 |
| Weighted average diluted common shares outstanding | 58,193 | 42,909 | 57,523 | 37,904 |
| Basic and diluted earnings (loss) available to common stockholders per common share | \$ (0.06) | \$ 0.09 | \$ 0.47 | \$ 0.30 |

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Shares of the Company's Series C preferred stock have not been included in the above calculation of earnings per share for either the three or nine months ended September 30, 2006 and 2005 as their effect would have been anti-dilutive.

Reclassifications

Certain amounts included in the financial statements for prior periods have been reclassified to conform to the most recent financial statement presentation.

Table of Contents**3. Investment in Hotel Properties**

Investment in hotel properties consisted of the following (in thousands):

| | September 30, 2006 (Unaudited) | December 31, 2005 |
|---|--------------------------------------|----------------------|
| Land | \$ 389,272 | \$ 361,222 |
| Buildings and improvements | 2,075,675 | 1,681,617 |
| Fixtures, furniture and equipment | 272,557 | 236,296 |
| Franchise fees | 1,392 | 1,399 |
| Construction in process | 16,874 | 25,786 |
| | 2,755,770 | 2,306,320 |
| Accumulated depreciation and amortization | (284,820) | (252,319) |
| | \$ 2,470,950 | \$ 2,054,001 |

On January 10, 2006, the Company purchased the 284-room Marriott Del Mar located in San Diego, California for \$69.1 million and named Marriott as manager. This hotel's results of operations from the acquisition date of January 10, 2006 through Marriott's third quarter ended September 8, 2006, have been included in the Company's statement of operations. The allocation of the purchase price is preliminary as the Company is in the process of obtaining a purchase price allocation from an independent third party. The Company has included depreciation expense based on this preliminary purchase price allocation.

On March 17, 2006, the Company purchased the 444-room Hilton Times Square located in New York City for \$241.4 million and named the Management Company as manager. In addition, concurrently with the acquisition, the Company exercised an option and made an additional \$15.0 million payment to convert the property to a franchise. This hotel's results of operations from the acquisition date of March 17, 2006 through the third quarter ended September 30, 2006 have been included in the Company's statement of operations. The allocation of the purchase price is preliminary as the Company is in the process of obtaining a purchase price allocation from an independent third party. The Company has included depreciation expense based on this preliminary purchase price allocation.

On May 17, 2006, the Company purchased the 335-room Embassy Suites La Jolla located near San Diego, California for \$100.7 million and named Hilton Hotels Corporation as manager. This hotel's results of operations from the acquisition date of May 17, 2006 through the third quarter ended September 30, 2006, have been included in the Company's statement of operations. The allocation of the purchase price is preliminary as the Company is in the process of obtaining a purchase price allocation from an independent third party. The Company has included depreciation expense based on this preliminary purchase price allocation.

On June 26, 2006, the Company purchased the 259-room W San Diego located in San Diego, California for \$95.9 million and named Starwood Hotels & Resorts Worldwide, Inc. as manager. This hotel's results of operations from the acquisition date of June 26, 2006 through the third quarter ended September 30, 2006, have been included in the Company's statement of operations. The allocation of the purchase price is preliminary as the Company is in the process of obtaining a purchase price allocation from an independent third party. The Company has included depreciation expense based on this preliminary purchase price allocation.

4. Discontinued Operations

As part of a strategic plan to dispose of non-core hotel assets, the Company sold thirteen hotels during the third quarter of 2006 for net proceeds of \$132.7 million which includes the receipt of a \$5.6 million note receivable. The Company recognized a net loss on sale of assets of \$6.3 million, and also recognized a \$4.7 million goodwill impairment loss. The Company also sold one hotel during the first quarter of 2006 for net proceeds of \$25.5 million and a net gain on sale of \$16.4 million, another hotel during the fourth quarter of 2005, and an additional two hotels during the second quarter of 2005. These seventeen hotel properties met the held for sale and discontinued operations criteria in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment and Disposal of Long-Lived Assets*.

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The following sets forth the discontinued operations for the three and nine months ended September 30, 2006 and 2005, related to hotel properties held for sale (in thousands):

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|--|--|--|---|---|
| Operating revenues | \$ 15,985 | \$ 20,164 | \$ 48,493 | \$ 57,239 |
| Operating expenses | (11,736) | (14,075) | (36,705) | (41,949) |
| Interest expense | (130) | (1,158) | (446) | (4,289) |
| Depreciation and amortization expense | (1,527) | (2,008) | (5,209) | (6,251) |
| Goodwill loss | (4,733) | | (4,733) | |
| Gain (loss) on sale of hotels | (6,349) | | 10,304 | 2,384 |
| Income (loss) from discontinued operations | \$ (8,490) | \$ 2,923 | \$ 11,704 | \$ 7,134 |

The following sets forth the assets and liabilities related to the discontinued operations at September 30, 2006 and December 31, 2005 (in thousands):

| | September 30, 2006 (Unaudited) | December 31, 2005 |
|--|--------------------------------------|----------------------|
| ASSETS | | |
| Total current assets | \$ | \$ 359 |
| Hotel property held for sale, net | | 9,111 |
| Deferred financing costs, net | | 190 |
| Other assets, net | | 18 |
| Total assets of discontinued operations | \$ | \$ 9,678 |
| LIABILITIES | | |
| Due to Management Company | \$ | \$ 105 |
| Total current liabilities | | 197 |
| Total liabilities of discontinued operations | \$ | \$ 302 |

5. Other Real Estate

Other real estate consists of the following (in thousands):

| | September 30, 2006 (Unaudited) | December 31, 2005 |
|--|--------------------------------------|----------------------|
| Office building and laundry facilities: | | |
| Land | \$ 3,824 | \$ 1,600 |
| Buildings and improvements | 6,865 | 4,462 |
| Fixtures, furniture and equipment | 4,383 | 3,796 |
| Construction in process | 2,221 | 214 |
| | 17,293 | 10,072 |

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| | | |
|--|-----------|----------|
| Accumulated depreciation | (3,514) | (2,983) |
| | 13,779 | 7,089 |
| Land held for future development or sale | 1,028 | 456 |
| | \$ 14,807 | \$ 7,545 |

During the first quarter of 2006, the Company purchased land and an office building adjacent to one of its hotels in Troy, Michigan for \$4.4 million.

6. Goodwill

The Company follows the requirements of SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142). Under SFAS No. 142, goodwill and intangible assets deemed to have indefinite lives are subject to annual impairment tests. As a result, the carrying value of goodwill allocated to the hotel properties and other real estate is reviewed at least annually and when facts and circumstances suggest that it may be impaired. Such review entails comparing the carrying value of the

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individual hotel property (the reporting unit) including the allocated goodwill to the fair value determined for that hotel property. If the aggregate carrying value of the hotel property exceeds the fair value, the goodwill of the hotel property is impaired to the extent of the difference between the fair value and the aggregate carrying value, not to exceed the carrying amount of the allocated goodwill. In conjunction with the sale of thirteen hotel properties during the third quarter of 2006, the Company wrote off the goodwill associated with these properties totaling \$4.7 million to impairment loss. The amount is included in income/(loss) from discontinued operations.

7. Other Assets

Other assets consist of the following (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---------------------------------------|-----------------------|----------------------|
| Corporate property and equipment, net | \$ 1,776 | \$ 1,726 |
| Pre acquisition costs | 400 | 7,865 |
| Other receivables | 6,592 | 6,469 |
| Other | 2,815 | 2,720 |
| | \$ 11,583 | \$ 18,780 |

During the first quarter of 2006, the Company received payment in full for a \$4.7 million note receivable generated from its 2004 sale of the San Marcos Resort & Conference Center in Chandler, Arizona. This note was previously written down to market value, resulting in a reserve of \$350,000 expensed during the fourth quarter of 2004. Upon full payment of this note in the first quarter of 2006, this reserve was reversed. Additionally, an expense of \$92,000 relating to the termination of the management agreement at the hotel was paid.

During the third quarter of 2006, the buyer of thirteen of the Company's hotels issued a \$5.6 million promissory note to the Company. The note includes an interest rate of 8.0% per year on the unpaid principal balance, and is due in October 2011.

