



YOUR IDEAL DESTINATION

2006 ANNUAL REPORT

A TRAVEL GUIDE TO SUNSTONE HOTELS



WINNING BRANDS



MAJOR MARKETS



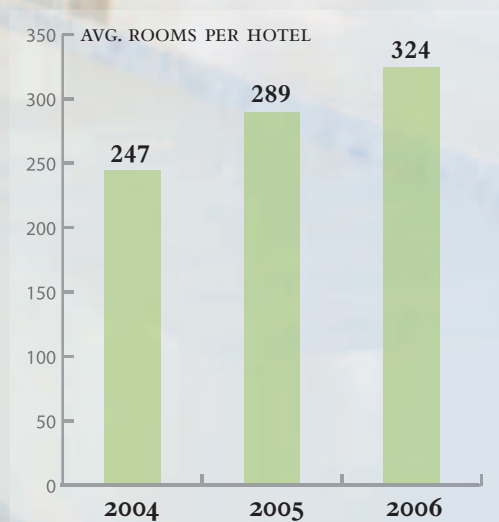
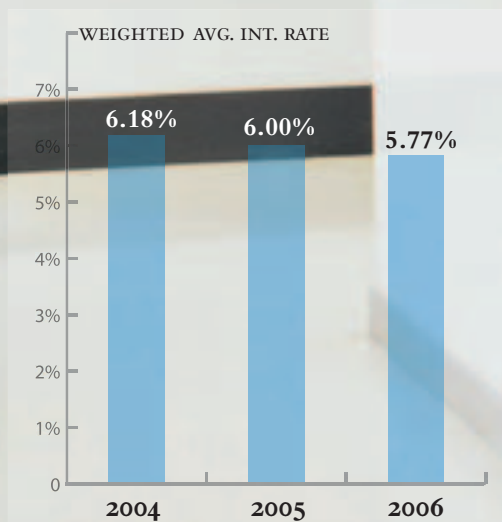
STYLISH RENOVATIONS



WORLD CLASS
MANAGEMENT

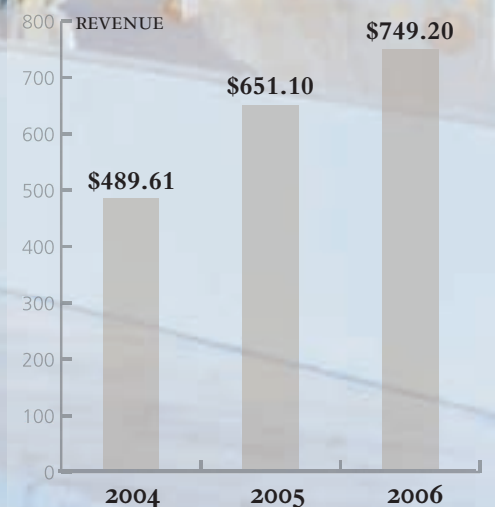
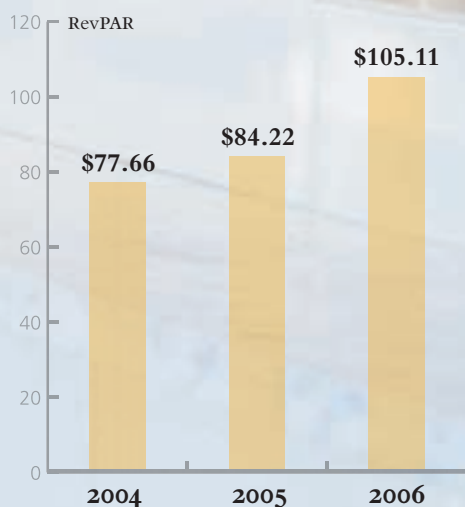


FROM SUNNY SOUTHERN CALIFORNIA TO THE HEART OF TIMES SQUARE, SUNSTONE TRULY IS THE IDEAL DESTINATION FOR EVERY INVESTOR. WITH ACCOMODATIONS LIKE THESE, WE'RE CERTAIN YOU WILL ENJOY YOUR STAY.



2006 HIGHLIGHTS

- ★ Comparable RevPAR growth of 8.7%
- ★ 13.7% FFO per share growth
- ★ 50.6% Adjusted EBITDA growth
- ★ 5 high quality acquisitions (including JV partnerships)
- ★ 15 non core assets sold
- ★ \$139.4 million spent on asset improvements










Sunstone's Renaissance Harborplace Hotel on Baltimore's historic Inner Harbor—your ideal homeport in the heart of "Charm City".

OVERVIEW OF SUNSTONE HOTELS

KEY TO ICONS

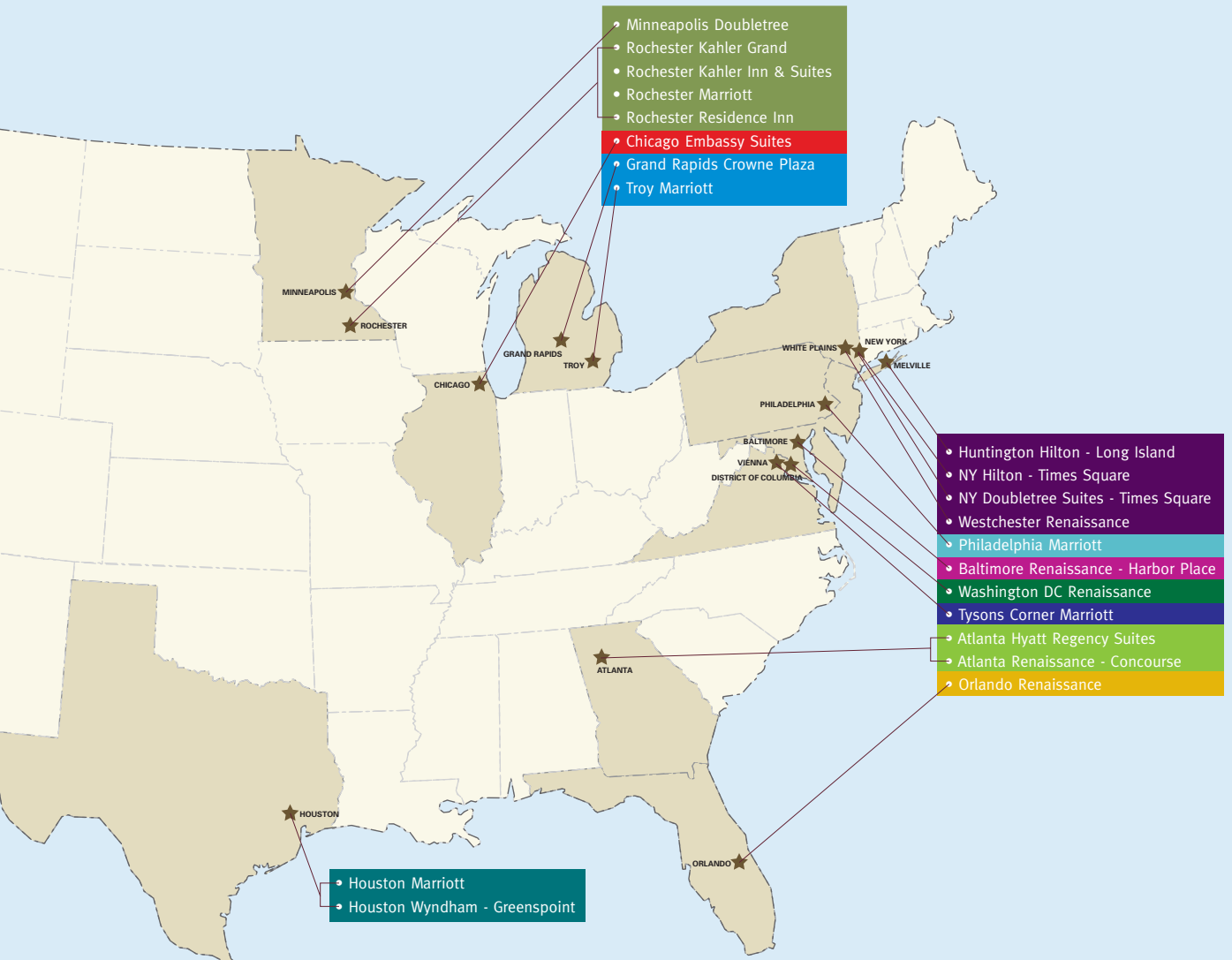
-  ROOM COUNT
-  ATTRACTIONS
-  MARKET REVPAR RATING
-  UNIQUE HISTORY
-  AAA RATING
-  HOTEL SERVICE AWARD
-  HOTEL FEATURES
-  ANNUAL EVENTS





Sunstone's Long Beach Renaissance amid a revived downtown—part of the greater renaissance that has swept this vibrant coastal community.

CALIFORNIA DC FLORIDA GEORGIA ILLINOIS MARYLAND MICHIGAN
MINNESOTA NEW YORK OREGON PENNSYLVANIA TEXAS UTAH VIRGINIA



FEATURE DESTINATIONS

IT'S THE SENSE OF ARRIVAL YOU EXPERIENCE UPON ENTERING THE LOBBY, THAT SUDDEN AWARENESS THAT THIS IS A HOTEL UNLIKE ANY OTHER. AND YET, THERE'S MORE HERE THAN MEETS THE EYE. YOU'LL FIND SOME OF THE BEST UPPER-UPSCALE HOTELS, IN SOME OF THE MOST EXCLUSIVE, HIGH-BARRIER MARKETS, GENERATING SOME OF THE HIGHEST AVERAGE DAILY RATES AND STRONGEST RevPAR PERFORMANCE IN THE BUSINESS.

SUNSTONE IS...YOUR IDEAL INVESTMENT DESTINATION.



The President's Sports Bar, a sophisticated spot to enjoy a drink or casual American grill cuisine.



Elegantly appointed guest rooms promise the perfect respite for either the business or pleasure traveler.



WASHINGTON, DC RENAISSANCE

999 Ninth Street NW Washington, DC 20001

★ ★ ★ ★ ★



807



White House
US Capitol
National Mall
Museums



Top 10



Meetings &
Convention
Magazine's
Gold Key
Award
Corporate
Incentive Travel
magazine's
Award of
Excellence



3 Diamonds

IN A CITY RICH IN AMERICAN HISTORY AND TEEMING WITH MUSEUM TREASURES, SUNSTONE'S CURRENT RENOVATION OF THE WASHINGTON DC RENAISSANCE HAS CREATED A LODGING DESTINATION THAT IS



historical in its own right. The Washington DC Renaissance was not the only local treasure to undergo restoration, the area surrounding the hotel has recently seen over \$6 billion in new construction. As a result, in the last three years, profits have doubled and the hotel has become one of the most successful properties in the Renaissance brand and Sunstone Portfolio.





