Sunstone Hotel Investors, Inc.
Form 10-K
February 25, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2012

OR

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

For the transition period from to

Commission file number 001-32319

Sunstone Hotel Investors, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	**20-1296886** (I.R.S. Employer Identification Number)
120 Vantis, Suite 350 **Aliso Viejo, California** (Address of Principal Executive Offices)	**92656** (Zip Code)

Registrant s telephone number, including area code: **(949) 330-4000**

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $0.01 par value	**New York Stock Exchange**
Series A Cumulative Redeemable Preferred Stock, $0.01 par value	**New York Stock Exchange**
Series D Cumulative Redeemable Preferred Stock, $0.01 par value	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

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 o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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, as amended (the Exchange Act), during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

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

The aggregate market value of the voting stock held by non-affiliates of the registrant based upon the closing sale price of the registrant s common stock on June 30, 2012 as reported on the New York Stock Exchange (NYSE) was approximately $1.5 billion. The registrant had no non-voting common equity outstanding on such date. This amount excludes 1,644,987 shares of the registrant s common stock held by the executive officers and directors. Exclusion of such shares should not be construed to indicate that any such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the registrant or that such person is controlled by or under common control with the registrant.

The number of shares of the registrant s common stock outstanding as of February 11, 2013 was 158,777,430.

Documents Incorporated by Reference

Part III of this Report incorporates by reference information from the definitive Proxy Statement for the registrant s 2013 Annual Meeting of Stockholders.

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SUNSTONE HOTEL INVESTORS, INC.

ANNUAL REPORT ON

FORM 10-K

For the Year Ended December 31, 2012

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The Company means Sunstone Hotel Investors, Inc., a Maryland corporation, and one or more of its subsidiaries, including Sunstone Hotel Partnership, LLC, or the Operating Partnership, and Sunstone Hotel TRS Lessee, Inc., or the TRS Lessee, and, as the context may require, Sunstone Hotel Investors only or the Operating Partnership only.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report, together with other statements and information publicly disseminated by the Company, contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and includes this statement for purposes of complying with these safe harbor provisions. Forward-looking statements, which are based on certain assumptions and describe the Company s future plans, strategies and expectations, are generally identifiable by use of the words believe, expect, intend, anticipate, estimate, project or similar expressions. You should not rely on forward-looking statements because they involve known and unknown risks, uncertainties and other factors that are, in some cases, beyond the Company s control and which could materially affect actual results, performances or achievements. Factors that may cause actual results to differ materially from current expectations include, but are not limited to the risk factors discussed in this Annual Report on Form 10-K. Accordingly, there is no assurance that the Company s expectations will be realized. Except as otherwise required by the federal securities laws, the Company disclaims any obligations or undertaking to publicly release any updates or revisions to any forward-looking statement contained herein (or elsewhere) to reflect any change in the Company s expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Item 1. Business

Our Company

We were incorporated in Maryland on June 28, 2004. We are a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended (the Code). As of December 31, 2012, we had interests in 30 hotels, including four hotels that we classified as held for sale and included in discontinued operations due to their sale in January 2013, leaving 26 hotels currently held for investment (the 26 hotels). The 26 hotels are comprised of 11,632 rooms, located in 12 states and in Washington, D.C.

Our primary business is to acquire, own, asset manage and renovate full-service hotel properties in the United States. As part of our ongoing portfolio management strategy, we may also sell certain hotel properties from time to time. Our hotels are operated under nationally recognized brands, such as Marriott, Hilton, Hyatt, Fairmont and Sheraton. Our portfolio primarily consists of upper upscale hotels in the United States. As of December 31, 2012, our 26 hotels include two luxury hotels, 22 upper upscale hotels and two upscale hotels. The classifications luxury, upper upscale and upscale are defined by Smith Travel Research, an independent provider of lodging industry statistical data. Smith Travel Research classifies hotel chains into the following segments: luxury; upper upscale; upscale; upper midscale; midscale; economy; and independent.