8. Notes Payable

Notes payable consist of the following (in thousands):

| | September 30, 2006 (Unaudited) | December 31, 2005 |
|---|--------------------------------------|----------------------|
| Notes payable requiring payments of interest and principal, with fixed rates ranging from 4.98% to 9.88%; maturing at dates ranging from March 2007 through August 2024. The notes are collateralized by first deeds of trust on 41 hotel properties and one laundry facility. | \$ 1,500,493 | \$ 1,106,178 |
| Term loan facility in the amount of \$75.0 million requiring monthly payments of interest only subject to an interest rate at the Company's option, equal to either a fluctuating rate equal to Citibank, N.A.'s base rate or a periodic fixed rate equal to one-, two-, or six-month LIBOR, plus, in each case, a margin of 1.25% for base rate loans and 2.25% for LIBOR loans. The term loan facility matures in October 2008, but was repaid in full in April 2006. | | 75,000 |
| | 1,500,493 | 1,181,178 |
| Less: current portion | (16,959) | (4,387) |
| | \$ 1,483,534 | \$ 1,176,791 |

In January 2006, the Company obtained a \$48.0 million fixed rate mortgage loan with a maturity date of January 2016 and a fixed interest rate of 5.69% in connection with the acquisition of the Marriott Del Mar, San Diego, California.

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In February 2006, the Company refinanced two of its hotel properties, replacing a \$36.9 million mortgage at a fixed interest rate of 8.25% scheduled to mature in 2008, with an eleven-year \$75.0 million mortgage at a fixed interest rate of 5.58%. Additionally, the Company replaced a \$35.8 million mortgage at a fixed rate of 8.25% scheduled to mature in 2008, with a ten-year \$34.0 million mortgage at a fixed rate of 5.66%. In connection with these transactions, the Company expensed \$7.4 million for loss on early extinguishment of debt related to the cost associated with the defeasance of the previous debt.

In March 2006, the Company assumed an \$81.0 million fixed rate mortgage loan with a maturity date of December 2010 and an interest rate of 5.92% in connection with the acquisition of the Hilton Times Square located in New York City.

In April 2006, the Company refinanced one of its hotel properties by defeasing the existing \$52.9 million loan at a fixed interest rate of 7.5% scheduled to mature in 2008 with a portion of the proceeds from a new loan of \$135.0 million at a

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fixed rate of 5.95% scheduled to mature in 2021. In connection with this transaction, the Company expensed \$2.6 million for loss on early extinguishment of debt related to the cost associated with the defeasance of the previous debt.

In April 2006, the Company repaid in full the \$75.0 million term loan, using proceeds received from the Series A Cumulative Redeemable Preferred Stock offering and cash on hand from the refinancing completed in April 2006.

In May 2006, the Company obtained a \$70.0 million fixed rate mortgage loan with a maturity date of June 2019 and a fixed interest rate of 6.60% in connection with the acquisition of the Embassy Suites, La Jolla, California.

In June 2006, the Company obtained a \$65.0 million fixed rate mortgage loan with a maturity date of January 2018 and an interest rate of 6.14% in connection with the acquisition of the W Hotel, San Diego, California.

In July 2006, the Company closed a \$200.0 million unsecured revolving credit facility (the "new credit facility"). This facility replaced the Company's \$150.0 million secured revolving credit facility. Amounts outstanding under the new credit facility bear interest at LIBOR plus the applicable margin for eurodollar rate advances or the Citibank, N.A. prime lending rate plus the applicable margin for base rate advances. The applicable margin ranges from 1.25% to 1.75% in the case of eurodollar rate advances and 0.25% to 0.75% in the case of base rate advances, depending upon the ratio of the Borrower's Total Debt to EBITDA. The maturity date of this facility is July 2010. In addition, the applicable margin will increase by 2.0% upon the occurrence and during the continuance of an event of default. Subject to certain conditions, the new credit facility may be extended for one year and increased to \$300.0 million. The new credit facility is unsecured and advances are not subject to any borrowing base requirement. The Company is required to maintain a pool of specified unencumbered assets (the "unencumbered pool assets"). Assets may be removed from or added to the unencumbered pool assets, subject to the satisfaction of certain conditions. The new credit facility contains customary financial covenants, including certain leverage and coverage ratios and a minimum tangible net worth. As of September 30, 2006 the Company's revolving credit facility had no amounts outstanding, and had \$13.1 million backing outstanding irrevocable letters of credit, leaving \$186.9 million available. In connection with this refinancing, the Company expensed \$1.3 million of deferred financing costs.

In August 2006, the Company exercised its right under the earn-out agreement for the loan on the Renaissance Orlando to draw an additional \$13.0 million of debt under the agreement. The terms under the revised mortgage loan remain the same, with interest only payments at a rate of 5.30% payable until July 2008, and a maturity date in July 2016.

Total interest incurred and expensed on the notes payable is as follows (in thousands):

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|--------------------------------------|--|--|---|---|
| Continuing operations: | | | | |
| Interest expense | \$ 22,538 | \$ 14,239 | \$ 59,512 | \$ 34,023 |
| Deferred financing fees | 1,458 | 478 | 4,180 | 2,667 |
| Prepayment penalties | | | | 2,659 |
| Loss on early extinguishment of debt | | | 9,976 | |
| | \$ 23,996 | \$ 14,717 | \$ 73,668 | \$ 39,349 |
| Discontinued operations: | | | | |
| Interest expense | \$ 8 | \$ 1,092 | \$ 86 | \$ 3,794 |
| Deferred financing fees | 122 | 66 | 360 | 320 |
| Prepayment penalties | | | | 175 |
| | \$ 130 | \$ 1,158 | \$ 446 | \$ 4,289 |

9. Series C Cumulative Convertible Redeemable Preferred Stock

In July 2005, the Company sold 4,102,564 shares of Series C Cumulative Convertible Redeemable Preferred Stock ("Series C preferred stock") with a liquidation preference of \$24.375 per share to Security Capital Preferred Growth, Incorporated, an investment vehicle advised by Security Capital Research & Management Incorporated, for gross proceeds of \$99.0 million, or \$24.13 per share, which included a 1% discount to the conversion price/liquidation preference. Other costs of the offering totaled \$130,000. Net proceeds of \$99.0 million were contributed to the

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Operating Partnership in exchange for preferred membership units with economic terms substantially identical to the Series C preferred stock. The net proceeds were used to partially finance the Company's acquisition of six Renaissance hotels. The Series C preferred stock is convertible into shares of the Company's common stock on a one-for-one basis, subject to customary antidilution provisions, including stock splits, stock dividends, non-cash distributions and above-market issuer self-tender or exchange offers. On or after July 8, 2010, the Series C preferred stock will be redeemable at the Company's option, in whole or in part, at any time

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or from time to time, for cash at a redemption price of \$24.375 per share, plus accrued and unpaid dividends up to and including the redemption date. The holders of the Series C preferred stock have the right to require the Company to redeem the Series C preferred stock in the event of any of the following: (1) a change in control of the Company, if certain conditions are not met; (2) a REIT termination event; or (3) a termination of the Company's listing on either the New York Stock Exchange or NASDAQ. In general, holders of Series C preferred stock vote on an as-converted basis as a single class with holders of the Company's common stock. If the Company is in violation of certain financial ratios for four consecutive quarters, the holders have the right to elect one director to serve on the Company's board of directors. In addition, if the Company is in arrears on dividends on the Series C preferred stock for four or more quarters, the holders have the right to elect additional directors to serve on the Company's board of directors. Subject to a limited exception, holders of Series C preferred stock cannot elect more than an aggregate of two directors. The holders are eligible to receive a participating dividend should the Company's dividend on its common stock increase beyond \$1.34 per share per annum. The Series C preferred stock has no maturity date and, except as set forth above, the Company is not required to redeem the Series C preferred stock at any time.