NEWPORT BEACH FAIRMONT

4500 MacArthur Boulevard, Newport Beach, CA 92660



444



Top 10



Meetings & Convention Magazine's Gold Key Award
Corporate Incentive Travel magazine's Award of Excellence



Newport Harbor
Newport & Laguna Beaches
Balboa Island
So. Coast Plaza
Fashion Island
John Wayne Airport



Newport Beach Boat Parade
Taste of Newport



Sky Deck Pool
Fairmont Gold Lounge
Presidential Suites

NEWPORT BEACH... JUST THE NAME CONJURES IMAGES OF STUNNING WATERFRONT PROPERTIES, MAGNIFICENT YACHTS CRUISING ITS FAMED PLEASURE HARBOR, AND SOME OF SOUTHERN



California's most affluent, designer shopping destinations. The Newport Beach Fairmont... just its name conjures images of regal marbled entries, tony guests lounging around its heated sky pool, and some of Southern California's most elegant, most luxurious guest suites. The Newport Beach Fairmont is, in fact, the city's only luxury branded hotel—and having just completed an extensive makeover totalling more than \$30 million, it's certain to remain an unrivaled luxury for that corporate retreat, business meeting or just that leisurely getaway with family and friends.



Legendary Southern California style and hospitality are on display the moment you step inside the Fairmont's completely renovated lobby.





This standard guest room view of Baltimore's historic Inner Harbor is anything but standard.



BALTIMORE RENAISSANCE ~ HARBORPLACE

202 East Pratt Street, Baltimore, MD 21202

★ ★ ★ ★ ★



622



Baltimore Harbor
Camden Yards
National Aquarium



Top 10



Grand Opening
Gala, a benefit
for the Pride of
Baltimore II



Attached to
Baltimore's
Gallery Mall



The Preakness
Stakes
The Baltimore
Marathon
The Volvo
Ocean Race



4 Diamonds

IT'S BEEN NEARLY THREE DECADES SINCE THE PRIDE OF BALTIMORE—A CLASSIC 1812-ERA TOP-SAIL SCHOONER—WAS RE-LAUNCHED, HELPING



to revitalize Baltimore's famed Inner Harbor. The city's historic waterfront has become a model of urban rebirth with the Baltimore Renaissance Harborplace Hotel in the center of it all. From the National Aquarium and Oriole Park at Camden Yard to Fells Point Historic District and shopping at the upscale Gallery Mall, the Baltimore Renaissance Harborplace Hotel is your perfect homeport in the heart of Charm City. And with major renovations scheduled for completion in 2007, you'll be able to set sail in total comfort without ever leaving land.

W HOTEL SAN DIEGO

421 West B. Street, San Diego, CA 92101



Wow! No other exclamation so simply and succinctly says it all when it comes to the San Diego W!

Located in the Columbia District of downtown San Diego, adjacent the premier dining, shopping and entertainment of the historic Gaslamp Quarter, the San Diego W Hotel is an urban retreat in “America’s Finest City”. The greatest “wow factor” of any visit to San Diego can be experienced first hand at the San Diego W Hotel—from the incredible luxury of its 1,200 square-foot “Wow Suites” to their remarkable rooftop “Beach Bar”, an urban oasis where you can warm your soul beneath the starry sky while warming your soles on a floor of heated sand. Named one of the 100 sexiest hotels in the world for the 2nd consecutive year, there’s truly little more that can be said about this world-class hotel other than... wow.



259



Petco Park
Balboa Park
Gaslamp District
San Diego Zoo



Top 5



Part of the hotel is built within the historic “Old Columbia Square” building

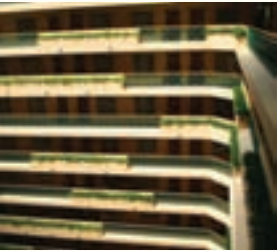


World’s 100 Sexiest Hotels
Condé Nast Gold List



Rooftop “Beach Bar”





A tropical oasis beneath a 12-story atrium, the hotel's lobby breathes new life into guests as they relax amid lush foliage and exotic flowers.



Newly renovated, spacious two-room suites are the standard for every guest at La Jolla's finest all-suite property.



LA JOLLA EMBASSY SUITES HOTEL

4550 La Jolla Village Drive, San Diego, CA 92122

★ ★ ★ ★ ★



335



Top 5



Successful Meetings magazine's Pinnacle Award Meetings & Convention Magazine's Gold Key Award Corporate Incentive Travel magazine's Award of Excellence



Scripps Institute of Oceanography
Steven Birch Aquarium & Museum
Salk Institute
UCSD



Buick Invitational at Torrey Pines Golf Course
Marine Corps "Top Gun" Annual Air Show



3 Diamonds



Historic Koi Pond
Helipad

CHRISTENED "LA JOLLA"—OR THE JEWEL—BY THE SPANIARDS, THIS EXCLUSIVE ENCLAVE ON THE SOUTHERN CALIFORNIA COAST IS HOME TO WORLD-CLASS BEACHES, WORLD-CLASS GOLF AT TORREY PINES (SITE OF THE 2008 U.S. OPEN) AND

the world-class Scripps Institute of Oceanography.

It's called the Golden Triangle and ideally situated within it all is the Embassy Suites Hotel. Here, the beauty and tranquility of the natural surroundings are reflected in the hotel's 12-story tropical atrium and spectacular koi pond. The \$10 million dollar renovation program scheduled for completion in 2007, reflects Sunstone's commitment to remake this all-suite luxury hotel into a gleaming jewel in its own right.



“IT IS NOT LOCATION, LOCATION, LOCATION.
IT IS MARKET, MARKET, MARKET.”

~ ROBERT ALTER, SUNSTONE CHIEF EXECUTIVE OFFICER.

ORLANDO RENAISSANCE

6677 Sea Harbor Drive, Orlando, CA 32821



778



Top 20



Successful Meetings magazine's Pinnacle Award
Meetings & Convention Magazine's Gold Key Award
Corporate Incentive Travel magazine's Award of Excellence



Seaworld Adventure Park
Walt Disney World Theme Parks
Discovery Cove
Epcot
Universal Studios



4 Diamonds

WHY SIMPLY VACATION AT SEAWORLD ORLANDO WHEN YOU CAN DIVE INTO A WORLD OF LUXURY AT THE ORLANDO RENAISSANCE RESORT AT SEAWORLD?



Here, beneath one of the world's largest atriums, you're not only steps away from SeaWorld but conveniently close to the rest of Orlando and central Florida's vacation destinations—including the Walt Disney World Theme Parks, Universal Studios and the Kennedy Space Center. Your stay here may well be the most thrilling adventure of your vacation.

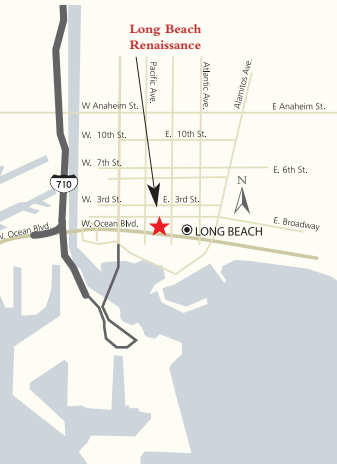


Mist, the Orlando Renaissance's latest hot spot, is set to descend upon the hotel this spring where sushi and martinis will be exquisitely served up amid the beauty of saltwater aquariums and the bar's eclectic modern design.





A chic, casual elegance permeates every one of the hotel's newly renovated guest rooms.



LONG BEACH RENAISSANCE

111 East Ocean Boulevard, Long Beach, CA 90802

★ ★ ★ ★ ★



374



Top 10



Toyota Grand Prix of Long Beach
Long Beach Marathon
Long Beach Jazz Festival



Queen Mary Aquarium of the Pacific
Long Beach Convention Center
The Pike Cruise Terminal



Scene Location for 1994 Meg Ryan & Andy Garcia Film, "When a Man Loves A Woman"

BETWEEN THE GLITZ AND GLAMOUR OF L.A. AND THE SUBURBAN CHIC OF THE O.C., LIES THE LONG BEACH RENAISSANCE. LONG BEACH HAS ENJOYED



quite a renaissance of its own—home to the Queen Mary and the Aquarium of the Pacific among other attractions. Meanwhile, located in the revitalized heart of the city, the Long Beach Renaissance is undergoing a transformation of its own. Now, next to taking the checkered flag at the

Toyota Grand Prix of Long Beach, a stay at the Long Beach Renaissance is your surest way to experience the winner's circle.





CENTURY PLAZA HYATT REGENCY

2025 Avenue of the Stars, Los Angeles, CA 90067



723



Top 10



Successful Meetings magazine's Pinnacle Award
Meetings & Convention Magazine's Gold Key Award
Corporate Incentive Travel magazine's Award of Excellence



Rodeo Drive & Beverly Hills
The Getty Museum
UCLA



Reagan's "Western White House"



L.A.'s only ground level, private entrance Regency Club Lounge



4 Diamonds



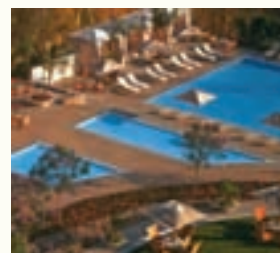
DGA Awards
Writer's Guild Awards
Women in Film

WITH MORE THAN \$23 MILLION SPENT ON RENOVATIONS IN 2006, THE CENTURY PLAZA HYATT REGENCY IS ONCE AGAIN SET TO STAR AS

the "World's Most Beautiful Hotel"—a title it initially earned upon its 1966 debut. Since that time, the gleaming 19-story landmark—built on the site of the 20th Century Fox movie ranch—has played host to every U.S. President from Lyndon Johnson to Bill Clinton.



Here, Nixon hosted a dinner in honor of the Apollo XI astronauts. During the Reagan years, the Century Plaza assumed the title role "Western White House." Now more than ever, this venerable star on L.A.'s Westside is the place to see and be seen.



Total escape from the hustle and bustle of L.A. can be found around the Century Plaza's beautiful pools.



Voted "Best gym in America" by *Fitness Magazine*, Equinox Fitness Clubs comes to the Century Plaza in 2007!



TO OUR SHAREHOLDERS



2006 proved to be another year of significant evolution for Sunstone Hotel Investors, Inc. Our mission is clear – to be a leading owner of high-quality hotels committed to maximizing shareholder value through disciplined acquisitions, selective dispositions, aggressive asset management, targeted capital investments and a balanced capital structure. We have successfully executed that mission.

PORTFOLIO MANAGEMENT – Throughout 2006, we refined the portfolio composition by acquiring five high-quality hotels with strong upside potential in top-performing markets and selling fifteen of our smaller, non-core hotels. Our five acquisitions totaled more than \$547 million and increased our presence within mid-town New York City and the greater San Diego market. Both the San Diego and New York markets produced great results in 2006 and are projected to generate strong growth in 2007 and beyond. We sold fifteen hotels in 2006 for proceeds of \$175 million. The sales reduced our exposure to slower-growth markets and locations with potential supply additions. Our forward focus will remain consistent, as evidenced by the acquisition of the 499 room Los Angeles International Airport Renaissance in January 2007.