Our hotels are operated by third-party managers pursuant to long-term management agreements with our TRS Lessee or its subsidiaries. As of December 31, 2012, our third-party managers included: subsidiaries of Marriott International, Inc. or Marriott Hotel Services, Inc. (collectively Marriott), managers of 10 of the Company s 26 hotels; a subsidiary of Interstate Hotels & Resorts, Inc. (IHR), manager of six of the Company s

26 hotels; Highgate Hotels L.P. and an affiliate (Highgate), manager of three of the Company s 26 hotels; Davidson Hotels & Resorts (Davidson) and Hilton Worldwide (Hilton), each a manager of two of the Company s 26 hotels; and Crestline Hotels & Resorts (Crestline), Fairmont Hotels & Resorts (U.S.) (Fairmont) and Hyatt Corporation (Hyatt), each a manager of one of the Company s 26 hotels. In addition, we own BuyEfficient, LLC (BuyEfficient), an electronic purchasing platform that allows members to procure food, operating supplies, furniture, fixtures and equipment. As of December 31, 2012, we also owned a commercial laundry facility located in Rochester, Minnesota, which we have classified as held for sale as of December 31, 2012 and included in discontinued operations due to its sale in January 2013.

Competitive Strengths

We believe the following competitive strengths distinguish us from other owners of lodging properties:

- **Strong Access to Capital.** As a publicly traded REIT, over the long-term, we benefit from greater access to a variety of forms of capital as compared to non-public investment vehicles.

- **Low Cost of Capital.** As a publicly traded REIT, over the long-term, we may benefit from a lower cost of capital as compared to non-public investment vehicles as a result of our liquidity, professional management and portfolio diversification.

• **Significant Cash Position**. As of December 31, 2012, we had $157.2 million in unrestricted cash and cash equivalents. In January 2013, we completed the sale of a four-hotel portfolio and a commercial laundry facility for a gross sales price of $230.0 million. Also in February 2013, we issued 22,000,000 shares of our common stock for net proceeds of approximately $256.7 million, excluding offering costs. We intend to deploy a material portion of our excess cash balance towards the repayment of maturing debt, selective acquisitions and capital investments in our portfolio. In conjunction with this strategy, in January 2013, we repurchased the remaining $58.0 million balance of our Operating Partnership s 4.60% exchangeable senior notes (the Senior Notes) for a price of $58.0 million, including accrued interest of approximately $23,000. Also in January 2013, we defeased or repaid two mortgages totaling $27.1 million in conjunction with our sale of the hotel and commercial laundry facility that secured the two mortgages for total consideration of $30.4 million. After these transactions, we have zero debt maturities through the two-year period ending December 31, 2014. In addition, in January 2013, we announced our intention to use a portion of the proceeds from our February 2013 common stock offering to redeem all 7,050,000 shares of our Series A cumulative redeemable preferred stock, or the Series A preferred stock, for $178.6 million, including accrued dividends to and including the date of the redemption totaling $2.3 million.

• **Flexible Capital Structure.** We believe our capital structure provides us with appropriate financial flexibility to execute our strategy. As of December 31, 2012, the weighted average term to maturity of our debt is approximately five years, and 70.2% of our debt is fixed rate with a weighted average interest rate of 5.5%. The weighted average interest rate on all of our debt, which includes our variable-rate debt obligations based on variable rates at December 31, 2012, is 4.9%. After our repurchase of the Senior Notes and the repayment of debt included in discontinued operations in January 2013, the weighted average term to maturity of our debt continues to be approximately five years, and 68.2% of our debt is fixed rate with a weighted average interest rate of 5.6%. The weighted average interest rate on all of our debt, which includes our variable-rate debt obligations based on variable rates at December 31, 2012, continues to be 4.9%. All of our debt is in the form of senior unsecured notes or single asset non-recourse loans rather than cross-collateralized multi-property pools. We believe this structure is appropriate for the operating characteristics of our business as it isolates risk and provides flexibility for various portfolio management initiatives, including the sale of individual hotels subject to the existing debt.

• **High Quality Portfolio.**

Presence in Key Markets. We believe that our hotels are located in desirable markets with major demand generators and significant barriers to entry for new supply. In 2012, approximately 91% of the revenues generated by the 26 hotels were earned by hotels located in key gateway markets such as Boston, New York, Washington, D.C./Baltimore, Chicago, Orlando, New Orleans, Los Angeles, Orange County and San Diego. Over time, we expect the revenues of hotels located in key gateway markets to grow more quickly than the average for U.S. hotels as a result of stronger economic drivers as well as higher levels of international travel.

Upper Upscale and Upscale Concentration. The upper upscale and upscale segments, which represented approximately 93% of the hotel revenue generated by the 26 hotels during 2012, tend to outperform the lodging industry, particularly in the recovery phase of the lodging cycle. As of December 31, 2012, the hotels comprising our 26 hotel portfolio average 447 rooms in size, and total Comparable Portfolio RevPAR was $139.22 for the year ended December 31, 2012.