The initial carrying value of the Series C preferred stock was recorded at its sales price less costs to issue on the date of issuance. This carrying value is periodically adjusted so that the carrying value will equal the redemption value on the redemption date, which is the earliest date available for the Company to redeem the Series C preferred stock. The carrying value will also be periodically adjusted for any accrued and unpaid dividends, if any. At September 30, 2006 and December 31, 2005, the Series C preferred stock carrying value consisted of the following (in thousands):

| | 2006 (Unaudited) | 2005 |
|---|---------------------|-----------|
| Initial fair value, sales price of \$99.0 million | \$ 99,000 | \$ 99,000 |
| Redemption value accretion | 246 | 96 |
| | \$ 99,246 | \$ 99,096 |

10. Stockholders' Equity**Series A Cumulative Redeemable Preferred Stock**

In March 2005, the Company sold an aggregate of 4,850,000 shares of 8.0% Series A and B Cumulative Redeemable Preferred Stock (Series A preferred stock and Series B preferred stock, respectively) with a liquidation preference of \$25.00 per share for gross proceeds of \$121.3 million. Underwriting and other costs of the offering totaled \$3.8 million. Net proceeds of \$117.5 million were contributed to the Operating Partnership in exchange for preferred membership units with economic terms substantially identical to the Series A and B preferred stock. Subsequent to this offering, the shares of Series B preferred stock were exchanged for an equivalent number of shares of Series A preferred stock. The net proceeds were used to reduce borrowings under the Company's credit facility and for acquisitions. On or after March 17, 2010, the Series A preferred stock will be redeemable at the Company's option, in whole or in part, at any time or from time to time, for cash at a redemption price of \$25.00 per share, plus accrued and unpaid dividends up to and including the redemption date. Holders of Series A preferred stock generally have no voting rights. However, if the Company is in arrears on dividends on the Series A preferred stock for six or more quarterly periods, whether or not consecutive, holders of the Series A preferred stock will be entitled to vote at its next annual meeting and each subsequent annual meeting of stockholders for the election of two additional directors to serve on the Company's board of directors until all unpaid dividends and the dividend for the then-current period with respect to the Series A preferred stock have been paid or declared and a sum sufficient for the payment thereof set aside for payment. The Series A preferred stock has no maturity date and the Company is not required to redeem the Series A preferred stock at any time.

In April 2006, the Company sold an additional 2,200,000 shares of Series A preferred stock with a liquidation preference of \$25.00 per share for gross proceeds of \$55.0 million. The proceeds to the Company, net of offering costs, were \$54.2 million, and were used together with proceeds of certain debt refinancings to repay the Company's term loan facility.

Common Stock

On February 2, 2006, the Company completed a follow-on offering of 5,500,000 shares of common stock at a price per share of \$28.80 (before underwriting discounts and offering costs), generating gross proceeds of \$158.4 million. The proceeds to the Company, net of offering costs, were \$158.1 million and were used to fund a portion of the acquisition price of the Hilton Times Square and for general corporate purposes.

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In July 2006, the Company entered into a forward sale agreement (the "Forward Sale Agreement") with an affiliate of Citigroup Global Markets Inc. as the forward counterparty, relating to 4,000,000 shares of the Company's common stock. In

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connection with the execution of the Forward Sale Agreement and at the Company's request, Citigroup Global Markets Inc., as agent for the forward counterparty, borrowed and sold in a public offering (the Offering) 4,000,000 shares of common stock. If the Company elects to physically settle the Forward Sale Agreement in shares of common stock, the Company will receive an amount equal to approximately \$111.0 million in net proceeds, subject to certain provisions of the Forward Sale Agreement, from the forward counterparty. If the Company elects to settle the Forward Sale Agreement in cash, the Company may not receive any proceeds and may owe cash to the forward counterparty. As of September 30, 2006, the Company has incurred \$0.4 million in offering costs. The Forward Sale Agreement provides for settlement on one or more settlement dates within one year from the date of the closing of the Offering, subject to specified rights of the forward counterparty to accelerate settlement of the contract in its entirety. If the Company decides to physically settle the Forward Sale Agreement in its entirety, the Company will issue 4,000,000 shares of its common stock to the forward counterparty under the Forward Sale Agreement. The forward sale price is initially equal to \$27.75 per share. The Forward Sale Agreement provides that the initial forward sale price will be subject to increase based on a floating interest factor equal to the federal funds rate, less a spread component, and will be subject to decrease by specified amounts on a quarterly basis during the term of the Forward Sale Agreement. The forward sale price may also be subject to decrease if the cost to the forward counterparty of borrowing Common Stock exceeds a specified amount. If the federal funds rate is less than the spread component on any day, the interest factor will result in a daily reduction of the forward sale price. If the quarterly adjustments are larger than the cumulative effect of the interest factor, the cumulative net effect of these adjustments will result in a decrease in the forward sale price over time.

11. Long-Term Incentive Plan

Restricted shares and restricted share units granted pursuant to the Company's Long-Term Incentive Plan generally vest over periods from three to five years from the date of grant. The value of shares granted has been calculated based on the share price on the date of grant and is being amortized as compensation expense in accordance with the Company's policy on a straight-line basis over the vesting periods for the entire award. For the three months ended September 30, 2006 and 2005, the Company's expense related to these restricted shares and restricted share units was \$1.4 million and \$0.6 million, respectively. For the nine months ended September 30, 2006 and 2005, the Company's expense related to these restricted shares and restricted share units was \$3.9 million and \$1.9 million, respectively.

12. Commitments and Contingencies

Franchise Agreements

Total franchise costs incurred by the Company during the three months ended September 30, 2006 and 2005 totaled \$11.2 million and \$7.6 million, respectively, and \$28.3 million and \$20.9 million for the nine months ended September 30, 2006 and 2005, respectively. Of the total franchise costs, franchise royalties totaled \$4.6 million and \$4.2 million, respectively, for the three months ended September 30, 2006 and 2005, and \$12.8 million and \$11.4 million for the nine months ended September 30, 2006 and 2005, respectively. The remaining franchise costs included advertising, reservation and priority club assessments. Franchise costs included in discontinued operations totaled \$1.3 million and \$1.5 million, respectively, for the three months ended September 30, 2006 and 2005 and \$3.6 million and \$4.2 million for the nine months ended September 30, 2006 and 2005, respectively.

Renovation and Construction Commitments

At September 30, 2006 and December 31, 2005, the Company had various contracts outstanding with third parties in connection with the renovation of certain of its hotel properties. The remaining commitments under these contracts at September 30, 2006 and December 31, 2005 totaled \$27.0 million and \$28.2 million, respectively.

Operating Leases

Rent expense incurred pursuant to ground lease agreements for the three months ended September 30, 2006 and 2005 totaled \$1.4 million and \$1.6 million, respectively, and totaled \$6.0 million and \$3.2 million, respectively for the nine months ended September 30, 2006 and 2005. Rent expense included in property tax, ground lease and insurance totaled \$1.4 million and \$1.3 million for the three months ended September 30, 2006 and 2005, respectively, and totaled \$5.5 million and \$2.4 million, respectively for the nine months ended September 30, 2006. Rent expense included in discontinued operations was nominal for the three months ended September 30, 2006, and totaled \$0.3 million for the same time period in 2005. On a year-to-date basis, rent expense included in discontinued operations totaled \$0.5 million and \$0.8 million, respectively, for the nine months ended September 30, 2006 and 2005.

Rent expense incurred pursuant to the lease on the corporate facility for the three months ended September 30, 2006 and 2005 totaled \$116,000 and \$82,000, respectively, and totaled \$347,000 and \$274,000, respectively, for the nine months

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ended September 30, 2006 and 2005. This rent expense was included in corporate overhead in the accompanying statements of operations.

Other

The Company has provided unsecured environmental indemnities to certain lenders. The Company has performed due diligence on the potential environmental risks, including obtaining an independent environmental review from outside environmental consultants. These indemnities obligate the Company to reimburse the guaranteed parties for damages related to certain environmental matters. There is no term or damage limitation on these indemnities; however, if an environmental matter arises, the Company could have recourse against other previous owners.

At September 30, 2006 and December 31, 2005, the Company had \$13.1 million and \$27.4 million, respectively, of outstanding irrevocable letters of credit to guarantee the Company's financial obligations related to the Management Company, workers' compensation insurance programs and certain notes payable. The beneficiary may draw upon these letters of credit in the event of a contractual default by the Company relating to each respective obligation. No draws have been made through September 30, 2006.

13. Transactions With Affiliates

Other Reimbursements

From time to time, the Company pays for certain expenses such as payroll, insurance and other costs on behalf of certain affiliates. The affiliates generally reimburse such amounts on a monthly basis. At September 30, 2006 and December 31, 2005, amounts owed to the Company by its affiliates amounted to \$1.3 million and \$2.0 million, respectively, and are included in due from affiliates.