AGGRESSIVE ASSET MANAGEMENT – Sunstone continually looks past conventional wisdom for creative approaches to raise the revenue bar at each one of our hotels. Under the leadership of Marc Hoffman, who joined us from Marriott International in the summer of 2006, we will continue to strengthen our asset management capabilities and drive incremental value from each of our hotels. Using the Century Plaza Hyatt Regency as an example, we renegotiated our workers compensation plan, sought a competitive energy contract, contracted with a third party to run the Equinox spa, and revamped our parking contract to provide the hotel with almost \$3.7 million per year in combined savings and added cash flow.

TARGETED CAPITAL INVESTMENTS – Our hotel renovation program was a top priority in 2006 and will continue to be in 2007. With more than \$139 million spent in 2006, the quality and design of the finished products have been first-rate, and I fully expect these renovations to generate significant returns for us in the coming years. The renovation highlights in 2006 include the completion of the Newport Beach Fairmont, Century Plaza Hyatt Regency and Tysons Corner Marriott. I am looking forward to completing the renovations of the Orlando, Baltimore and Long Beach Renaissance Hotels, the New York Hilton – Times Square, and La Jolla Embassy Suites in 2007.

BALANCED CAPITAL STRUCTURE – We have continued to follow a disciplined approach to our balance sheet. We finished the year with 100% of our debt fixed at an average interest rate of 5.8% and average term of approximately nine years. Our balance sheet will continue to provide us with the capacity and flexibility needed to facilitate the Company's long term growth objectives.

THE LODGING INDUSTRY – In 2006 the lodging industry was in the early stages of a broad-based recovery. In 2007 I believe the industry fundamentals remain strong, especially in many of the major metropolitan markets where we have an established presence. These markets will have limited supply additions over the



near term and continued strong demand growth. These factors combined will provide significant opportunities to drive earnings growth throughout 2007 and into 2008. Sunstone continues to focus on positioning our portfolio to capitalize on the opportunities afforded by these favorable industry fundamentals.

LOOKING FORWARD – Sunstone has experienced significant growth over the past two years – evolving into a prominent acquirer and owner of high-quality hotels. In continuing Sunstone’s evolution in 2007 and beyond, I am pleased to introduce to you my successor, Steven Goldman, as Chief Executive Officer. Steven joined Sunstone from Global Hyatt Corporation in March of this year. His proven leadership, experience and industry relationships will complement the established senior management team and lead Sunstone into its next stage of evolution.

I would like to personally thank our shareholders and other supporters. We continue to shape Sunstone Hotel Investors, Inc. to be “Your Ideal Destination”.

Sincerely,

Handwritten signature of Robert A. Alter

Robert A. Alter
Chief Executive Officer

FINANCIAL INFORMATION



Selected Financial Data	15
Management's Discussion and Analysis of Financial Condition and Results of Operations	16
Report of Independent Registered Public Accounting Firm	27
Consolidated Balance Sheets	28
Consolidated and Combined Statements of Operations	29
Consolidated and Combined Statements of Stockholders' and Members' Equity	30
Consolidated and Combined Statements of Cash Flows	33
Notes to Consolidated and Combined Financial Statements	34
Report of Independent Registered Public Accounting Firm	53
Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	54
Corporate Information	55

SELECTED FINANCIAL DATA

The following table sets forth selected financial information for the Company and its predecessor companies, or the Predecessor, that has been derived from the consolidated and combined financial statements and notes. This information should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated and combined financial statements and related notes included elsewhere in this Annual Report.

	The Company			The Predecessor		
	Year Ended December 31, 2006	Year Ended December 31, 2005	Period October 26 to December 31, 2004	Period January 1 to October 25, 2004	Year Ended December 31, 2003	Year Ended December 31, 2001
(\$ in thousands)						
OPERATING DATA:						
Revenues:						
Room	\$ 589,572	\$ 381,217	\$ 44,707	\$ 236,005	\$ 252,650	\$ 135,636
Food and beverage	234,337	152,968	19,754	80,432	93,462	36,097
Other operating	79,147	52,293	7,155	33,553	33,432	18,522
Management and other fees from affiliates	—	—	4	688	705	194
Total revenues	903,056	586,478	71,620	350,678	380,249	190,449
Operating expenses:						
Room	131,572	85,016	10,636	50,540	58,323	30,015
Food and beverage	167,116	107,191	13,367	55,255	65,575	26,156
Other operating	39,532	30,214	4,743	22,460	23,153	12,334
Advertising and promotion	51,103	37,650	4,564	20,653	23,586	11,218
Repairs and maintenance	36,784	24,597	3,339	14,318	16,890	7,672
Utilities	34,914	24,009	3,137	14,084	15,488	8,109
Franchise costs	33,930	21,776	3,108	16,947	17,977	9,753
Property tax, ground lease and insurance	55,366	31,168	4,022	18,473	23,972	9,307
Property general and administrative	102,882	66,014	8,885	28,881	30,175	12,508
Corporate overhead	19,046	14,490	7,176	23,214	25,187	19,599
Depreciation and amortization	96,285	64,612	9,329	40,751	44,336	26,038
Impairment loss	—	—	—	1,245	5,911	4,855
Total operating expenses	768,530	506,737	72,306	306,821	350,573	177,564
Operating income (loss)	134,526	79,741	(686)	43,857	29,676	12,885
Equity in earnings of unconsolidated joint venture	140	—	—	—	—	—
Interest and other income	4,208	3,079	154	560	785	2,080
Interest expense	(96,109)	(56,881)	(16,253)	(38,785)	(46,980)	(22,351)
Income (loss) before minority interest, income taxes, and discontinued operations	42,765	25,939	(16,785)	5,632	(16,519)	(7,386)
Minority interest	—	(1,761)	2,706	125	(17)	—
Income tax benefit	—	—	—	271	2,949	4,834
Income (loss) from continuing operations	42,765	24,178	(14,079)	6,028	(13,587)	(2,552)
Income (loss) from discontinued operations	10,472	6,027	(3,818)	(24,231)	(8,679)	(7,834)
Net income (loss)	53,237	30,205	\$ (17,897)	\$ (18,203)	\$ (22,266)	\$ (10,386)
Preferred stock dividends and accretion	(19,616)	(10,973)				
Income available to common stockholders	\$ 33,621	\$ 19,232				
Net income (loss) per common share	\$ 0.59	\$ 0.47	\$ (0.54)			
Cash flows provided by (used in)						
operating activities	\$ 163,104	\$ 113,403	\$ (236)	\$ 33,064	\$ 60,034	\$ 26,720
BALANCE SHEET DATA:						
Investment in hotel properties, net	\$ 2,477,514	\$ 2,054,001	\$ 1,127,272		\$ 1,227,537	\$ 1,316,659
Total assets	2,760,373	2,249,189	1,253,745		1,364,942	1,145,889
Total debt	1,499,828	1,181,178	712,461		917,652	942,423
Total liabilities	1,623,294	1,290,164	791,583		1,033,993	1,047,147
Equity	1,037,783	859,929	417,332		330,345	398,742
COMMON STOCK/MEMBERSHIP UNIT INFORMATION:						
Common stock outstanding	57,775	52,191	34,519			
Membership units outstanding	—	—	3,700			
Unvested restricted stock issuable ⁽¹⁾	409	298	293			
Total diluted common stock, membership units and unvested restricted stock units outstanding	58,184	52,489	38,512			

⁽¹⁾ Shares of common stock issuable related to unvested restricted stock units.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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, and Starwood.

OPERATIONS

Our financial data prior to October 26, 2004 is for our predecessor companies, or the Predecessor, who owned and operated the hotels during the periods presented. In conjunction with our initial public offering, we made substantial changes to our operations to effect certain formation and structuring transactions and to qualify and elect to be treated as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended, or the Code. As a result, our historical results of operations prior to October 26, 2004 are not indicative of our current or future results of operations.

Formation and structuring transactions and our initial public offering. As a result of our initial public offering and the related formation and structuring transactions, the following items affect the comparability of our results from and after October 26, 2004, and our results prior to that date:

- the payment of management fees to the Management Company which assumed responsibility for our hotel operations at the majority of our hotels pursuant to the management agreements with us;
- the reduction of corporate general and administrative costs as a result of the transfer of employees to the Management Company;
- the reflection of a minority interest to give effect to the interests in Sunstone Hotel Partnership owned by the predecessor companies (which subsequently were converted into shares of our common stock);
- the exclusion of two hotels that were not contributed to us;
- the reduction in interest expense as a result of the repayment of some of our notes payable;
- the reduction in ground lease expense reflecting the acquisition of the ground lessor's interest in the land under the Embassy Suites Hotel, Chicago, Illinois; and
- the incremental costs associated with operating as a public company.

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 Code, Sunstone Hotel Partnership and its subsidiaries have leased our hotel properties to 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 are from the performance of our hotels. The earnings of the TRS Lessee are subject to taxation like other C corporations, which reduce our operating results, funds from operations and the cash otherwise available for distribution to our stockholders.

FACTORS AFFECTING OUR RESULTS OF OPERATIONS

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;
- 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.; and
- Management and other fees from affiliates, which consists of other non-operating income and management and other fees from our affiliates prior to our initial public offering.

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

- occupancy;
- average daily rate, or ADR;
- revenue per available room, or RevPAR, which is the product of occupancy and ADR, but does not include food and beverage revenue, other operating revenue or management and other fees from affiliates.

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;
- 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 typically only result in increases in limited categories of 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 translate revenues into profits by limiting 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, or our Predecessor, acquired or developed from the beginning of 2004 through December 31, 2006, and indicates their room count and acquisition date:

Hotel	Rooms	Acquisition Date
2006		
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
2005		
Hyatt Regency Century Plaza, Los Angeles, California	728	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⁾
2004		
Residence Inn by Marriott, Rochester, Minnesota	80	June 18, 2004 ⁽³⁾
JW Marriott, Cherry Creek, Colorado(4)	196	April 28, 2004 ⁽³⁾
Total January 1, 2004 to December 31, 2006	6,299	

⁽¹⁾ Acquired 85% ownership interest.

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

⁽³⁾ Opening date of developed hotel.

⁽⁴⁾ Following our initial public offering, this hotel is not a part of our hotel portfolio.

The aggregate cost for these 15 hotel acquisitions was approximately \$1.5 billion, or \$244,000 per room.

Investment in unconsolidated joint venture. On December 28, 2006, we entered into a joint venture agreement with Whitehall Street Global Real Estate Limited Partnership 2005 and Highgate Holdings to acquire the 460-room Doubletree Guest Suites Hotel located in New York City for approximately \$68.5 million. Our \$68.5 million investment was funded entirely from cash on hand and is comprised of two parts: (i) a \$28.5 million mezzanine loan, which bears an interest rate of 8.5% on a face value of \$30.0 million and (ii) a \$40.0 million equity investment representing a 38% ownership interest in the joint venture.

Acquisition of hotels since December 31, 2006. On January 4, 2007, we acquired the 499-room LAX Renaissance hotel located in Los Angeles, California for approximately \$65.0 million, or approximately \$130,000 per room, and retained Marriott International as manager.