Nationally Recognized Brands. All of our hotels are operated under nationally recognized brands, including Marriott, Hilton, Hyatt, Fairmont and Sheraton. We believe that affiliations with strong brands improve the appeal of our hotels to a broad set of travelers and help to drive business to our hotels.

Recently Renovated Hotels. From January 1, 2008 through December 31, 2012, we invested $306.6 million in capital renovations throughout the 26 hotels. We believe that these capital renovations have improved the competitiveness of our hotels and have helped to position our portfolio for future growth.

- **Seasoned Management Team.** Each of our core disciplines, asset management, acquisitions and finance, are overseen by industry leaders with demonstrated track records.

Asset Management. Our asset management team is responsible for maximizing the long-term value of our real estate investments by achieving above average revenue and profit performance through proactive oversight of hotel operations. Our asset management team leads property-level innovation, benchmarks best practices and aggressively oversees hotel management teams and property plans. We work with our operators to develop hotel-level master plans, which include positioning and capital renovation plans. We believe that a proactive asset management program can help to grow the revenues of our hotel portfolio and maximize operational efficiency by leveraging best practices and innovations across our various hotels, and by initiating well-timed focused capital improvements aimed at improving the appeal of our hotels.

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Acquisitions. Our acquisitions team is responsible for enhancing our portfolio quality and scale by executing well-timed acquisitions and dispositions that maximize our risk-adjusted return on invested capital. We believe that our significant acquisition and disposition experience will allow us to continue to execute our cycle-appropriate strategy to redeploy capital from slower growth to higher growth hotels. From the date of our initial public offering through December 31, 2012, we acquired interests in 22 hotel properties and sold 38 hotel properties. Pursuant to our cycle-appropriate strategy, our focus shifted from acquisitions to dispositions in 2007, 2008 and for the majority of 2009 as the lodging cycle peaked and experienced a down cycle. Towards the later part of 2009 and into 2010 and 2011, our focus shifted to the selective acquisition of upper upscale hotels as we believe we have entered a recovery phase in the lodging cycle. We maintained this focus of selective acquisitions in 2012, and will continue to do so in 2013, as we believe that our industry relationships may create opportunities for us to acquire individual hotel assets at attractive values. Meanwhile, we will also focus on capital recycling and may selectively sell hotels that we believe have lower growth prospects, have significant ongoing capital needs or are encumbered with large debt balances.

Finance. We have a highly experienced finance team focused on minimizing our cost of capital and maximizing our financial flexibility by proactively managing our capital structure and opportunistically sourcing appropriate capital for growth, while maintaining a best in class disclosure and investor relations program. We remain committed to thoughtfully and methodically reducing leverage while maintaining a focus on creating and protecting stockholder value. During 2012, we reduced our total debt by $180.9 million through amortization, debt repayments and the disposition of hotels with high debt balances.

Business Strategy

Our mission is to create meaningful value for our stockholders by becoming the premier hotel owner. Our values include transparency, trust, ethical conduct, communication and discipline. Our goal is to improve the quality and scale of our portfolio while methodically deleveraging our balance sheet. As demand for lodging generally fluctuates with the overall economy (we refer to these changes in demand as the lodging cycle), we seek to employ a balanced, cycle-appropriate corporate strategy that encompasses proactive portfolio management, intensive asset management, disciplined external growth and measured balance sheet improvement as detailed below:

- **Proactive Portfolio Management**. The leaders of each of our core disciplines function as a portfolio management team. The portfolio management team s purpose is to strategically maximize the long-term value of our assets by enhancing our portfolio quality and scale, optimizing our exposure to key markets, and improving the effectiveness and efficiency of our decision making. Accordingly, the team is responsible for developing a portfolio-wide strategy related to brand and operator relationships, asset quality and scale, target markets, capital investments, and portfolio capitalizations. Our portfolio strategy may also include the disposition of certain hotels.

- **Intensive Asset Management**. Through all phases of the lodging cycle, our strategy emphasizes internal growth and value enhancements through proactive asset management, which entails working closely with our third-party hotel operators to develop and implement long-term strategic plans for each hotel designed to enhance revenues, minimize operational expenses and asset risk, maximize the appeal of our hotels to travelers and maximize our return on invested capital. We also focus on improving the appeal and growth potential of our existing hotels through internally-managed hotel renovations.