Transactions With Others

The Company purchases telecommunications equipment from Gemini Telemanagement Systems, or GTS, a telecommunications equipment provider based in Redwood City, California. The Company's Chief Executive Officer and President, Robert A. Alter, is a 5.2% stockholder in GTS, and his brother, Richard Alter, is the majority stockholder in GTS. The Company paid GTS \$72,000 and \$201,000, respectively, for the three and nine months ended September 30, 2006, and \$35,000 and \$344,000, respectively, for the three and nine months ended September 30, 2005.

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Cautionary Statement

This report contains forward-looking statements that have been made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, forecasts, expects, plans, anticipates, believes, estimates, potential, or continue or the negative of such terms and other comparable terminology. These statements are only predictions. Actual events or results may differ materially from those expressed or implied by these forward-looking statements. In evaluating these statements, you should specifically consider the risks outlined in detail in our Annual Report on Form 10-K, filed with the Securities and Exchange Commission on February 15, 2006, under the caption Risk Factors and elsewhere in this Quarterly Report on Form 10-Q, including but not limited to the following factors:

our level of outstanding debt, including secured and variable rate debt;

financial and other covenants in our debt;

competition for the acquisition of hotels and in the operation of our hotels;

rising operating expenses;

relationships with and requirements of franchisors;

the need for renovations and other capital expenditures for our hotels;

the performance of the Management Company and the other managers of our hotels;

the ground or air leases for ten of our hotels;

our need to operate as a REIT and comply with other applicable laws and regulations;

changes in business strategy or acquisition or disposition plans;

general economic and business conditions affecting the hotel and travel industry, both nationally and locally;

our ability to complete acquisitions;

the performance of acquired properties after they are acquired;

necessary capital expenditures and the impact of renovations on hotel operations; and

other events beyond our control.

These factors may cause our actual events to differ materially from the expectations expressed or implied by any forward-looking statement. We do not undertake to update any forward-looking statement.

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

Overview

We own primarily luxury, upper upscale and upscale hotels in the United States operated under leading brand names franchised or licensed from others, such as Marriott, Hilton, Hyatt, Fairmont, Starwood, and Wyndham.

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Operations

REIT structure. For us to qualify as a REIT, our income cannot be derived from our operation of hotels. Therefore, consistent with the provisions of the Internal Revenue Code of 1986, as amended, and the rules and regulations thereunder (the Code), Sunstone Hotel Partnership and its subsidiaries have leased our hotel properties to our taxable REIT subsidiary lessee, Sunstone Hotel TRS Lessee, Inc., or the TRS Lessee, which has in turn contracted with eligible independent contractors to manage our hotels. Under the Code, an eligible independent contractor is an independent contractor who is actively engaged in the trade or business of operating qualified lodging facilities for any person unrelated to us and the TRS Lessee. Sunstone Hotel Partnership and the TRS Lessee are consolidated into our financial statements for accounting purposes. Since we control both Sunstone Hotel Partnership and our TRS Lessee, our principal source of funds on a consolidated basis is from the performance of our hotels. The earnings of the TRS Lessee are subject to taxation like other C corporations, which may reduce our operating results, funds from operations and the cash otherwise available for distribution to our stockholders.

Factors Affecting Our Results of Operations

The following performance indicators are commonly used in the hotel industry:

occupancy;

average daily rate, or ADR; and

revenue per available room, or RevPAR, which is the product of occupancy and ADR, but does not include food and beverage revenue, or other operating revenue.

Revenues. Substantially all of our revenues are derived from the operation of our hotels. Specifically, our revenues consist of the following:

Room revenue, which is primarily driven by occupancy and average daily rate;

Food and beverage revenue, which is primarily driven by occupancy and banquet/catering bookings; and,

Other operating revenue, which consists of ancillary hotel revenue such as performance guarantees and other items primarily driven by occupancy such as telephone, transportation, parking, spa, entertainment and other guest services. Additionally, this category includes operating revenue from our two commercial laundry facilities located in Rochester, Minnesota and Salt Lake City, Utah and our electronic purchasing platform, Buy Efficient, L.L.C.

Operating costs and expenses. Our operating costs and expenses consist of the following:

Room expense, which is primarily driven by occupancy and, therefore, has a significant correlation with room revenue;

Food and beverage expense, which is primarily driven by food and beverage sales and banquet and catering bookings and, therefore, has a significant correlation with food and beverage revenue;

Other operating expense, which consists of the corresponding expense of other operating revenue, advertising and promotion, repairs and maintenance, utilities, and franchise fees and assessments categories;

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Property tax, ground lease and insurance expense, which consists of the expenses associated with property tax, ground lease and insurance payments, each of which are primarily fixed expenses;

Property general and administrative expense, which consists of our property-level general and administrative expenses, such as payroll and related costs, professional fees, and travel expenses, as well as management fees with respect to our hotels;

Corporate overhead expense, which consists of our corporate-level expenses such as payroll and related costs, amortization of deferred stock compensation, professional fees, travel expenses and office rent; and

Depreciation and amortization expense, which consists of depreciation on our hotel buildings, improvements, furniture, fixtures and equipment.

Most categories of variable operating expenses, such as utilities and certain labor costs, such as housekeeping, fluctuate with changes in occupancy. Increases in RevPAR attributable to improvements in occupancy are accompanied by increases in most categories of variable operating costs and expenses. Increases in RevPAR attributable to improvements in ADR

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typically result in more limited increases in operating costs and expenses, primarily credit card commissions, franchise fees and franchise assessments. Thus, improvements in ADR have a more significant impact on improving our operating margins than occupancy.

We continually work with our operators to improve our operating leverage, which generally refers to the ability to generate incremental profit based on limited variable costs. Notwithstanding our efforts to reduce variable costs, there are limits to how much our operators can accomplish in that regard without affecting the competitiveness of our hotels and our guests' experiences at our hotels. Furthermore, we have significant fixed costs, such as depreciation and amortization, insurance, principal and interest payments on our debt, and other expenses associated with owning hotels that do not necessarily decrease when circumstances such as market factors cause a reduction in our hotel revenue. For example, we have experienced increases in wages, employee benefits (especially health insurance), and utility costs, which negatively affected our operating margin. Additionally, recent increases in property insurance costs will negatively impact our margins over the next year. Our historical performance may not be indicative of future results, and our future results may be worse than our historical performance.

Acquisition, Sale and Major Redevelopment Activity

Our results during the periods discussed have been, and our future results will be, affected by our acquisition, sale and redevelopment activity during the applicable period.

Acquisition of hotels. The following table sets forth the hotels that we have acquired or developed since the beginning of 2005:

| Hotel | Rooms | Acquisition Date |
|--|--------------|------------------------------|
| W Hotel, San Diego, California | 259 | June 26, 2006 |
| Embassy Suites, La Jolla, California | 335 | May 17, 2006 |
| Hilton Times Square, New York City, New York | 444 | March 17, 2006 |
| Del Mar Marriott, San Diego, California | 284 | January 10, 2006 |
| Hyatt Century Plaza, Los Angeles, California | 726 | October 5, 2005 |
| Fairmont Hotel, Newport Beach, California | 444 | July 11, 2005 |
| Sheraton Hotel, Cerritos, California | 203 | June 27, 2005 |
| Renaissance Orlando Resort at Sea World, Orlando, Florida ⁽¹⁾ | 780 | June 23, 2005 |
| Renaissance Harborplace, Baltimore, Maryland | 622 | June 23, 2005 |
| Renaissance Concourse, Atlanta, Georgia | 387 | June 23, 2005 |
| Renaissance Long Beach, Long Beach, California | 373 | June 23, 2005 |
| Renaissance Westchester, White Plains, New York | 357 | June 23, 2005 |
| Renaissance Washington, D.C., Washington, D.C. | 807 | June 23, 2005 ⁽²⁾ |

⁽¹⁾ Acquired 85% ownership interest.

⁽²⁾ Acquired 25% ownership interest on June 23, 2005, and the remaining 75% interest July 13, 2005.

The aggregate cost for the four hotels acquired during the first nine months of 2006 totaled approximately \$522.1 million, or \$395,000 per room.