Sale of hotels. The following table sets forth the hotels that we, or our Predecessor, sold from the beginning of 2004 through December 31, 2006, and indicates their room count and sale date:

Hotel	Rooms	Sale Date
2006		
Holiday Inn, Rochester, Minnesota	170	December 21, 2006
Courtyard by Marriott, Fresno, California	116	September 13, 2006
Courtyard by Marriott, Lynnwood, Washington	164	September 13, 2006
Courtyard by Marriott, Santa Fe, New Mexico	213	September 13, 2006
Crowne Plaza, Englewood, New Jersey	194	September 13, 2006
Crowne Plaza, Williamsburg, Virginia	303	September 13, 2006
Hawthorn Suites, Kent, Washington	152	September 13, 2006
Holiday Inn, Boise, Idaho	265	September 13, 2006
Holiday Inn, Craig, Colorado	152	September 13, 2006
Holiday Inn, Price, Utah	151	September 13, 2006
Holiday Inn, Renton, Washington	226	September 13, 2006
Holiday Inn, San Diego (Stadium), California	175	September 13, 2006
Marriott, Ogden, Utah	292	September 13, 2006
Marriott, Pueblo, Colorado	164	September 13, 2006
Holiday Inn, Hollywood, California	160	March 15, 2006
2005		
Holiday Inn, Provo, Utah	78	December 22, 2005
Doubletree, Carson, California	224	April 14, 2005
Holiday Inn, Mesa, Arizona	246	April 14, 2005
2004		
San Marcos Resort, Chandler, Arizona	295	November 18, 2004
Holiday Inn, Flagstaff, Arizona	156	November 10, 2004
Concord Hotel and Conference Center, Concord, California	324	September 30, 2004
Four Points—Sheraton, Silverthorne, Colorado	160	August 27, 2004
Holiday Inn, Anchorage, Alaska	247	May 27, 2004
Holiday Inn, La Mirada, California	292	May 18, 2004
Hawthorn Suites, Anaheim, California	129	April 15, 2004
Total January 1, 2004 to December 31, 2006		5,048

The aggregate net sale proceeds for the 25 closed hotel dispositions through December 31, 2006 was \$252.1 million, or \$50,000 per room. The results of operations of all of the hotels identified above and the gains or losses on dispositions through December 31, 2006 are included in discontinued operations for all periods presented through the time of sale. The 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 (including that of our Predecessor) from the beginning of 2004 through December 31, 2006, adjusted for the hotels acquired and sold during the respective periods.

	2006	2005	2004
PORTFOLIO DATA—HOTELS			
Number of hotels—beginning of period	60	54	61
Add: Acquisitions	4	9	—
Add: Developments	—	—	2 ⁽¹⁾
Less: Sales	(15)	(3)	(7)
Less: Assets not included	—	—	(2) ⁽²⁾
Number of hotels—end of period	49	60	54
PORTFOLIO DATA—ROOMS			
Number of rooms—beginning of period	17,333	13,183	14,901
Add: Acquisitions	1,322	4,701	—
Add: Developments	—	—	276 ⁽¹⁾
Add: Room expansions	—	—	20
Less: Sales	(2,897)	(548)	(1,603)
Less: Rooms converted to other usage	—	(3)	—
Less: Assets not included	—	—	(411) ⁽²⁾
Number of rooms—end of period	15,758	17,333	13,183
Average rooms per hotel—end of period	322	289	244

⁽¹⁾ Reflects the opening of the Residence Inn by Marriott, Rochester, Minnesota and the acquisition of the JW Marriott, Cherry Creek, Colorado.

⁽²⁾ Reflects the exclusion of the JW Marriott, Cherry Creek, Colorado (196 rooms) and the Embassy Suites Hotel, Los Angeles, California (215 rooms) that were not contributed in connection with our initial public offering.

OPERATING RESULTS

The following table presents our operating results for 2006 and 2005, including the amount and percentage change in the results between the two periods. These period amounts can be found in our consolidated and combined financial statements and related notes included elsewhere in this Annual Report.

	2006	2005	Change \$	Change %
(dollars in thousands, except statistical data)				
REVENUES				
Room	\$ 589,572	\$ 381,217	\$ 208,355	54.7
Food and beverage	234,337	152,968	81,369	53.2
Other operating	79,147	52,293	26,854	51.4
Total revenues	903,056	586,478	316,578	54.0
OPERATING EXPENSES				
Hotel operating	550,317	361,621	188,696	52.2
Property general and administrative	102,882	66,014	36,868	55.8
Corporate overhead	19,046	14,490	4,556	31.4
Depreciation and amortization	96,285	64,612	31,673	49.0
Total operating expenses	768,530	506,737	261,793	51.7
OPERATING INCOME	134,526	79,741	54,785	68.7
Equity in earnings of unconsolidated joint venture	140	—	140	100.0
Interest and other income	4,208	3,079	1,129	36.7
Interest expense	(96,109)	(56,881)	(39,228)	(69.9)
INCOME BEFORE MINORITY INTEREST AND DISCONTINUED OPERATIONS	42,765	25,939	16,826	64.9
Minority interest	—	(1,761)	1,761	100.0
INCOME FROM CONTINUING OPERATIONS	42,765	24,178	18,587	76.9
Income from discontinued operations	10,472	6,027	4,445	73.8
NET INCOME	53,237	30,205	\$ 23,032	76.3
Preferred stock dividends and accretion	(19,616)	(10,973)		
INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$ 33,621	\$ 19,232		
OPERATING STATISTICS				
Occupancy ⁽¹⁾	74.4%	73.4%		
Average daily rate ⁽¹⁾	\$ 141.28	\$ 131.70	\$ 9.58	7.3%
RevPAR ⁽¹⁾	\$ 105.11	\$ 96.67	\$ 8.44	8.7%

⁽¹⁾ Operating statistics are based on 45 hotels that we owned as of December 31, 2006, and exclude four hotels undergoing rebranding and renovation programs (Hyatt Regency Century Plaza, Renaissance Orlando, Marriott Tysons Corner, and Embassy Suites La Jolla).

The following table presents our operating results for 2005 and 2004, including the amount and percentage change in the results between the two periods. The operating results for 2004 have been derived by combining the Predecessor results for the period of January 1, 2004 through October 25, 2004, and our results for the period October 26, 2004 through December 31, 2004. These period amounts can be found in our consolidated and combined financial statements and related notes included elsewhere in this Annual Report.

	2005	2004	Change \$	Change %
(dollars in thousands, except statistical data)				
REVENUES				
Room	\$ 381,217	\$ 280,712	\$ 100,505	35.8
Food and beverage	152,968	100,186	52,782	52.7
Other operating	52,293	40,708	11,585	28.5
Management and other fees from affiliates	—	692	(692)	(100.0)
Total revenues	586,478	422,298	164,180	38.9
OPERATING EXPENSES				
Hotel operating	361,621	259,646	101,975	39.3
Property general and administrative	66,014	37,766	28,248	74.8
Corporate overhead	14,490	30,390	(15,900)	(52.3)
Depreciation and amortization	64,612	50,080	14,532	29.0
Impairment loss	—	1,245	(1,245)	(100.0)
Total operating expenses	506,737	379,127	127,610	33.7
OPERATING INCOME				
Interest and other income	79,741	43,171	36,570	84.7
Interest expense	3,079	714	2,365	331.2
	(56,881)	(55,038)	(1,843)	(3.3)
INCOME (LOSS) BEFORE MINORITY INTEREST,				
INCOME TAXES AND DISCONTINUED OPERATIONS				
Minority interest	25,939	(11,153)	37,092	332.6
Income tax benefit	(1,761)	2,831	(4,592)	(162.2)
	—	271	(271)	(100.0)
INCOME (LOSS) FROM CONTINUING OPERATIONS				
Income (loss) from discontinued operations	24,178	(8,051)	32,229	400.3
	6,027	(28,049)	34,076	121.5
NET INCOME (LOSS)				
Preferred stock dividends and accretion	30,205	\$ (36,100)	\$ 66,305	183.7
	(10,973)			
INCOME AVAILABLE TO COMMON STOCKHOLDERS				
	\$ 19,232			
OPERATING STATISTICS				
Occupancy ⁽¹⁾	73.4%	72.0%		
Average daily rate ⁽¹⁾	\$ 131.70	\$ 103.99	\$ 27.71	26.6%
RevPAR ⁽¹⁾	\$ 96.67	\$ 74.87	\$ 21.80	29.1%

⁽¹⁾ Operating statistics are based on 45 hotels that we owned as of December 31, 2006, and exclude 4 hotels undergoing rebranding and renovation programs (Hyatt Regency Century Plaza, Renaissance Orlando, Marriott Tysons Corner, and Embassy Suites La Jolla). 2004 amounts do not include prior ownership data.

Room revenue. Room revenue increased \$208.4 million, or 54.7%, for the year ended December 31, 2006 as compared to the year ended December 31, 2005. We have acquired 13 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 \$184.4 million to room revenue during 2006. In addition, growth in the hotels we acquired prior to December 31, 2004 (which we refer to as our “existing portfolio”) contributed \$24.0 million to room revenue during 2006 due to increases in both occupancy (\$2.7 million) and ADR (\$21.3 million).

Room revenue increased \$100.5 million, or 35.8% for the year ended December 31, 2005 as compared to the year ended December 31, 2004. We acquired ten hotels during the period from January 1, 2004 to January 1, 2006: Rochester Residence Inn, Renaissance Orlando, Renaissance Harborplace, Renaissance Concourse, Renaissance Long Beach, Renaissance Westchester, Renaissance Washington D.C., Sheraton Hotel Cerritos, Fairmont Newport Beach, and Hyatt Regency Century Plaza (which we refer to as the “ten hotels”). The ten hotels contributed \$84.7 million to room revenue during 2005. In addition, growth in our existing portfolio contributed \$26.5 million to room revenue during 2005 due to increases in both occupancy (\$2.4 million) and ADR (\$24.1 million). These increases were partially offset by \$10.7 million in room revenue related to properties that were included in our 2004 results of operations but were not contributed to us by our Predecessor.

Food and beverage revenue. Food and beverage revenue increased \$81.4 million, or 53.2%, for the year ended December 31, 2006 as compared to the year ended December 31, 2005. The thirteen hotels contributed \$77.9 million to food and beverage revenue during 2006. Food and beverage revenue generated from our existing portfolio increased \$3.5 million during 2006 as compared to 2005.

Food and beverage revenue increased \$52.8 million, or 52.7%, for the year ended December 31, 2005 as compared to the year ended December 31, 2004. The ten hotels contributed \$50.9 million to food and beverage revenue during 2005. Food and beverage revenue generated from our existing portfolio increased \$4.3 million during 2005 as compared with 2004. These increases were partially offset by \$2.4 million from properties that were included in our 2004 results of operations but were not contributed to us by our Predecessor.