- **Disciplined External Growth**. By gradually increasing the scale and quality of our portfolio, we may provide our stockholders with greater exposure to key growth markets, improved liquidity and broader access to value-adding transactions. Accordingly, our strategy emphasizes disciplined external growth during the recovery phase of the lodging cycle. Our external growth plan is oriented around investing in institutional-quality hotels that generate returns in excess of our cost of capital, that are additive to the quality of our portfolio, that have attractive growth potential and that may benefit from our asset management competencies. We endeavor to structure our acquisitions in ways that will not only increase the value of our shares of common stock, but also will advance our other corporate objectives, such as improving our financial flexibility and reducing our leverage. During periods of cyclical decline, our strategy may emphasize opportunistically investing in distressed assets and the repurchase of our equity or debt securities. In addition to hotel acquisitions, we may seek to grow our portfolio by making investments in defaulted and/or distressed debt positions in loan-to-own hotel transactions, utilizing our REIT structure to effect strategic combinations with select property owners, effecting portfolio purchases from institutional and other owners seeking portfolio liquidity, and by providing capital solutions to illiquid owners facing debt maturities or capital requirements.

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- **Measured Balance Sheet Improvement**. We believe that a low overall cost of capital and significant financial flexibility are very important to the successful execution of our strategy. Our balance sheet strategy is oriented toward maximizing financial flexibility especially during cyclical declines. Accordingly, our financial objectives include the measured improvement of our credit ratios, maintenance of appropriate levels of liquidity, and a gradual reduction in our financial leverage throughout the cyclical recovery phase. Our financial objectives are integral to our overall corporate strategy and, accordingly, we have developed our financial objectives in conjunction with our portfolio management and growth objectives. The lodging industry is economically sensitive. Therefore, our financial objectives are aimed at reducing the potentially negative impact of combining high operating leverage with high financial leverage, while preserving access to multiple capital sources and minimizing our weighted-average cost of capital. We seek to capitalize our acquisitions in a way that will advance our financial objectives. For example, as the measured reduction of our financial leverage is currently a key objective, we expect to fund our acquisitions with a greater proportion of equity capital than debt capital. During the mature phase of the lodging cycle, our financial objectives may include increasing our liquidity position as a means to enhance financial flexibility in the event of a subsequent period of cyclical decline. Our liquidity improvement objective may be accomplished through selective hotel dispositions, capital raises or by retaining excess cash generated by our operations.

Through our industry relationships, our knowledge and experience in both real estate and REIT issues, our extensive experience in acquiring and upgrading hotel properties, as well as our financial structuring capabilities, flexible capital structure, strong liquidity position and REIT structure, we believe we are well positioned to create meaningful value to our stockholders.

Competition

The hotel industry is highly competitive. Our hotels compete with other hotels for guests in each of their markets. Competitive advantage is based on a number of factors, including location, quality of accommodations, convenience, brand affiliation, room rates, service levels and amenities, and level of customer service. Competition is often specific to the individual markets in which our hotels are located and includes competition from existing and new hotels operated under brands in the luxury, upper upscale and upscale segments. Increased competition could harm our occupancy or revenues or may lead our operators to increase service or amenity levels, which may reduce the profitability of our hotels.

We believe that competition for the acquisition of hotels is fragmented. We face competition from institutional pension funds, private equity investors, other REITs and numerous local, regional and national owners, including franchisors, in each of our markets. Some of these entities may have substantially greater financial resources than we do and may be able and willing to accept more risk than we believe we can prudently manage. During the recovery phase of the lodging cycle, when we seek to acquire hotels, competition among potential buyers may increase the bargaining power of potential sellers, which may reduce the number of suitable investment opportunities available to us or increase pricing. Similarly, during times when we seek to sell hotels, competition from other sellers may increase the bargaining power of the potential property buyers.

All of the 26 hotels are operated under nationally recognized brands as of December 31, 2012. We believe that the market s perception of quality and service associated with the brands our hotels operate under, including Marriott, Hilton, Hyatt, Fairmont and Sheraton, is an important driver of demand.