Sale of hotels. The following table sets forth the hotels that we have sold since the beginning of 2005 and indicates their room count and sale date:

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| Hotel | Rooms | Sale Date |
|--------------------------------------|--------------|--------------------|
| Holiday Inn, Boise, Idaho | 265 | September 12, 2006 |
| Holiday Inn, Craig, Colorado | 152 | September 12, 2006 |
| Holiday Inn, Price, Utah | 151 | September 12, 2006 |
| Holiday Inn, Renton, Washington | 226 | September 12, 2006 |
| Holiday Inn, San Diego, California | 175 | September 12, 2006 |
| Crowne Plaza, Englewood, New Jersey | 194 | September 12, 2006 |
| Crowne Plaza, Williamsburg, Virginia | 303 | September 12, 2006 |
| Hawthorn Suites, Kent, Washington | 152 | September 12, 2006 |
| Marriott, Ogden, Utah | 292 | September 12, 2006 |
| Marriott, Pueblo, Colorado | 164 | September 12, 2006 |
| Courtyard, Lynnwood, Washington | 164 | September 12, 2006 |
| Courtyard, Fresno, California | 116 | September 12, 2006 |
| Courtyard, Santa Fe, New Mexico | 213 | September 12, 2006 |
| Holiday Inn, Hollywood, California | 160 | March 15, 2006 |
| Holiday Inn, Provo, Utah | 78 | December 23, 2005 |
| Doubletree, Carson, California | 224 | April 14, 2005 |
| Holiday Inn, Mesa, Arizona | 246 | April 14, 2005 |

The aggregate net sale proceeds for the fourteen hotels disposed of during our first three quarters of 2006 were \$158.2 million (including a \$5.6 million promissory note), or \$58,000 per room. The results of operations of all of the hotels identified above and the gains or losses on dispositions through September 30, 2006 are included in discontinued operations for all periods presented through the time of sale. The cash proceeds from the sales are included in our cash flows from investing activities for the respective periods.

The following table summarizes our portfolio and room data since the beginning of 2005 through September 30, 2006 adjusted for the hotels acquired and sold during the respective periods.

| | January 1, 2006 | January 1, 2005 |
|---------------------------------------|-------------------------------|------------------------------|
| | through | through |
| | September 30, 2006 | December 31, 2005 |
| Portfolio Data Hotels | | |
| Number of hotels beginning of period | 60 | 54 |
| Add: Acquisitions | 4 | 9 |
| Less: Sales | (14) | (3) |
| Number of hotels end of period | 50 | 60 |
| Portfolio Data Rooms | | |
| Number of rooms beginning of period | 17,333 | 13,183 |
| Add: Acquisitions | 1,322 | 4,701 |
| Less: Sales | (2,727) | (548) |
| Less: Rooms converted to other usage | | (3) |
| Number of rooms end of period | 15,928 | 17,333 |
| Average rooms per hotel end of period | 319 | 289 |

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The following table presents our unaudited operating results for the three months ended September 30, 2006 and 2005, including the amount and percentage change in the results between the two periods.

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | \$ Change | % Change |
|--|---|--|-------------------|----------------|
| | (dollars in thousands, except statistical data) | | | |
| REVENUES | | | | |
| Room | \$ 155,477 | \$ 111,820 | \$ 43,657 | 39.0% |
| Food and beverage | 49,703 | 38,687 | 11,016 | 28.5% |
| Other operating | 21,833 | 11,222 | 10,611 | 94.6% |
| Total revenues | 227,013 | 161,729 | 65,284 | 40.4% |
| OPERATING EXPENSES | | | | |
| Hotel operating | 140,112 | 101,246 | 38,866 | 38.4% |
| Property general and administrative | 24,301 | 19,088 | 5,213 | 27.3% |
| Corporate overhead | 3,116 | 3,534 | (418) | (11.8)% |
| Depreciation and amortization | 26,078 | 18,771 | 7,307 | 38.9% |
| Total operating expenses | 193,607 | 142,639 | 50,968 | 35.7% |
| Operating income | 33,406 | 19,090 | 14,316 | 75.0% |
| Interest and other income | 616 | 910 | (294) | (32.3)% |
| Interest expense | (23,996) | (14,717) | (9,279) | (63.0)% |
| Income before minority interest and discontinued operations | 10,026 | 5,283 | 4,743 | 89.8% |
| Minority interest | | (321) | 321 | 100.0% |
| Income from continuing operations | 10,026 | 4,962 | 5,064 | 102.1% |
| Income (loss) from discontinued operations | (8,490) | 2,923 | (11,413) | (390.5)% |
| NET INCOME | 1,536 | 7,885 | (6,349) | (80.5)% |
| Preferred stock dividends and accretion | (5,188) | (4,084) | (1,104) | |
| INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDERS | \$ (3,652) | \$ 3,801 | \$ (7,453) | |
| Operating Statistics | | | | |
| Occupancy ⁽¹⁾ | 78.7% | 77.6% | | |
| Average daily rate ⁽¹⁾ | \$ 140.00 | \$ 130.97 | \$ 9.03 | 6.9% |
| RevPAR ⁽¹⁾ | \$ 110.18 | \$ 101.63 | \$ 8.55 | 8.4% |

⁽¹⁾ Operating statistics are based on 46 hotels that we owned as of September 30, 2006, and exclude 4 hotels undergoing rebranding and renovation programs (Hyatt Regency Century Plaza, Renaissance Orlando, Renaissance Washington D.C. and Marriott Tysons Corner). The following table presents our unaudited operating results for the nine months ended September 30, 2006 and 2005, including the amount and percentage change in the results between the two periods.

| | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 | \$ Change | % Change |
|--|---|---|-----------|----------|
|--|---|---|-----------|----------|

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(dollars in thousands, except statistical data)

| REVENUES | | | | |
|--|------------------|------------------|------------------|---------------|
| Room | \$ 433,896 | \$ 257,905 | \$ 175,991 | 68.2% |
| Food and beverage | 165,697 | 88,148 | 77,549 | 88.0% |
| Other operating | 57,083 | 31,718 | 25,365 | 80.0% |
| Total revenues | 656,676 | 377,771 | 278,905 | 73.8% |
| OPERATING EXPENSES | | | | |
| Hotel operating | 396,755 | 230,291 | 166,464 | 72.3% |
| Property general and administrative | 74,063 | 44,448 | 29,615 | 66.6% |
| Corporate overhead | 13,495 | 10,278 | 3,217 | 31.3% |
| Depreciation and amortization | 71,213 | 43,824 | 27,389 | 62.5% |
| Total operating expenses | 555,526 | 328,841 | 226,685 | 68.9% |
| Operating income | 101,150 | 48,930 | 52,220 | 106.7% |
| Interest and other income | 2,227 | 2,614 | (387) | (14.8)% |
| Interest expense | (73,668) | (39,349) | (34,319) | (87.2)% |
| Income before minority interest and discontinued operations | 29,709 | 12,195 | 17,514 | 143.6% |
| Minority interest | | (1,115) | 1,115 | 100.0% |
| Income from continuing operations | 29,709 | 11,080 | 18,629 | 168.1% |
| Income from discontinued operations | 11,704 | 7,134 | 4,570 | 64.1% |
| NET INCOME | 41,413 | 18,214 | 23,199 | 127.4% |
| Preferred stock dividends and accretion | (14,429) | (6,886) | (7,543) | |
| INCOME AVAILABLE TO COMMON STOCKHOLDERS | \$ 26,984 | \$ 11,328 | \$ 15,656 | |
| Operating Statistics | | | | |
| Occupancy ⁽¹⁾ | 75.6% | 75.0% | | |
| Average daily rate ⁽¹⁾ | \$ 136.86 | \$ 126.87 | \$ 9.99 | 7.9% |
| RevPAR ⁽¹⁾ | \$ 103.47 | \$ 95.15 | \$ 8.32 | 8.7% |

⁽¹⁾ Operating statistics are based on 46 hotels that we owned as of September 30, 2006, and exclude 4 hotels undergoing rebranding and renovation programs (Hyatt Regency Century Plaza, Renaissance Orlando, Renaissance Washington D.C. and Marriott Tysons Corner).