Other operating revenue. Other operating revenue increased \$26.9 million, or 51.4%, for the year ended December 31, 2006 as compared to the year ended December 31, 2005. The thirteen hotels contributed \$25.2 million to other operating revenue during 2006. In addition, other operating revenue generated from our existing portfolio contributed \$1.6 million during 2006 as compared to 2005. A substantial portion of our other operating revenue in 2006 resulted from a performance guarantee provided by the manager of the Hyatt Regency Century Plaza. We used a total of \$17.4 million of the \$27.0 million performance guarantee during 2006 and \$6.8 million during 2005 for a total of \$24.2 million cumulatively. We expect to fully utilize the remaining amount of this guarantee in 2007, which will result in lower other operating revenues in future periods as compared to 2006 and 2005. The increases in other operating revenues from our existing portfolio during 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. and by one of our laundry facilities.

Other operating revenue increased \$11.6 million, or 28.5%, for the year ended December 31, 2005 as compared to the year ended December 31, 2004. The ten hotels contributed \$12.4 million to other operating revenue during 2005. This increase was partially offset by a decrease of \$0.8 million from properties that were included in our 2004 results of operations but were not contributed to us by our Predecessor. Other operating revenue generated from our existing portfolio remained relatively constant in 2005 as compared to 2004.

Management and other fees from affiliates. No management and other fees from affiliates were generated during either the year ended December 31, 2006 or the year ended December 31, 2005. Management and other fees from affiliates in 2004 relate to the Doubletree, Nashville, Tennessee and Residence Inn by Marriott, Beverly Hills, California, which are properties owned by affiliates. Following our initial public offering, we no longer provide any services for, or receive any management or other fees from, these hotels.

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 \$188.7 million, or 52.2%, for the year ended December 31, 2006 as compared to the year ended December 31, 2005. The thirteen hotels contributed \$176.3 million to hotel operating expenses during 2006. In addition, hotel operating expense in our existing portfolio increased \$12.4 million during 2006 as compared to 2005. These higher costs in our existing portfolio during 2006 were primarily the 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, property and liability insurance due to higher insurance premiums, and property tax due to higher tax rates as well as supplemental tax bills assessed on several of our hotels.

Hotel operating expenses increased \$102.0, or 39.3%, during the year ended December 31, 2005 as compared to the year ended December 31, 2004. The ten hotels contributed \$97.1 million in other operating expenses during 2005. In addition, hotel operating expenses in our existing hotel portfolio increased \$13.8 million during 2005 as compared with 2004 primarily as a result of increases in room expenses, food and beverage expenses, advertising and promotion, and franchise costs. These increases were partially offset by \$8.9 million in hotel operating expenses from properties that were included in our 2004 results of operations but were not contributed to us by our Predecessor, as well as ground lease expense incurred in 2004 but which ground lease was purchased as a part of our formation and structuring transactions in connection with our initial public offering.

Property general and administrative expense. Property general and administrative expense increased \$36.9 million, or 55.8%, for the year ended December 31, 2006 as compared to the year ended December 31, 2005. The thirteen hotels contributed \$31.9 million to property general and administrative expense. In addition, property general and administrative expense in our existing portfolio increased \$5.0 million due to increases in management fees payable to our management companies, and other hotel specific expenses, such as increased credit card commissions, associated with the overall increase in revenue.

Property general and administrative expense increased \$28.2 million, or 74.8%, for the year ended December 31, 2005 as compared to the year ended December 31, 2004. The ten hotels contributed \$18.6 million to property general and administrative expense during 2005. The remaining increase was due to \$9.6 million in management and accounting fees payable to the Management Company that were not payable in 2004 prior to our initial public offering, other hotel specific expenses, such as increased credit card commissions and franchise fees associated with the overall increase in revenue, partially offset by properties that were included in our 2004 results of operations but were not contributed to us by our Predecessor.

Corporate overhead expense. Corporate overhead expense increased \$4.6 million, or 31.4%, during the year ended December 31, 2006 as compared to the year ended December 31, 2005, primarily as a result of increases in payroll and related expenses, including deferred stock compensation expense.

Corporate overhead expense decreased \$15.9 million, or 52.3%, during the year ended December 31, 2005 as compared to the year ended December 31, 2004, primarily as a result of the decrease in salaries and wages attributable to the transfer of certain employees to the Management Company, partially offset by the increased costs of being a public company.

Depreciation and amortization expense. Depreciation and amortization expense increased \$31.7 million, or 49.0% during the year ended December 31, 2006 as compared to the year ended December 31, 2005. The thirteen hotels contributed \$30.9 million in depreciation and amortization expense during 2006. Depreciation and amortization expense in our existing portfolio increased by \$0.8 million.

Depreciation and amortization increased \$14.5 million, or 29.0%, during the year ended December 31, 2005 as compared to the year ended December 31, 2004. The ten hotels contributed \$15.0 million, slightly offset by properties that were included in our 2004 results of operations but were not contributed to us by the predecessor companies.

Interest expense. Interest expense increased \$39.2 million, or 69.9%, during the year ended December 31, 2006 as compared to the year ended December 31, 2005. This increase was primarily due to greater outstanding loan balances in 2006 compared with 2005, as we obtained additional loans to finance our acquisitions. As a result of new loans and refinancing activities, interest expense includes an additional \$30.8 million in interest incurred during the year ended December 31, 2006 compared to the year ended December 31, 2005. In addition, we incurred increased amortization of deferred financing fees of \$1.2 million during 2006 as compared to 2005. In connection with our refinancing of three hotel properties during 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 2006 as compared to 2005.

Interest expense increased \$1.8 million, or 3.3% during the year ended December 31, 2005 as compared to the year ended December 31, 2004. We incurred an additional \$8.7 million in interest expense during 2005 as compared with 2004 due to greater outstanding loan balances in 2005 as compared with 2004, as we obtained additional loans to finance our acquisitions. This was offset by a decrease in deferred financing fees amortization of \$4.0 million, a decrease in prepayment penalties of \$2.4 million, and a decrease in loss on interest rate capitalization agreements of \$0.5 million in 2005 as compared with 2004.

Our total notes payable, including the current portion, was \$1,499.8 million at December 31, 2006 and \$1,181.2 million at December 31, 2005, with a weighted average interest rate per annum of approximately 5.8% at December 31, 2006 and 5.9% at December 31, 2005. At December 31, 2006, the interest rates for all of our outstanding notes payable were fixed.

Income tax benefit. As limited liability companies, the predecessor companies were pass-through entities and not liable for Federal and certain state income taxes, which were the responsibility of their respective members. However, subsidiaries of some of our predecessor companies were corporations that were liable for taxes on their earnings. We maintain a taxable REIT subsidiary which is liable for taxes on its earnings. The change in the tax benefit is attributable to the historical tax benefit for our predecessor companies being eliminated.

Income (loss) from discontinued operations. Income (loss) from discontinued operations totaled income of \$10.5 million for the year ended December 31, 2006, income of \$6.0 million for the year ended December 31, 2005, and a loss of \$28.0 million for the year ended December 31, 2004. As described under “—Acquisition, Sale and Major Redevelopment Activity—Sale of Hotels,” we sold fifteen hotels in 2006, three hotels in 2005, and seven hotels in 2004. 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 hotels as discontinued operations.

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, contributions by the Predecessor, 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, distributions to the Predecessor, repayment of notes payable and dividends on our common and preferred stock.

Operating activities. Net cash provided by operating activities was \$163.1 million for 2006 compared to \$113.4 million for 2005, and \$32.8 million in 2004. This increase was primarily due additional cash generated from our acquired properties and increased cash flow generated by our existing portfolio.

Investing activities. Our cash used in investing activities fluctuates primarily based on acquisitions, sales and renovation of hotels. Net cash used in investing activities was \$500.7 million in the year ended December 31, 2006 compared to net cash used of

\$974.3 million in the year ended December 31, 2005, and net cash used of \$37.0 million in the year ended December 31, 2004. During 2006, we acquired four hotels for \$522.2 million, including the assumption of \$81.0 million in debt and a \$6.5 million deposit paid at the end of 2005, acquired an office building and land adjacent to one of our hotels for \$4.4 million, incurred additional costs of \$0.8 million related to our 2005 acquisitions, and paid an \$8.5 million deposit for a hotel purchased in January 2007, for a total cash outlay of \$448.4 million. In addition, in 2006, we paid cash of \$68.6 million to acquire a 38% ownership interest in a joint venture to acquire an additional hotel, \$139.4 million for renovations to our hotels, increased the balance on our restricted cash replacement reserve accounts by \$2.1 million, and received net proceeds of \$157.7 million from the sale of fifteen hotels combined with the collection of additional proceeds from a hotel we sold in 2004.

During 2005, we acquired nine hotels for \$963.9 million, including the assumption of \$63.1 million in debt and paid \$6.5 million in other deposits to be applied to 2006 acquisitions, for a total of \$907.3 million. In addition, we invested \$71.6 million of capital expenditures in our hotels, increased the balance on our restricted cash replacement reserve accounts by \$26.8 million, and we received net proceeds of \$31.4 million from the sale of three hotels and a vacant land parcel.

During 2004, we developed and acquired two hotels for \$38.8 million, decreased the balance on our restricted cash replacement reserve accounts by \$8.7 million and invested \$65.3 million of capital expenditures in our hotels. Additionally, we received net proceeds of \$58.4 million from the sale of seven hotels.

Financing activities. Net cash provided by financing activities was \$349.1 million for the year ended December 31, 2006 compared to net cash provided of \$872.4 million for the year ended December 31, 2005, and net cash used of \$15.8 million for the year ended December 31, 2004. Net cash provided by financing activities in 2006 consisted primarily of proceeds from notes payable of \$440.5 million, and net proceeds from our preferred and common stock offerings of \$54.1 million and \$157.7 million, respectively, partially offset by \$202.9 million of principal payments on notes payable and \$10.0 million related to the cost associated with the defeasance of debt we refinanced, \$86.7 million of dividends, and \$3.7 million in deferred financing costs.

Net cash provided by financing activities in 2005 consisted primarily of net proceeds from our preferred securities and primary common stock offerings of \$216.3 million and \$312.2 million, respectively, and proceeds from notes payable of \$701.2 million, partially offset by \$56.8 million of dividends and distributions to our stockholders and holders of membership units in the Operating Partnership (all of which were converted to common stock in the fourth quarter of 2005), \$295.6 million of principal payments on notes payable and \$4.8 million in deferred financing costs.