Management Agreements

All of our 26 hotels are managed by third parties pursuant to management agreements with our TRS Lessee or its subsidiaries. As of December 31, 2012, 10 of our hotels were managed by Marriott, six of our hotels were managed by IHR, three of our hotels were managed by Highgate, two of our hotels were managed by Davidson, two of our hotels were managed by Hilton, and the other three hotels were individually managed by Crestline, Fairmont and Hyatt. The following is a general description of our third-party management agreements as of December 31, 2012.

Marriott. Our management agreements with Marriott require us to pay Marriott a base management fee between 2.31% and 3.0% of total revenue. These management agreements expire between 2014 and 2055, absent prior termination by either party. Additionally, five of these aforementioned management agreements require payment of an incentive fee of 20.0% of the excess of gross operating profit over a certain threshold; one management agreement requires payment of an incentive fee of 20% of the excess of gross operating profit over a certain threshold, however the total base and incentive fees are capped at 4.25% of gross revenues for 2012 and 2013, 4.5% of gross revenues for 2014, 4.75% of gross revenues for 2015, 5.0% of gross revenues for the first seven months of 2016, and 5.25% of gross revenues for the remaining term of the agreement; one management agreement requires payment of an incentive fee of 35.0% of the excess of gross operating profit over a certain threshold; one management agreement requires payment of an incentive fee equal to a fixed sum if gross operating profit is over a certain threshold for years 2012 and 2013 and thereafter

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20.0% of the excess of gross operating profit over a certain threshold; one management agreement requires payment of an incentive fee of 10.0% of adjusted gross operating profit, limited to 3.0% of gross revenue; and one management agreement does not require payment of an incentive fee. The management agreements with Marriott may be terminated earlier than the stated term if certain events occur, including the failure of Marriott to satisfy certain performance standards, a condemnation of, a casualty to, or force majeure event involving a hotel, the withdrawal or revocation of any license or permit required in connection with the operation of a hotel and upon a default by Marriott or us that is not cured prior to the expiration of any applicable cure periods. In certain instances, Marriott has rights of first refusal to either purchase or lease hotels, or to terminate the applicable management agreement in the event we sell the respective hotel.

IHR. Our management agreements with IHR require us to pay a management fee ranging from 2.0% to 2.1% of gross revenues; plus an incentive fee of 10.0% of the excess of net operating income over a threshold. The incentive fee, however, may not exceed a range of 1.5% to 1.9% of the total revenues for all the hotels managed by IHR for any fiscal year.

With the exception of the IHR management agreement at the Sheraton Cerritos (which agreement is subject to automatic two-year renewal terms, the first of which commenced in 2012), the IHR management agreements expire in 2024 and provide us the right to renew each management agreement for up to two additional terms of five years each, absent a prior termination by either party.

Highgate. Our Doubletree Guest Suites Times Square, Hilton Times Square and Renaissance Westchester hotels located in New York are operated under management agreements with Highgate, and require us to pay Highgate a base management fee of 3.0% of gross revenue. The management agreement at the Doubletree Guest Suites Times Square expires in 2037, absent a prior termination by either party. In addition, the management agreement at the Doubletree Guest Suites Times Square requires us to pay an incentive fee of 1.0% of annual gross receipts in the event that a certain return threshold is achieved. The management agreement at the Hilton Times Square expires in 2021 and provides Highgate with the right to renew for two additional terms of five years upon the achievement of certain performance thresholds, absent a prior termination by either party. In addition, the management agreement at the Hilton Times Square requires us to pay an incentive fee of 50.0% of the excess of net operating income over a certain threshold, limited to 1.25% of total revenue. The management agreement at the Renaissance Westchester expires in 2022, absent early termination by either party, and does not require payment of an incentive fee.

Davidson. Our Embassy Suites Chicago and Hyatt Chicago Magnificent Mile hotels located in Illinois are operated under management agreements with Davidson. The management agreement at the Embassy Suites Chicago expires in 2015, and provides us with the right to renew for up to two additional terms of five years each, absent a prior termination by either party. The agreement requires us to pay 2.0% of total revenue as a base management fee and calls for an incentive fee of 15.0% of the excess of net operating income over a certain threshold (capped at 1.0% of total revenue) and an additional incentive fee in the amount of 1.0% of total revenue upon achieving a certain level of net operating income (capped at 1.0% of total revenue). The base and incentive management fees payable to Davidson under the Embassy Suites Chicago management agreement have an aggregate cap of 4.0% of total revenue. The management agreement at the Hyatt Chicago Magnificent Mile expires in 2019, and provides us with the right to renew for up to two additional terms of five years each, absent a prior termination by either party. The agreement requires us to pay 2.5% of total revenue as a base management fee and calls for an incentive fee of 10.0% of the excess of net operating income over a certain threshold (capped at 1.5% of total revenue). The base and incentive management fees payable to Davidson under the Hyatt Chicago Magnificent Mile management agreement have an aggregate cap of 4.0% of total revenue. In addition to the base and incentive management fees, the Hyatt Chicago Magnificent Mile management agreement requires us to pay a development fee as consideration for Davidson s assistance with the conversion of the hotel from a Wyndham to a Hyatt. The development fee will equal the lesser of (1) 2.0% of the total development costs incurred by us to convert the hotel to a Hyatt, and (2) $0.5 million. We expect to make the last payment towards the development fee during the third quarter of 2013 once the conversion is complete.