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Room revenue. Room revenue increased \$43.7 million, or 39.0%, for the three months ended September 30, 2006 as compared to the three months ended September 30, 2005. The increase was primarily due to room revenue generated from newly acquired hotels. We acquired twelve hotels either during or subsequent to our third quarter 2005: W Hotel San Diego, Embassy Suites La Jolla, Hilton Times Square, Del Mar Marriott, Hyatt Regency Century Plaza, Fairmont Newport Beach, Renaissance Orlando, Renaissance Harborplace, Renaissance Concourse, Renaissance Long Beach, Renaissance Westchester and Renaissance Washington D.C. (which we refer to as the twelve hotels). The twelve hotels contributed \$37.6 million to room revenue during our third quarter 2006. In addition, growth in the hotels we acquired prior to December 31, 2004 (which we refer to as our existing portfolio) contributed \$6.1 million to room revenue during our third quarter due to increases in both occupancy (\$0.6 million) and ADR (\$5.5 million). For the nine months ended September 30, 2006 (which we refer to as year-to-date), room revenue increased \$176.0 million, or 68.2%, in 2006 as compared to the same time period in 2005. We acquired thirteen hotels subsequent to January 1, 2005: W Hotel San Diego, Embassy Suites La Jolla, Hilton Times Square, Del Mar Marriott, Hyatt Regency Century Plaza, Fairmont Newport Beach, Sheraton Hotel Cerritos, Renaissance Orlando, Renaissance Harborplace, Renaissance Concourse, Renaissance Long Beach, Renaissance Westchester and Renaissance Washington D.C. (which we refer to as the thirteen hotels). The thirteen hotels contributed \$158.2 million to room revenue year-to-date. In addition, growth in our existing portfolio contributed \$17.8 million to room revenue on a year-to-date basis due to increases in both occupancy (\$1.2 million) and ADR (\$16.6 million).

Food and beverage revenue. Food and beverage revenue increased \$11.0 million, or 28.5%, for the three months ended September 30, 2006 as compared to the three months ended September 30, 2005. The twelve hotels contributed \$10.3 million of food and beverage revenue during our third quarter 2006. Food and beverage revenue generated from our existing portfolio increased \$0.7 million during our third quarter 2006 as compared to the same time period in 2005. On a year-to-date basis, food and beverage revenue increased \$77.5 million, or 88.0%, in 2006 as compared to the same time period in 2005. The thirteen hotels contributed \$74.4 million of food and beverage revenue year-to-date. Food and beverage revenue generated from our existing portfolio increased \$3.1 million year-to-date as compared to the same time period in 2005.

Other operating revenue. Other operating revenue increased \$10.6 million, or 94.6%, for the three months ended September 30, 2006 as compared to the three months ended September 30, 2005. The twelve hotels contributed \$9.9 million to other operating revenue during our third quarter 2006. In addition, other operating revenue generated from our existing portfolio contributed \$0.7 million during our third quarter 2006 as compared to the same time period in 2005. On a year-to-date basis, other operating revenue increased \$25.4 million, or 80.0%, in 2006 as compared to the same time period in 2005. The thirteen hotels contributed \$24.2 million year-to-date. In addition, other operating revenue generated from our existing portfolio contributed \$1.2 million year-to-date as compared to the same time period in 2005. A substantial portion of our other operating revenue in both the three and nine months ended September 30, 2006 resulted from a performance guaranty provided by the manager of the Hyatt Regency Century Plaza. We used a total of \$12.9 million of the \$27.0 million performance guaranty during the nine months ended September 30, 2006 and \$17.9 million cumulatively. We expect to fully utilize the remaining amount of this guaranty in the fourth quarter of 2006 and in 2007. The increases in our existing portfolio for both the three and nine months ended September 30, 2006 were primarily due to increased attrition and cancellation fees collected by our hotels, combined with increased revenue generated by our electronic purchasing platform, Buy Efficient, L.L.C.

Hotel operating expenses. Hotel operating expenses, which are comprised of room, food and beverage, advertising and promotion, repairs and maintenance, utilities, and other hotel operating expenses, increased \$38.9 million, or 38.4%, during the three months ended September 30, 2006 as compared to the three months ended September 30, 2005. The twelve hotels contributed \$35.3 million to hotel operating expense during our third quarter 2006. In addition, hotel operating expenses in our existing portfolio increased \$3.6 million during our third quarter 2006 as compared to the same time period in 2005. On a year-to-date basis, hotel operating expenses increased \$166.5 million, or 72.3%, in 2006 as compared to the same time period in 2005. The thirteen hotels contributed \$156.8 million to hotel operating expense year-to-date. In addition, hotel operating expenses in our existing portfolio increased \$9.7 million on a year-to-date basis as compared with the same time periods in 2005. These higher costs in our existing portfolio for both the three and the nine months ended September 30, 2006 were primarily a result of increases in room expense and franchise costs due to increases in occupancy and revenue, combined with increases in utility expense due to higher energy costs, and an increase in property taxes due to a \$0.8 million supplemental property tax bill assessed on one of our hotels.

Property general and administrative expense. Property general and administrative expense increased \$5.2 million, or 27.3%, during the three months ended September 30, 2006 as compared to the three months ended September 30, 2005. The twelve hotels contributed \$5.7 million in property general and administrative expense during our third quarter 2006. Property general and administrative expenses in our existing portfolio decreased \$0.5 million during our third quarter 2006 as compared to the same time period in 2005 primarily due to decreases in the bad debt reserves at two of our hotels totaling

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\$1.5 million. These decreases were partially offset by increases in management and accounting fees payable to the Management Company, and other hotel specific expenses, such as increased credit card commissions, associated with the overall increase in revenue. On a year-to-date basis, property general and administrative expense increased \$29.6 million, or 66.6%, in 2006 as compared to the same time period in 2005. The thirteen hotels contributed \$29.3 million to property general and administrative expense year-to-date. Property general and administrative expenses in our existing portfolio increased \$2.4 million on a year-to-date basis as compared to the same time period in 2005 primarily due to the same increases discussed above for our third quarter 2006. On a year-to-date basis, these increases were largely offset by a decrease of \$2.1 million in the nine months ended September 30, 2006 as compared with the same period in 2005 due to a bad debt reserve recorded in the second quarter of 2005 for a contract interpretation issue with a customer. This reserve was reversed during the fourth quarter of 2005, as we favorably resolved the issue.

Corporate overhead expense. Corporate overhead expense decreased \$0.4 million, or 11.8%, during the three months ended September 30, 2006 as compared to the three months ended September 30, 2005, primarily due to a decrease in the corporate bonus accrual, partially offset by increases in payroll and related expenses, including deferred stock compensation expense. On a year-to-date basis, corporate overhead expense increased \$3.2 million, or 31.3%, in 2006 as compared to the same time period in 2005. These increases were primarily a result of increases in payroll and related expenses, including deferred stock compensation expense.

Depreciation and amortization expense. Depreciation and amortization expense increased \$7.3 million, or 38.9%, during the three months ended September 30, 2006 as compared to the three months ended September 30, 2005. The twelve hotels contributed \$7.2 million in depreciation and amortization expense during our third quarter 2006. Our existing portfolio contributed an additional \$0.6 million in depreciation and amortization expense during our third quarter 2006, which was partially offset by a decrease of \$0.5 million due to the sale of fifteen of our hotels subsequent to our third quarter 2005. On a year-to-date basis, depreciation and amortization increased \$27.4 million, or 62.5%, in 2006 as compared to the same time period in 2005. The thirteen hotels contributed \$27.1 million in depreciation and amortization expense year-to-date. On a year-to-date basis, our existing portfolio contributed an additional \$1.3 million, which was partially offset by a decrease of \$1.0 million due to the sale of seventeen hotels subsequent to January 1, 2005.

Interest expense. Interest expense increased \$9.3 million and \$34.3 million during the three and nine months ended September 30, 2006, respectively, as compared to the same time periods during 2005. These increases were primarily due to greater outstanding loan balances in 2006 as compared with 2005, as we obtained additional loans to finance our acquisitions. As a result of new loans, interest expense includes an additional \$8.3 million and \$25.6 million in interest incurred during the three and nine months ended September 30, 2006, respectively, as compared to the same time periods in 2005. In addition, we incurred increased amortization of deferred financing fees of \$1.0 million and \$1.5 million during the three and nine months ended September 30, 2006, respectively. In connection with our refinancing of three hotel properties during the first nine months of 2006, we incurred a loss on early extinguishment of debt of \$10.0 million related to the cost associated with the defeasance of the debt being refinanced. These increases were partially offset by a decrease of \$2.8 million in prepayment penalties during the nine months ended September 30, 2006.

Our total notes payable, including the current portion, was \$1,500.5 million at September 30, 2006 and \$1,020.3 million at September 30, 2005, with a weighted average interest rate per annum of approximately 5.8% at both September 30, 2006 and September 30, 2005. At September 30, 2006, the interest rates for all of our outstanding notes payable were fixed.