Net cash used in financing activities in 2004 consisted primarily of \$9.4 million of distributions to the Predecessor, \$246.5 million to purchase membership units from the Predecessors' members and minority interest, \$620.2 million of principal payments on notes payable, \$6.5 million in payments of loan financing costs, partly offset by the proceeds from notes payable of \$457.3 million, contributions from the Predecessor of \$25.3 million and proceeds from our initial public offering, including the exercise of the over-allotment options of \$384.1 million, net of related 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, sale of hotel properties, and proceeds from our forward stock sale agreement and 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 13 to our consolidated financial statements, 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 December 31, 2006, our revolving credit facility had no amounts outstanding, and had \$11.6 million backing outstanding irrevocable letters of credit, leaving \$188.4 million available at December 31, 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 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 December 31, 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 December 31, 2006 (in thousands):

Contractual obligations (in thousands)	Payment due by period				
	Total	Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years
Notes payable	\$ 1,499,828	\$ 23,231	\$ 33,568	\$ 353,056	\$ 1,089,973
Interest obligations on notes payable	694,921	87,087	170,163	152,649	285,022
Operating lease obligations	319,336	4,849	9,860	8,840	295,787
Construction commitments	26,212	26,212	—	—	—
Employment obligations	2,613	1,231	1,382	—	—
Total	\$ 2,542,910	\$ 142,610	\$ 214,973	\$ 514,545	\$ 1,670,782

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 primarily relate to the ongoing maintenance of our hotels and are budgeted in the reserve accounts described in the following paragraph. We also incur capital expenditures following the acquisition of hotels for renovation and development. We spent \$139.4 million during 2006 for renovations to our hotels. For 2007, our renovation budget includes \$26.2 million of contractual construction commitments. Our capital expenditures for the twelve months following December 31, 2006 are expected to be approximately \$120.0 million to \$130.0 million. All of these amounts are expected to be funded out of our operating cash flow and 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 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 December 31, 2006, \$36.6 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

Our off-balance sheet arrangements consist of our ownership interest in a joint venture. For further discussion of this joint venture and its effect on our financial condition, results of operations and cash flows, see Note 6 to the Consolidated Financial Statements.

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. Quarterly revenue also may be adversely affected by events beyond our control, such as extreme weather conditions, terrorist attacks or alerts, SARS, airline strikes, 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	\$ 101,298	\$ 113,316	\$ 161,060	\$ 210,804
2006	\$ 197,564	\$ 230,407	\$ 226,094	\$ 248,991

INFLATION

Inflation may affect our expenses, including, without limitation, by increasing such costs as 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 and combined financial statements, which have been prepared in accordance with GAAP. 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, 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 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.

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, and currently cannot estimate the impact to our financial statements.

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, and currently cannot estimate the impact to our financial statements.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

To the extent that we incur debt with variable interest rates, 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 December 31, 2006 none of our outstanding debt is subject to variable interest rates.

CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

Based upon an evaluation of the effectiveness of disclosure controls and procedures, Sunstone Hotel Investors, Inc.'s Chief Executive Officer (CEO) and Chief Financial Officer (CFO) have concluded that as of the end of the period covered by our Annual Report on Form 10-K 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.

(b) Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act), to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Due to its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate due to changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including our CEO and CFO, we conducted an evaluation of the effectiveness of our internal control over financial reporting using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control—Integrated Framework. Based on its evaluation, our management concluded that our internal control over financial reporting was effective as of December 31, 2006.

Ernst & Young LLP, an independent registered public accounting firm, has audited the Consolidated and Combined Financial Statements included in this Annual Report and, as part of its audit, has issued its reports, included herein, on (1) our management's assessment of the effectiveness of our internal control over financial reporting and (2) the effectiveness of our internal control over financial reporting.

(c) Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND STOCKHOLDERS

SUNSTONE HOTEL INVESTORS, INC.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Sunstone Hotel Investors, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Sunstone Hotel Investors, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Sunstone Hotel Investors, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Sunstone Hotel Investors, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Sunstone Hotel Investors, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders' equity, and cash flows for the years ended December 31, 2006 and 2005, and for the period from October 26, 2004 (commencement of operations) through December 31, 2004, the related combined statements of operations, members' equity, and cash flow of the Sunstone Predecessor Company for the period January 1, 2004 through October 25, 2004 of Sunstone Hotel Investors, Inc. and our report dated February 6, 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP
Irvine, California
February 6, 2007

CONSOLIDATED BALANCE SHEETS

	December 31, 2006	December 31, 2005
(In thousands)		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 29,029	\$ 17,538
Restricted cash	65,669	54,305
Accounts receivable, net	41,695	42,879
Due from affiliates	1,383	1,994
Inventories	3,089	2,814
Prepaid expenses	7,006	4,187
Current assets of discontinued operations	—	359
Total current assets	147,871	124,076
Investment in hotel properties, net	2,477,514	2,054,001
Investment in hotel properties held for sale, net	—	9,111
Other real estate, net	14,673	7,545
Investment in unconsolidated joint venture	68,714	—
Deferred financing costs, net	7,381	8,299
Goodwill	22,249	27,169
Other assets, net	21,971	18,780
Other assets of discontinued operations, net	—	208
Total assets	\$ 2,760,373	\$ 2,249,189
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$ 31,912	\$ 22,293
Accrued payroll and employee benefits	12,338	8,960
Due to Management Company	16,607	19,404
Dividends payable	23,826	19,831
Other current liabilities	32,354	29,414
Current portion of notes payable	23,231	4,387
Current liabilities of discontinued operations	—	302
Total current liabilities	140,268	104,591
Notes payable, less current portion	1,476,597	1,176,791
Other liabilities	6,429	8,782
Total liabilities	1,623,294	1,290,164
Commitments and contingencies (Note 15)	—	—
Preferred stock, Series C Cumulative Convertible Redeemable		
Preferred Stock, \$0.01 par value, 4,102,564 shares authorized, issued and outstanding at December 31, 2006 and 2005, liquidation preference of \$24.375 per share	99,296	99,096
Stockholders' equity		
Preferred stock, \$0.01 par value, 100,000,000 shares authorized.		
8.0% Series A Cumulative Redeemable Preferred Stock, 7,050,000 shares issued and outstanding at December 31, 2006 and 4,850,000 shares 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, 57,775,089 shares issued and outstanding at December 31, 2006 and 52,190,649 shares issued and outstanding at December 31, 2005	578	522
Additional paid in capital	958,887	798,400
Retained earnings	65,545	12,308
Cumulative dividends	(163,477)	(72,551)
Total stockholders' equity	1,037,783	859,929
Total liabilities and stockholders' equity	\$ 2,760,373	\$ 2,249,189

See accompanying notes to consolidated and combined financial statements.

CONSOLIDATED AND COMBINED STATEMENTS OF OPERATIONS

	The Company			The Predecessor
	Year Ended December 31, 2006	Year Ended December 31, 2005	Period October 26, 2004 through December 31, 2004	Period January 1, 2004 through October 25, 2004
(In thousands, except per share data)				
REVENUES				
Room	\$ 589,572	\$ 381,217	\$ 44,707	\$ 236,005
Food and beverage	234,337	152,968	19,754	80,432
Other operating	79,147	52,293	7,155	33,553
Management and other fees from affiliates	—	—	4	688
Total revenues	903,056	586,478	71,620	350,678
OPERATING EXPENSES				
Room	131,572	85,016	10,636	50,540
Food and beverage	167,116	107,191	13,367	55,255
Other operating	39,532	30,214	4,743	22,460
Advertising and promotion	51,103	37,650	4,564	20,653
Repairs and maintenance	36,784	24,597	3,339	14,318
Utilities	34,914	24,009	3,137	14,084
Franchise costs	33,930	21,776	3,108	16,947
Property tax, ground lease, and insurance	55,366	31,168	4,022	18,473
Property general and administrative	102,882	66,014	8,885	28,881
Corporate overhead	19,046	14,490	7,176	23,214
Depreciation and amortization	96,285	64,612	9,329	40,751
Impairment loss	—	—	—	1,245
Total operating expenses	768,530	506,737	72,306	306,821
Operating income (loss)	134,526	79,741	(686)	43,857
Equity in earnings of unconsolidated joint venture	140	—	—	—
Interest and other income	4,208	3,079	154	560
Interest expense	(96,109)	(56,881)	(16,253)	(38,785)
Income (loss) before minority interest, income taxes and discontinued operations	42,765	25,939	(16,785)	5,632
Minority interest	—	(1,761)	2,706	125
Income tax benefit	—	—	—	271
Income (loss) from continuing operations	42,765	24,178	(14,079)	6,028
Income (loss) from discontinued operations	10,472	6,027	(3,818)	(24,231)
NET INCOME (LOSS)	53,237	30,205	\$ (17,897)	\$ (18,203)
Preferred stock dividends and accretion	(19,616)	(10,973)		
INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$ 33,621	\$ 19,232		
Basic per share amounts:				
Income (loss) from continuing operations	\$ 0.40	\$ 0.32	\$ (0.42)	
Income (loss) from discontinued operations	0.19	0.15	(0.12)	
Net income (loss) per common share	\$ 0.59	\$ 0.47	\$ (0.54)	
Diluted per share amounts:				
Income (loss) from continuing operations	\$ 0.40	\$ 0.32	\$ (0.42)	
Income (loss) from discontinued operations	0.18	0.15	(0.12)	
Net income (loss) per common share	\$ 0.58	\$ 0.47	\$ (0.54)	
Weighted average common shares outstanding:				
Basic	57,247	40,655	33,196	
Diluted	57,691	40,959	33,196	
Dividends paid per common share	\$ 1.22	\$ 1.155	\$ 0.285	

See accompanying notes to consolidated and combined financial statements.

CONSOLIDATED AND COMBINED STATEMENTS OF STOCKHOLDERS' AND MEMBERS' EQUITY

	Preferred Stock		Common Stock		Additional Paid in Capital	Retained Earnings (Deficit)	Cumulative Dividends	Accumulated Other Comprehensive Loss	Members' Equity	Total
	Number of Shares	Amount	Number of Shares	Amount						
(In thousands, except per share data)										
THE PREDECESSOR										
Balance at December 31, 2003								\$ (1,742)	\$ 332,087	\$ 330,345
Contributions									25,322	25,322
Distributions									(9,350)	(9,350)
Net loss									(18,203)	(18,203)
Comprehensive loss										
(18,203)										
Balance at October 25, 2004										
THE COMPANY										
Adjustments for formation and structuring transactions (Note 13)								(1,742)	329,856	328,114
Reclassify Predecessor members' equity	9,990,932	\$ 354,760							26,646	26,646
Net proceeds from sale of common stock	24,459,737	\$ 344			383,733			1,742	(356,502)	—
Record the acquisition of membership units in the Sunstone Hotel Operating Partnership from the Predecessor's members										384,077
Record minority interests for Predecessor members' continuing interests					(195,921)					(195,921)
Issuance of unvested restricted common stock					(99,167)					(99,167)
Vesting of restricted common stock	67,947	1			1,441					1,442

CONSOLIDATED AND COMBINED STATEMENTS OF STOCKHOLDERS' AND MEMBERS' EQUITY

	Preferred Stock		Common Stock		Additional Paid in Capital	Retained Earnings (Deficit)	Cumulative Dividends	Accumulated Other Comprehensive Loss	Members' Equity	Total
	Number of Shares	Amount	Number of Shares	Amount						
(In thousands, except per share data)										
Dividends declared and payable at \$0.285 per share						\$ (17,897)	\$ (9,962)			(9,962)
Net loss										(17,897)
Balance at December 31, 2004			34,518,616	345	444,846	(17,897)	(9,962)	—	—	417,332
Net proceeds from sale of Series A preferred stock	4,850,000	\$ 121,250			(3,799)					117,451
Offering costs from sale of Series C preferred stock					(130)					(130)
Net proceeds from sale of common stock			13,936,909	140	312,100					312,240
Issuance of unvested restricted common stock			35,552							—
Vesting of restricted common stock					1,992					1,992
Common dividends declared and payable at \$1.155 per share										
Series A preferred dividends declared and payable at \$1.578 per share							(51,616)			(51,616)
Series C preferred dividends declared and payable at \$0.786 per share							(7,652)			(7,652)
Accretion of discount on Series C preferred stock							(3,225)			(3,225)
Conversion of minority interest membership units in the Operating Partnership to common shares			3,699,572	37	43,391		(96)			(96)
Net income						30,205				43,428
Balance at December 31, 2005	4,850,000	121,250	52,190,649	522	798,400	12,308	(72,551)	—	—	859,929