Hilton. Our Embassy Suites La Jolla and Hilton San Diego Bayfront hotels located in California are operated under management agreements with Hilton. The management agreement at the Embassy Suites La Jolla expires in 2016 (absent early termination by either party), and provides no renewal options. The agreement requires us to pay a base management fee of 2.25% of gross revenue. The agreement includes an incentive fee of 15.0% of our net profit at the hotel in excess of certain net profit thresholds. The management agreement at the Hilton San Diego Bayfront expires in 2018 and provides Hilton with the right to renew for up to three additional terms of five years each, absent a prior termination by either party. The agreement requires us to pay a base fee of 2.5% of total revenues and an incentive fee of 15.0% of the excess of operating cash flow over a certain percentage.

Crestline. Our Hilton Garden Inn Chicago Downtown/Magnificent Mile hotel located in Illinois is operated under a management agreement with Crestline. The agreement expires in 2022 (absent early termination by either party), and provides us with the right to renew for up to two additional terms of five years each. The agreement requires us to pay 2.0% of gross revenue as a base management fee, and requires us to pay an incentive fee of 10.0% of the excess of operating profit over a certain threshold.

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Fairmont. Our Fairmont Newport Beach, California hotel is operated under a management agreement with Fairmont. The agreement expires in 2015 (absent early termination by either party) and provides Fairmont with two extension options, the first option having a term of 20 years and the second option having a term of 10 years. The agreement requires us to pay 3.0% of total revenue as a base management fee and calls for payment of incentive fees ranging from 20.0% to 30.0% of the hotel s net profit above certain net profit thresholds. The base and incentive management fees payable to Fairmont under the management agreement have an aggregate cap of 6.0% of total revenue. In addition, we entered into an agreement with Fairmont whereby Fairmont agreed to provide us with a limited performance guaranty up to $6.0 million to ensure, subject to certain limitations, a return on equity to us. Under the terms of this agreement, we received $3.5 million of the $6.0 million performance guaranty during 2008, and $2.5 million of the performance guaranty during 2009. As of December 31, 2009, we have fully utilized this $6.0 million performance guaranty.

Hyatt. Our Hyatt Regency Newport Beach, California hotel is operated under a management agreement with Hyatt. This agreement expires in 2019 and provides either party the right to renew for successive periods of 10 years (provided that the term of the agreement shall in no event extend beyond 2039), absent early termination by either party. The agreement requires us to pay 3.5% of total hotel revenue as a base management fee, with an additional 0.5% of total revenue payable to Hyatt based upon the hotel achieving specific operating thresholds. The agreement also requires us to pay an incentive fee equal to 10.0% of the excess of adjusted profit over $2.0 million, and 5.0% of the excess of adjusted profit over $6.0 million.

The existing management agreements with Marriott, Fairmont, Hilton and Hyatt require the manager to furnish chain services that are generally made available to other hotels managed by that operator. Costs for these chain services are reimbursed by us. Such services include: (1) the development and operation of computer systems and reservation services; (2) management and administrative services; (3) marketing and sales services; (4) human resources training services; and (5) such additional services as may from time to time be more efficiently performed on a national, regional or group level.

Franchise Agreements

As of December 31, 2012, 14 of the 26 hotels were operated subject to franchise agreements. Franchisors provide a variety of benefits to franchisees, including nationally recognized brands, centralized reservation systems, national advertising, marketing programs and publicity designed to increase brand awareness, training of personnel and maintenance of operational quality at hotels across the brand system.