Income (loss) from discontinued operations. Income (loss) from discontinued operations was a loss of \$8.5 million and income of \$2.9 million for the three months ended September 30, 2006 and 2005, respectively. On a year-to-date basis, income (loss) from discontinued operations totaled income of \$11.7 million in 2006 as compared to income of \$7.1 million in 2005. As described under "Acquisition, Sale and Major Redevelopment Activity - Sale of Hotels," two hotels were sold during the second quarter of 2005, one was sold during the fourth quarter of 2005, one was sold during the first quarter of 2006, and thirteen were sold during the third quarter of 2006. Consistent with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we have reclassified the results of operations for these seventeen hotels as discontinued operations.

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Liquidity and Capital Resources

Historical. During the periods presented, our sources of cash included our operating activities, working capital, notes payable, our revolving credit facility, sales of hotel properties, and proceeds from our public and private offerings of common and preferred stock. Our primary uses for cash were for acquisitions of hotels, capital expenditures for hotels, operating expenses, repayment of notes payable and dividends on our common and preferred stock.

Operating activities. Net cash provided by operating activities was \$124.7 million for the nine months ended September 30, 2006 compared to \$78.1 million for the nine months ended September 30, 2005. This increase was primarily due to additional cash generated from acquired properties and increased cash flow generated by our existing portfolio during the nine months ended September 30, 2006.

Investing activities. Our cash used in investment activities fluctuates primarily based on acquisitions, sales and renovation of hotels. Net cash used in investing activities was \$389.6 million for the nine months ended September 30, 2006 compared to \$656.8 million for the nine months ended September 30, 2005. During the nine months ended September 30, 2006, we acquired four hotels for \$522.1 million, including the assumption of \$81.0 million in debt and a \$6.5 million deposit paid at the end of 2005, and acquired an office building and land adjacent to one of our hotels for \$4.4 million, for a total cash outlay of \$439.0 million. In addition, we paid cash of \$102.9 million for renovations to our hotels, increased the balance in our restricted cash replacement reserve accounts by \$0.6 million, and received net proceeds of \$152.9 million from the sale of fourteen hotels combined with the collection of additional proceeds from a hotel we sold in 2004. During the same time period in 2005, we acquired eight hotels for \$671.3 million, which included the assumption of \$63.1 million in debt, paid a deposit of \$15.0 million on an additional hotel which we acquired in October 2005, and paid \$0.6 million in other deposits, for a total of \$623.8 million. In addition, we paid cash of \$42.4 million for renovations to our hotels, increased the balance in our restricted cash replacement reserve accounts by \$18.4 million, and received net proceeds of \$27.9 million from the sale of two hotels and a vacant land parcel.

Financing activities. Net cash provided by financing activities was \$372.5 million for the nine months ended September 30, 2006 compared to \$718.3 million for the nine months ended September 30, 2005. Net cash provided by financing activities for the nine months ended September 30, 2006 consisted primarily of proceeds from notes payable of \$440.5 million, and net proceeds from our preferred and common stock offerings of \$54.2 million and \$157.7 million, respectively, partially offset by \$202.2 million of principal payments on notes payable and \$10.0 million related to the cost associated with the defeasance of debt we refinanced, \$64.0 million of dividends, and \$3.7 million in deferred financing costs. Net cash provided by financing activities for the nine months ended September 30, 2005 consisted primarily of proceeds from notes payable of \$526.2 million, net proceeds from our preferred and common stock offerings of \$216.3 million and \$298.0 million, respectively, partially offset by \$281.5 million of principal payments on notes payable, \$38.0 million of dividends and distributions to our shareholders, and \$2.8 million in deferred financing costs.

Future. We expect our primary uses for cash to be for acquisitions of hotels, capital expenditures for hotels, operating expenses, repayment of principal on our notes payable, interest expense and dividends. We expect our primary sources of cash will come from our operating activities, working capital, notes payable, our revolving credit facility, sales of hotel properties, and proceeds from public and private offerings of common and preferred stock. Our ability to incur additional debt depends on a number of financial factors, including our leverage, the value of our unencumbered assets and borrowing restrictions imposed by lenders under our existing notes payable, and our revolving credit facility. Our ability to raise funds through the issuance of equity securities depends on, among other things, general market conditions for hotel companies and REITs and market perceptions about us. We will continue to analyze which source of capital is most advantageous to us at any particular point in time. However, the capital markets may not be available to us when needed on favorable terms or at all.

We believe that our capital structure, including our \$200.0 million revolving credit facility, proceeds available to us under our forward sale agreement (see Note 10, Stockholders' Equity - Common Stock), and cash flow from operations, will provide us with sufficient liquidity to meet our current operating expenses and other expenses directly associated with our business for the foreseeable future, and in any event for at least the next twelve months. As of September 30, 2006, our revolving credit facility had no amounts outstanding, and had \$13.1 million backing outstanding irrevocable letters of credit, leaving \$186.9 million available at September 30, 2006. We are subject to compliance with applicable credit ratios under the revolving credit facility. In January 2006, we obtained a \$48.0 million mortgage loan with a maturity date of January 2016 and a fixed interest rate of 5.69%. In February 2006, we refinanced two of our hotel properties, replacing a \$36.9 million mortgage at a fixed interest rate of 8.25% scheduled to mature in 2008, with an eleven-year \$75.0 million mortgage at a fixed interest rate of 5.58%, and replacing a \$35.8 million mortgage at a fixed rate of 8.25% scheduled to mature in 2008, with a ten-year \$34.0 million mortgage at a fixed rate of 5.66%. In March 2006, we assumed an \$81.0 million fixed rate mortgage loan with a maturity date of December 2010 and a fixed interest rate of 5.92%. In April 2006, we refinanced one of our hotel

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properties, replacing a \$52.9 million mortgage at a fixed interest rate of 7.5%, scheduled to mature in 2008, with a 15-year \$135.0 million mortgage at a fixed interest rate of 5.95%. Also in April 2006, we repaid in full our \$75.0 million subordinated term loan. In May 2006, we obtained a \$70.0 million mortgage loan maturing in June 2019 with a fixed interest rate of 6.60% to finance a hotel acquisition. In June 2006, we obtained a \$65.0 million fixed rate mortgage loan with a maturity date of January 2018 and an interest rate of 6.14% to finance a hotel acquisition. In August 2006, we exercised our right under the earn-out agreement for a loan on one of our hotels to draw an additional \$13.0 million. The terms under the revised mortgage loan remain the same, with interest only payments at a rate of 5.30% payable until July 2008, and a maturity date in July 2016.

As of September 30, 2006, all of our outstanding debt has fixed interest rates. The majority of our mortgage debt is in the form of single asset loans rather than cross-collateralized multi-property pools. We believe this structure is appropriate for the operating characteristics of our business and provides flexibility for assets to be sold subject to the existing debt.

Contractual Obligations

The following table summarizes our payment obligations and commitments as of September 30, 2006 (in thousands):

| Contractual obligations | Total | Payment due by period | | | |
|---------------------------------------|--------------|-----------------------|-----------------|-----------------|----------------------|
| | | Less than 1 year | 1 to 3 years | 3 to 5 years | More than 5 years |
| | | (in thousands) | | | |
| Notes payable | \$ 1,500,493 | \$ 16,959 | \$ 22,076 | \$ 365,888 | \$ 1,095,570 |
| Interest obligations on notes payable | 719,595 | 87,572 | 171,617 | 159,634 | 300,772 |
| Operating lease obligations | 310,015 | 4,625 | 9,410 | 8,598 | 287,382 |
| Construction commitments | 26,963 | 26,963 | | | |
| Employment obligations | 2,945 | 1,326 | 1,556 | 63 | |
| Total | \$ 2,560,011 | \$ 137,445 | \$ 204,659 | \$ 534,183 | \$ 1,683,724 |

Capital Expenditures and Reserve Funds

We believe we maintain each of our hotels in good repair and condition and in conformity with applicable franchise agreements, ground leases, laws and regulations. Our capital expenditures are for the ongoing maintenance and renovation of our hotels. We also incur capital expenditures following the acquisition of hotels for renovation and development. Our capital expenditures for 2006 are expected to be approximately \$130.0 million to \$140.0 million, of which we spent \$102.9 million in the first nine months of 2006. This renovation budget includes \$27.0 million of contractual construction commitments and discretionary amounts in excess of our contractual requirements. All of these amounts are expected to be funded out of our cash and reserve accounts. If we acquire, renovate or develop additional hotels in the future, our capital expenditures will increase. Our capital expenditures also fluctuate from year to year, since we are not required to spend the entire amount in the reserve accounts each year.