CONSOLIDATED AND COMBINED STATEMENTS OF STOCKHOLDERS' AND MEMBERS' EQUITY

	Preferred Stock		Common Stock		Additional Paid in Capital	Retained Earnings (Deficit)	Cumulative Dividends	Accumulated Other Comprehensive Loss	Members' Equity	Total
	Number of Shares	Amount	Number of Shares	Amount						
(In thousands, except per share data)										
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			84,440	1	3,677					3,678
Common dividends declared and payable at \$1.22 per share								(71,277)		(71,277)
Series A preferred dividends declared and payable at \$2.00 per share								(13,000)		(13,000)
Series C preferred dividends declared and payable at \$1.572 per share								(6,449)		(6,449)
Accretion of discount on Series C preferred stock								(200)		(200)
Net income								53,237		53,237
Balance at December 31, 2006	7,050,000	\$ 176,250	57,775,089	\$ 578	\$ 958,887	\$ 65,545	\$ 163,477	\$ —	\$ —	\$1,037,783

CONSOLIDATED AND COMBINED STATEMENTS OF CASH FLOWS

	The Company			The Predecessor
	Year Ended December 31, 2006	Year Ended December 31, 2005	Period October 26, 2004 through December 31, 2004	Period January 1, 2004 through October 25, 2004
(In thousands)				
CASH FLOWS FROM OPERATING ACTIVITIES				
Net income (loss)	\$ 53,237	\$ 30,205	\$ (17,897)	\$ (18,203)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Bad debt expense (recovery)	796	(170)	605	1,351
Minority interest	—	1,761	(2,706)	(125)
(Gain) loss on sale of hotel properties	(9,048)	(2,431)	(592)	1,251
Loss on early extinguishment of debt	9,976	—	—	—
Depreciation	101,733	73,029	9,773	49,560
Amortization of deferred franchise fees	104	129	1,685	304
Amortization of deferred financing costs	4,831	3,995	5,818	4,328
Amortization of loan premiums	(2,486)	(609)	—	—
Amortization of deferred stock compensation	3,677	1,992	1,442	—
Impairment loss—investment in hotel properties, discontinued operations and goodwill	4,920	—	—	24,393
(Gain) loss on derivatives	3	1	1	544
Equity in earnings of unconsolidated joint venture	(140)	—	—	—
Distributions of income from unconsolidated joint venture	28	—	—	—
Deferred income taxes	—	—	—	(2,617)
Changes in operating assets and liabilities:				
Restricted cash	(9,290)	(1,398)	(4,739)	(1,470)
Accounts receivable	647	(14,695)	1,755	(13,528)
Due from affiliates	611	(1,847)	178	(144)
Inventories	(260)	(307)	31	(44)
Prepaid expenses and other assets	(32)	(628)	(1,105)	(7,070)
Accounts payable and other liabilities	3,244	14,412	4,740	(5,062)
Accrued payroll and employee benefits	3,378	3,146	739	41
Due to Management Company	(2,902)	4,099	36	—
Accrued pension liability	—	—	—	(445)
Discontinued operations	77	(77)	—	—
Net cash provided by (used in) operating activities	163,104	113,403	(236)	33,064
CASH FLOWS FROM INVESTING ACTIVITIES				
Proceeds from sale of hotel properties	157,718	31,412	20,772	37,584
Restricted cash – replacement reserve	(2,074)	(26,793)	2,856	5,907
Contributions and advances to unconsolidated joint venture	(68,602)	—	—	—
Acquisitions of hotel properties	(448,373)	(907,342)	—	(38,820)
Additions to hotel properties and other real estate	(139,364)	(71,555)	(15,273)	(50,032)
Net cash (used in) provided by investing activities	(500,695)	(974,278)	8,355	(45,361)
CASH FLOWS FROM FINANCING ACTIVITIES				
Proceeds from preferred stock offering	55,000	220,250	—	—
Payment of preferred stock offering costs	(842)	(3,929)	—	—
Proceeds from common stock offering	158,400	320,979	362,011	—
Payment of common stock offering costs	(693)	(8,739)	(28,511)	—
Acquisition of membership units from the Predecessor's members	—	—	(195,921)	—
Proceeds from notes payable	440,542	701,207	396,364	60,983
Payments on notes payable	(212,868)	(295,633)	(545,979)	(74,259)
Net proceeds from the exercise of the over-allotment option	—	—	50,577	—
Purchase of minority interest	—	—	(50,577)	—
Payments of deferred financing costs	(3,726)	(4,847)	(6,141)	(345)
Acquisition of interest rate cap agreements	—	—	—	(53)
Contributions from members	—	—	—	25,322
Dividends and distributions paid	(86,731)	(56,841)	—	(9,350)
Contributions from minority interest holders	—	—	—	105
Distributions to minority interest holders	—	—	—	(40)
Net cash provided by (used in) financing activities	349,082	872,447	(18,177)	2,363
Net increase (decrease) in cash and cash equivalents	11,491	11,572	(10,058)	(9,934)
Cash and cash equivalents, beginning of year	17,538	5,966	16,024	20,229
Cash and cash equivalents, end of year	\$ 29,029	\$ 17,538	\$ 5,966	\$ 10,295
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION				
Cash paid for interest	\$ 92,824	\$ 56,265	\$ 14,960	\$ 41,165
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	\$ 23,826	\$ 19,831	\$ 11,016	\$ —

See accompanying notes to consolidated and combined financial statements.

NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

1. ORGANIZATION AND DESCRIPTION OF BUSINESS

Sunstone Hotel Investors, Inc. (the “Company”), through its 100% 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 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 25, 2004, the Company did not have any operations.

The Predecessor transferred certain of its property and operating interests in the Sunstone Predecessor Companies in exchange for limited partnership interests in the Operating Partnership and common stock of the Company.

The transfer of the properties and operating interests of Sunstone Predecessor Companies for ownership interests in the Operating Partnership and common stock of the Company was accounted for at the historical cost of the Predecessor similar to a pooling of interests as the Sunstone Predecessor Companies were all under common control.

On October 26, 2004, the Company commenced operations after completing the IPO, which consisted of the sale of 21,294,737 shares of common stock at a price per share of \$17.00, generating gross proceeds of approximately \$362.0 million. The proceeds to the Company, net of underwriters’ discount and offering costs, were approximately \$333.5 million. Concurrently with the IPO, the Company received gross proceeds of \$75.0 million from a new unsecured term loan facility and \$10.0 million from a draw on a new \$150.0 million revolving credit facility. The Company also entered into a new mortgage loan with one of its existing lenders and repaid the existing indebtedness. The costs associated with the unsecured term loan facility, revolving credit facility and the new mortgage loan totaled \$6.1 million. The proceeds from the IPO and the unsecured term loan facility were used to acquire limited partnership interests in the Operating Partnership held by the Predecessors’ members as a result of the IPO for \$195.9 million, repay secured notes payable of \$210.1 million, and purchase a ground lessor’s interest in a ground lease under one of the properties that was purchased for \$6.3 million.

On November 23, 2004, as a result of the exercise of the underwriters’ over-allotment option, the Company sold an additional 3,165,000 shares of common stock resulting in gross proceeds of \$53.8 million which it used to purchase an additional 3,165,000 limited partnership interests in the Operating Partnership from the Predecessor.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The accompanying consolidated financial statements as of December 31, 2006 and December 31, 2005, and for the years ended December 31, 2006 and 2005, and for the period October 26, 2004 through December 31, 2004, include the accounts of the Company, the Operating Partnership and the TRS Lessee and their subsidiaries. Property interests contributed to the Operating Partnership by the Predecessor have been accounted for as a reorganization of entities under common control in a manner similar to a pooling-of-interests. Accordingly, the contributed assets and assumed liabilities were recorded at the Predecessors’ historical cost basis. All significant intercompany balances and transactions have been eliminated.

The accompanying combined financial statements for the period January 1, 2004 through October 25, 2004 include the accounts of SHI, WB, and WB IV. Significant intercompany accounts and transactions have been eliminated. Minority interest for the year ended December 31, 2005 and for the period October 26, 2004 through December 31, 2004 represents the allocation of earnings to outside equity interests of the Operating Partnership.

Certain amounts included in the consolidated and combined financial statements for prior years have been reclassified to conform with the most recent financial statement presentation.

USE OF ESTIMATES

The preparation of consolidated and combined 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 33 of the Company's properties as of December 31, 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 December 31, 2006, report results on a monthly basis. In contrast, Marriott International, Inc. ("Marriott"), the manager of ten of the Company's properties as of December 31, 2006, uses a fiscal year ending on the Friday closest to December 31, and reports twelve weeks of operations each for 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 results of operations for the Marriott managed hotels for the year ended December 31, 2006 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 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.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents are defined as cash on hand and in banks plus all short-term investments with an original maturity of three months or less.

The Company maintains cash and cash equivalents and certain other financial instruments with various financial institutions. These financial institutions are located throughout the country and the Company's policy is designed to limit exposure to any one institution. The Company performs periodic evaluations of the relative credit standing of those financial institutions that are considered in the Company's investment strategy. At December 31, 2006 and 2005, the Company had amounts in banks that were in excess of federally insured amounts.

RESTRICTED CASH

Restricted cash is comprised of reserve accounts for debt service, interest reserves, capital replacements, and ground leases, property taxes and insurance impounds. These restricted funds are subject to supervision and disbursement approval by certain of the Company's lenders.

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 December 31, 2006 and 2005 includes an allowance for doubtful accounts of \$0.6 million and \$0.8 million, respectively. At December 31, 2006 and 2005, the Company had approximately \$4.0 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 these particular receivables in the amount of \$50,000 and \$100,000, respectively.

INVENTORIES

Inventories, consisting primarily of food and beverages, are stated at the lower of cost or market, with cost determined on a method that approximates first-in, first-out basis.

INVESTMENTS IN HOTEL PROPERTIES, OTHER REAL ESTATE AND FRANCHISE FEES

Hotel properties and other real estate assets are recorded at cost, less accumulated depreciation. 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.