The franchise agreements generally specify management, operational, record-keeping, accounting, reporting and marketing standards and procedures with which our subsidiary, as the franchisee, must comply. The franchise agreements obligate the subsidiary to comply with the franchisors standards and requirements with respect to training of operational personnel, safety, maintaining specified insurance, the types of services and products ancillary to guest room services that may be provided by the subsidiary, display of signage and the type, quality and age of furniture, fixtures and equipment included in guest rooms, lobbies and other common areas. The franchise agreements for our hotels require that we reserve up to 5.0% of the gross revenues of the hotels into a reserve fund for capital expenditures.

The franchise agreements also provide for termination at the franchisor s option upon the occurrence of certain events, including failure to pay royalties and fees or to perform other obligations under the franchise license, bankruptcy and abandonment of the franchise or a change in control. The subsidiary that is the franchisee is responsible for making all payments under the franchise agreements to the franchisors, however the Company guaranties certain obligations under a majority of the franchise agreements.

In June 2012, we purchased the Wyndham Chicago and immediately rebranded the hotel the Hyatt Chicago Magnificent Mile. As incentive to rebrand the hotel to a Hyatt, Hyatt Franchising, L.L.C. agreed to pay us $6.5 million once the conversion to Hyatt is complete, which is expected to occur during the third quarter of 2013. We will amortize the $6.5 million once received on a straightline basis over the remaining 25-years of our franchise agreement with Hyatt, which term ends in 2039.

Tax Status

We have elected to be taxed as a REIT under Sections 856 through 859 of the Code, commencing with our taxable year ended December 31, 2004. Under current federal income tax laws, we are required to distribute at least 90% of our net taxable income to our stockholders. While REITs enjoy certain tax benefits relative to C corporations, as a REIT we may, however, be subject to certain federal, state and local taxes on our income and property. We may also be subject to federal income and excise tax on our undistributed income.

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Taxable REIT Subsidiary

Subject to certain limitations, a REIT is permitted to own, directly or indirectly, up to 100% of the stock of a taxable REIT subsidiary, or TRS. The TRS may engage in businesses that are prohibited to a REIT. In particular, a hotel REIT is permitted to own a TRS that leases hotels from the REIT, rather than requiring the lessee to be an unaffiliated third party. However, a hotel leased to a TRS still must be managed by an unaffiliated third party in the business of managing hotels. The TRS provisions are complex and impose certain conditions on the use of TRSs. This is to assure that TRSs are subject to an appropriate level of federal corporate taxation.

A TRS is a fully taxable corporation that may earn income that would not be qualifying income if earned directly by us. A TRS may perform activities such as development, and other independent business activities. However, a TRS may not directly or indirectly operate or manage any hotels or provide rights to any brand name under which any hotel is operated.

We and the TRS Lessee must make a joint election with the IRS for the TRS Lessee to be treated as a TRS. A corporation of which a qualifying TRS owns, directly or indirectly, more than 35% of the voting power or value of the corporation s stock will automatically be treated as a TRS. Overall, no more than 25% of the value of our assets may consist of securities of one or more TRS, and no more than 25% of the value of our assets may consist of the securities of TRSs and other assets that are not qualifying assets for purposes of the 75% asset test. The 75% asset test generally requires that at least 75% of the value of our total assets be represented by real estate assets, cash, or government securities.

The rent that we receive from a TRS qualifies as rents from real property as long as the property is operated on behalf of the TRS by a person who qualifies as an independent contractor and who is, or is related to a person who is, actively engaged in the trade or business of operating qualified lodging facilities for any person unrelated to us and the TRS (an eligible independent contractor). A qualified lodging facility is a hotel, motel or other establishment in which more than one-half of the dwelling units are used on a transient basis. A qualified lodging facility does not include any facility where wagering activities are conducted. A qualified lodging facility includes customary amenities and facilities operated as part of, or associated with, the lodging facility as long as such amenities and facilities are customary for other properties of a comparable size and class owned by other unrelated owners.

We have formed the TRS Lessee as a wholly owned TRS. We lease each of our hotels to the TRS Lessee or one of its subsidiaries. These leases provide for a base rent plus variable rent based on occupied rooms and departmental revenues. These leases must contain economic terms which are similar to a lease between unrelated parties. If they do not, the IRS could impose a 100% excise tax on certain transactions between our TRS and us or our tenants that are not conducted on an arm s-length basis. We believe that all transactions between us and the TRS Lessee are conducted on an arm s-length basis. Further, the TRS rules limit the deductibility of interest paid or accrued by a TRS to us to assure that the TRS is subject to an appropriate level of corporate taxation.