With respect to our hotels that are operated under franchise agreements with major national hotel brands and for all of our hotels subject to a first mortgage lien, we are obligated to maintain a furniture, fixture and equipment, or FF&E, reserve account for future planned and emergency-related capital expenditures at these hotels. The amount funded into each of these reserve accounts is determined pursuant to the management, franchise and/or loan agreements for each of the respective hotels, ranging between 4.0% and 5.0% of the respective hotel's total annual revenue. As of September 30, 2006, \$35.2 million was available in restricted cash reserves for future capital expenditures at our hotels. According to the respective loan agreements, the reserve funds are to be held by the respective lenders in a restricted cash account.

Off-Balance Sheet Arrangements

At September 30, 2006, we did not have any off-balance sheet arrangements.

Seasonality

The lodging business is seasonal in nature, and we experience some seasonality in our business as indicated in the table below. Revenue for hotels in tourist areas generally is substantially greater during tourist season (i.e., second and third quarter) than other times of the year.

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Quarterly revenue also may be adversely affected by events beyond our control, such as extreme weather conditions, terrorist attacks or alerts, public health concerns (such as SARS and bird flu), airline strikes,

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economic factors and other considerations affecting travel. Our revenues by quarter during 2005 and 2006 were as follows (dollars in thousands):

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|-----------------|------------------|-------------------|------------------|-------------------|
| Revenues | | | | |
| 2005 | \$ 101,936 | \$ 114,106 | \$ 161,729 | \$ 211,453 |
| 2006 | \$ 198,308 | \$ 231,355 | \$ 227,013 | |

Inflation

Inflation may affect our expenses by increasing costs including, without limitation, taxes, property and casualty insurance and utilities.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses and related disclosure of contingent assets and liabilities.

We evaluate our estimates on an ongoing basis. We base our estimates on historical experience, information that is currently available to us and on various other assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect the most significant judgments and estimates used in the preparation of our combined financial statements.

Impairment of long-lived assets. We periodically review each property for possible impairment. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. In this analysis of fair value, we use discounted cash flow analysis to estimate the fair value of our properties taking into account each property's expected cash flow from operations, holding period and proceeds from the disposition of the property. The factors addressed in determining estimated proceeds from disposition include anticipated operating cash flow in the year of disposition, terminal capitalization rate and selling price per room. Our judgment is required in determining the discount rate applied to estimated cash flows, growth rate of the properties, the need for capital expenditures, as well as specific market and economic conditions. Additionally, the classification of these assets as held-for-sale (if applicable) requires the recording of these assets at their estimated fair value less estimated selling costs which can affect the amount of impairment recorded.

Depreciation and amortization expense. Depreciation expense is based on the estimated useful life of our assets. The life of the assets is based on a number of assumptions, including the cost and timing of capital expenditures to maintain and refurbish our hotels, as well as specific market and economic conditions. Hotel properties and other completed real estate investments are depreciated using the straight-line method over estimated useful lives ranging from five to 35 years for buildings and improvements and three to 12 years for furniture, fixtures and equipment. While management believes its estimates are reasonable, a change in the estimated lives could affect depreciation expense and net income or the gain or loss on the sale of any of our hotels. We have not changed the estimated useful lives of any of our assets during the periods discussed.

Accrual of self-insured obligations. We are self-insured up to certain amounts with respect to employee medical, employee dental, general liability insurance, personal injury claims, workers' compensation, automobile liability and other coverages. We establish reserves for our estimates of the loss that we will ultimately incur on reported claims as well as estimates for claims that have been incurred but not yet reported. Our reserves, which are reflected in Due to Management Company and other liabilities in our consolidated and combined balance sheets, are based on actuarial valuations and our history of claims. Our actuaries incorporate

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historical loss experience and judgments about the present and expected levels of costs per claim. Trends in actual experience are an important factor in the determination of these estimates. We believe that our estimated reserves for such claims are adequate, however, actual experience in claim frequency and amount could materially differ from our estimates and adversely affect our results of operations, cash flow, liquidity and financial condition.

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New Accounting Standards and Accounting Changes

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in our financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* . The provisions of FIN 48 are effective for our fiscal year beginning January 1, 2007. We are currently evaluating the impact of the provisions of FIN 48.

In September 2006, the FASB issued Statement No. 157 (FAS 157), *Fair Value Measurements* (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of FAS 157 are effective for our fiscal year beginning January 1, 2008. We are currently evaluating the impact of the provisions of FAS 157.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our future income, cash flows and fair values relevant to financial instruments are dependent upon prevailing market interest rates. Market risk refers to the risk of loss from adverse changes in market prices and interest rates. As of September 30, 2006 none of our outstanding debt is subject to variable interest rates. Due to the types of debt instruments we hold, a 10% change in period-end interest rates or a hypothetical 100 basis point adverse move in interest rates would not have a significant negative effect on our results of operations.

Interest risk amounts were determined by considering the impact of hypothetical interest rates on our financial instruments. These analyses do not consider the effect of a reduced level of overall economic activity. If overall economic activity is significantly reduced, we may take actions to further mitigate our exposure. However, because we cannot determine the specific actions that would be taken and their possible effects, these analyses assume no changes in our financial structure.

Item 4. Disclosure Controls and Procedures

Evaluation of Disclosure Controls and Procedures. Based upon an evaluation of the effectiveness of disclosure controls and procedures, Sunstone Hotels Investors, Inc.'s Chief Executive Officer (CEO) and Chief Financial Officer (CFO) have concluded that as of the end of the period covered by this Quarterly Report on Form 10-Q our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) were effective to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified by the rules and forms of the Securities and Exchange Commission and is accumulated and communicated to management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting. During our most recent fiscal quarter, there has not occurred any change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

During 2003, a suit against our predecessor companies was filed by a hotel guest who became ill and alleged the illness resulted from exposure to Legionella bacteria during a stay at one of our formerly owned hotels. On September 18, 2006, we entered into a memorandum of understanding to settle this litigation for \$537,500. We expect that all of this amount will be covered by our liability insurance. We will not admit any wrongdoing in connection with the settlement. If the settlement is not finalized, we intend to continue to defend this matter vigorously.

Item 1A. Risk Factors

There have been no material changes from risk factors as previously disclosed in the Risk Factors section of our Annual Report on Form 10-K for the period ended December 31, 2005, filed with the SEC on February 15, 2006.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

The following Exhibits are filed as a part of this report:

Exhibit

| Number | Description |
|---------------|---|
| 10.1 | Revolving Credit Agreement dated as of July 17, 2006 among Sunstone Hotel Partnership, LLC, Sunstone Hotel Investors, Inc., the Subsidiary Guarantors named therein, the Initial Lenders, the Initial Issuing Bank, the Swing Line Bank, Citicorp North America, Inc., as Administrative Agent, Wachovia Capital Markets, LLC, as syndication agent, Calyon New York Branch, as co-syndication agent, Keybank National Association, as documentation agent, and Citigroup Global Markets, Inc. and Wachovia Capital Markets, LLC, as joint lead managers and joint book running managers (incorporated by reference to Exhibit 99.1 to the Current Report on Form 8-K filed by the Company on July 18, 2006). |

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- 10.2 Forward Sale Agreement between Sunstone Hotel Investors, Inc., and Citibank, N.A. (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed by the Company on July 24, 2006).
- 10.3 First Letter Amendment dated as of August 14, 2006 to Revolving Credit Agreement dated as of July 17, 2006 among Sunstone Hotel Partnership, LLC, Sunstone Hotel Investors, Inc., the Subsidiary Guarantors named therein, the Initial Lenders, the Initial Issuing Bank, the Swing Line Bank, Citicorp North America, Inc., as Administrative Agent, Wachovia Capital Markets, LLC, as syndication agent, Calyon New York Branch, as co-syndication agent, Keybank National Association, as documentation agent, and Citigroup Global Markets, Inc. and Wachovia Capital Markets, LLC, as joint lead managers and joint book running managers.
- 31.1 Certification of CEO Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of CFO Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of CEO and CFO Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Sunstone Hotel Investors, Inc.

Date: November 1, 2006

By: /s/ JON D. KLINE
Jon D. Kline

(Principal Financial Officer and Duly Authorized Officer)