The TRS Lessee has engaged eligible independent contractors to manage the hotels it leases from Sunstone Hotel Partnership, LLC.

Ground, Building and Air Lease Agreements

At December 31, 2012, 10 of the 26 hotels are subject to ground, building and/or air leases with unaffiliated parties that cover either all or portions of their respective properties. As of December 31, 2012, the remaining terms of these ground, building and air leases (including renewal options) range from approximately 31 to 114 years. These leases generally require us to make rental payments and payments for all or portions of costs and expenses, including real and personal property taxes, insurance and utilities associated with the leased property.

Any proposed sale of a property that is subject to a ground, building or air lease or any proposed assignment of our leasehold interest as ground, building or air lessee under the ground, building or air lease may require the consent of the applicable ground, building or air lessor. As a result, we may not be able to sell, assign, transfer or convey our ground, building or air lessee s interest in any such property in the future absent the consent of the ground, building or air lessor, even if such transaction may be in the best interests of our stockholders. Four of the 10 leases prohibit the sale or conveyance of the hotel and assignment of the lease by us to another party without first offering the lessor the opportunity to acquire our interest in the associated hotel and property upon the same terms and conditions as offered by us to the third party.

Four of the 10 leases allow us the option to acquire the ground or building lessor s interest in the ground or building lease subject to certain exercisability provisions. From time to time, we evaluate our options to purchase the ground lessors interests in the leases.

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Offices

We lease our headquarters located at 120 Vantis, Suite 350, Aliso Viejo, California 92656 from an unaffiliated third party. We occupy our headquarters under a lease that terminates on August 30, 2018.

Employees

At February 1, 2013, we had 74 employees, including 29 employees at BuyEfficient. We believe that our relations with our employees are positive. All persons employed in the day-to-day operations of the hotels are employees of the management companies engaged by the TRS Lessee or its subsidiaries to operate such hotels.

Environmental

Environmental reviews have been conducted on all of our hotels. Environmental consultants retained by our lenders have conducted Phase I environmental site assessments on many of our properties. In certain instances, these Phase I assessments relied on older environmental assessments prepared in connection with prior financings. Phase I assessments are designed to evaluate the potential for environmental contamination of properties based generally upon site inspections, facility personnel interviews, historical information and certain publicly available databases. Phase I assessments will not necessarily reveal the existence or extent of all environmental conditions, liabilities or compliance concerns at the properties. While some of these assessments have led to further investigation and sampling, none of the environmental assessments have revealed, nor are we aware of, any environmental liability (including asbestos-related liability) that we believe would harm our business, financial position, results of operations or cash flow.

Under various federal, state and local laws and regulations, an owner or operator of real estate may be liable for the costs of removal or remediation of certain hazardous or toxic substances on the property. These laws often impose such liability without regard to whether the owner knew of, or was responsible for, the presence of hazardous or toxic substances. Furthermore, a person that arranges for the disposal or transports for disposal or treatment of a hazardous substance at another property may be liable for the costs of removal or remediation of hazardous substances released into the environment at that property. The costs of remediation or removal of such substances may be substantial, and the presence of such substances, or the failure to promptly remediate such substances, may adversely affect the owner s ability to sell such real estate or to borrow using such real estate as collateral. In connection with the ownership and operation of our properties, we or the TRS Lessee, as the case may be, may be potentially liable for such costs.

As an owner of real estate, we are not directly involved in the operation of our properties or other activities that produce meaningful levels of greenhouse gas emissions. As a result, we have not implemented a formal program to measure or manage emissions associated with our corporate office or hotels. Although we do not believe that climate change represents a direct material risk to our business, we could be indirectly affected by climate change and other environmental issues to the extent these issues negatively affect the broader economy, result in increased regulation or costs, or have a negative impact on travel.

We have provided unsecured environmental indemnities to certain lenders. We have performed due diligence on the potential environmental risks including obtaining an independent environmental review from outside environmental consultants. These indemnities obligate us to reimburse the guaranteed parties for damages related to environmental matters. There is generally no term or damage limitation on these indemnities; however, if an environmental matter arises, we could have recourse against other previous owners. Although we have tried to mitigate environmental risk through insurance, this insurance may not cover all or any of the environmental risks we encounter.