Intangible assets consist of two easement agreements and one ground lease with use rights agreement, and are initially recorded at fair value. One of the easement agreements and the ground lease with use rights agreement are amortized using the straight-line method over the remaining non-cancelable terms of the related agreements, 85 and 93 years, respectively. The cost basis of these two intangible assets amounted to \$26.0 million and zero at December 31, 2006 and 2005, respectively. Accumulated amortization amounted to \$0.2 million and zero at December 31, 2006 and 2005, respectively. Amortization expense for these two intangible assets amounted to \$0.2 million for the year ended December 31, 2006, and zero for the years ended December 31, 2005 and 2004, respectively, and will be \$0.3 million every year thereafter until the agreements expire. The second easement agreement, recorded at fair value of \$9.7 million, has an indefinite useful life, and, therefore, is not amortized. This non-amortizable intangible asset is reviewed annually for impairment and more frequently if events or circumstances indicate that the asset may be impaired. If a non-amortizable intangible asset is subsequently determined to have a finite useful life, the intangible asset will be written down to the lower of its fair value or carrying amount and then amortized prospectively, based on the remaining useful life of the intangible asset.

Initial franchise fees are recorded at cost and amortized using the straight-line method over the lives of the franchise agreements ranging from six to 20 years. All other franchise fees that are based on the Company's results of operations are expensed as incurred.

The Company follows the requirements of Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets ("FAS No. 144"). FAS No. 144 requires impairment losses to be recorded on long-lived assets to be held and used by the Company when indicators of impairment are present and the future undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amount. When an impairment loss is required for assets to be held and used by the Company, the related assets are adjusted to their estimated fair values. When an impairment loss is required for assets held for sale, the related assets are adjusted to their estimated fair values, less costs to sell. Operating results of any long-lived assets with their own identifiable cash flows that are disposed of or held for sale are removed from income from continuing operations and reported as discontinued operations. Depreciation ceases when a property is held for sale. The operating results for any such assets for any prior periods presented must also be reclassified as discontinued operations.

As a result of a depressed state in certain markets of the hotel industry, during 2004 the Predecessor determined that the carrying values of certain hotels were no longer recoverable based on estimated future undiscounted cash flows to be generated from these hotels. As a result, the Predecessor recognized an impairment loss, exclusive of impairment of discontinued operations (Note 4) and goodwill, of \$1.2 million for the period January 1, 2004 through October 25, 2004, based on the difference between the carrying values and the fair values of the hotels as determined by the Predecessor based on supporting factors such as net operating cash flows, terminal capitalization rates and replacement costs. These hotels continue to be held for use by the Company and, accordingly, the hotel impairment loss is included in continuing operations for the period January 1, 2004 through October 25, 2004. No additional impairment charges were recorded on long-lived assets held for use by the Company for either the years ended December 31, 2006 and 2005, or the period October 26, 2004 through December 31, 2004. Based on the Company's review, management believes that there were no other impairments on its long-lived assets held for use and that the carrying values of its hotel properties and other real estate are recoverable at December 31, 2006. Fair value represents the amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than a forced or liquidation sale. The estimation process involved in determining if assets have been impaired and in the determination of fair value is inherently uncertain because it requires estimates of current market yields as well as future events and conditions. Such future events and conditions include economic and market conditions, as well as the availability of suitable financing. The realization of the Company's investment in hotel properties and other real estate is dependent upon future uncertain events and conditions and, accordingly, the actual timing and amounts realized by the Company may be materially different from their estimated fair values.

DEFERRED FINANCING COSTS

Deferred financing costs consist of loan fees and other financing costs related to the Company's outstanding indebtedness and are amortized to interest expense over the terms of the related debt.

Whenever the underlying debt is paid off, any related unamortized deferred financing cost is charged to interest expense. During 2006 and 2005, approximately \$3.7 million and \$4.8 million, respectively, were incurred and paid, related to new debt and debt refinancings. Such costs are being amortized over the related terms of the loans.

Interest expense related to the amortization of deferred financing costs was \$4.8 million for the year ended December 31, 2006, \$4.0 million for the year ended December 31, 2005, \$5.8 million, of which \$5.1 million was related to one-time costs associated with the initial public offering, for the period October 26, 2004 through December 31, 2004, and \$4.3 million for the period January 1, 2004 through October 25, 2004.

GOODWILL

The Company follows the requirements of Statement No. 142, Goodwill and Other Intangible Assets ("FAS No. 142"). Under FAS 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 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 fourteen hotel properties during the third and fourth quarters of 2006, the Company wrote off the goodwill associated with these properties totaling \$4.9 million, respectively, to impairment loss. The amount is included in income/(loss) from discontinued operations. The fair values of the reporting units were determined using factors such as net operating cash flows, terminal capitalization rates and replacement costs.

Based on the Company's review at December 31, 2006 and December 31, 2005, management believes that there were no additional impairments on its goodwill.

PROPERTY AND EQUIPMENT

Property and equipment is stated on the cost basis and includes computer equipment and other corporate office equipment and furniture. Property and equipment is depreciated on a straight-line basis over the estimated useful lives ranging from three to 12 years. The cost basis of property and equipment amounted to \$7.5 million and \$6.6 million at December 31, 2006 and 2005, respectively. Accumulated depreciation amounted to \$5.7 million and \$4.8 million at December 31, 2006 and 2005, respectively. Property and equipment net of related accumulated depreciation is included in other assets.

INVESTMENT IN UNCONSOLIDATED JOINT VENTURE

In December 2006 the Company entered into a joint venture agreement to obtain a 38% interest in the Doubletree Guest Suites Hotel in New York City, New York. The Company accounts for this ownership interest using the equity method. The Company does not have a controlling interest, but exercises significant influence on this investment.

FAIR VALUE OF FINANCIAL INSTRUMENTS

As of December 31, 2006 and 2005, the carrying amount of certain financial instruments, including cash and cash equivalents, accounts receivable, accounts payable, and accrued expenses were representative of their fair values due to the short-term maturity of these instruments. As of December 31, 2006, all of the Company's outstanding debt has fixed interest rates. The Company's fixed-rate mortgage debt is at commensurate terms with similar debt instruments based on risk, collateral, and other characteristics, except for two mortgage loans assumed in 2005, one of which was refinanced in 2006. The Company adjusted the carrying value of the remaining loan in 2006 by \$0.7 million, and adjusted both loans by \$3.2 million in 2005. These adjustments are included in Other Liabilities. Management believes the carrying value of the mortgage and other debt is a reasonable estimation of its fair value as of December 31, 2006 and 2005. At December 31, 2005, the Company held interest rate cap agreements to manage its exposure to the interest rate risks related to its floating rate debt. The interest rate cap agreements were recorded at their estimated fair values. The Company did not hold any interest rate cap agreements at December 31, 2006.

REVENUE RECOGNITION

Room revenue and food and beverage revenue are recognized as earned, which is generally defined as the date upon which a guest occupies a room and/or utilizes the hotel's services. Additionally, some of the Company's hotel rooms are booked through independent Internet travel intermediaries. Revenue for these rooms is booked at the price the Company sold the room to the independent Internet travel intermediary less any discount or commission paid.

Other operating revenues consist of revenues derived from incidental hotel services such as concessions, movie rentals, golf operations, retail sales, fitness services, internet access, telephone, sublease revenues relating to the restaurants and retail shops. In addition, as part of the Company's purchase of the Hyatt Regency Century Plaza, the Company entered into a 30-year term agreement with Hyatt Corporation whereby Hyatt Corporation will provide the Company with a limited performance guarantee that will ensure, subject to certain limitations, a return on equity to the Company. Under the terms of this agreement, should the net cash flow generated by the hotel be insufficient to cover the Company's debt service related to this hotel, plus a 10% return on the Company's equity investment in the hotel, Hyatt Corporation will pay the Company the difference, up to \$27.0 million over the term of the agreement. The Company recognizes into revenue quarterly, the amount due from Hyatt under this agreement. Also, as an adjunct to the Company's hotels located in Rochester, Minnesota and Salt Lake City, Utah, the Company operates commercial laundries at those locations providing laundry services to the Company's hotels and

other third parties in the respective locations. Revenues from incidental hotel services, management agreements, and laundry services are recognized in the period the related services are provided or the revenue is earned. The Company also has an online purchasing platform ("Buy Efficient, L.L.C.") that offers volume discounts to third parties. Revenues generated by Buy Efficient, L.L.C. include transactions fees, development fees, and rebate sales. The Company charges the third party for the installation associated with configuring the third party's information technology system with the purchasing platform and access rights to the purchasing platform. Fees for the installation are typically based on time and materials and are recognized as the services are performed. Fees associated with access rights are based on a percentage of the price of goods purchased by the third party from the vendor and are recognized when earned.

Management and other fees from affiliates consist of management fees, acquisition fees, and disposition fees earned from services provided to affiliates of the Predecessor. Management fees and accounting fees were recognized as services when rendered. Acquisition and disposition fees were recognized upon successful closings. Incentive fees were not recognized until earned. No incentive fees were earned for any of the periods presented.

ADVERTISING AND PROMOTION COSTS

Advertising and promotion costs are expensed when incurred. Advertising and promotion costs represent the expense for franchise advertising and reservation systems under the terms of the hotel franchise agreements and general and administrative expenses that are directly attributable to advertising and promotions.

INCOME TAXES

For the years ended December 31, 2006 and 2005, as well as for the period October 26, 2004 through December 31, 2004, the Company elected to be treated as a REIT pursuant to the Internal Revenue Code, as amended. Management believes that the Company has qualified and intends to continue to qualify as a REIT. Therefore, the Company will be permitted to deduct distributions paid to our stockholders, eliminating the federal taxation of income represented by such distributions at the company level. REITs are subject to a number of organizational and operational requirements. If the Company fails to qualify as a REIT in any taxable year, the Company will be subject to federal income tax (including any applicable alternative minimum tax) on taxable income at regular corporate tax rates.

The Predecessor was treated as a partnership for federal and most state income tax purposes. However, certain states may impose entity level taxes and fees. In addition, the Predecessor owned various corporations included in these combined financial statements which are subject to federal and state income taxes. These corporations were owned through a series of partnerships and limited liability companies and cannot be consolidated for federal and/or state income tax purposes.

With respect to taxable subsidiaries, the Company and the Predecessor account for income taxes in accordance with Statement No. 109, Accounting for Income Taxes ("FAS No. 109"). Accordingly, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse.

MINORITY INTEREST

Prior to November 2005, minority interests of the Company represented the limited partnership interests 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 limited partnership interests. During November 2005, the membership units held by the minority interest owners were converted to shares of common stock and were subsequently sold in a public offering eliminating the minority interests of the Company. As such, the Company beneficially owns all of the membership interests in the Operating Partnership.

Minority interests of the Predecessor represented the limited partners' interest in limited partnerships that were controlled by WB IV. The carrying value of the minority interest was increased by the minority interest's share of WB IV earnings and reduced by WB IV partnership cash distributions as well as return of capital distributions.

DIVIDENDS

The Company pays quarterly dividends to its Series A Cumulative Redeemable and Series C Cumulative Convertible Redeemable preferred stockholders, as well as its common stockholders as declared by the Board of Directors. The Company's ability to pay dividends is dependent on the receipt of distributions from the Operating Partnership.

EARNINGS PER SHARE

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

	Year Ended December 31, 2006	Year Ended December 31, 2005	Period October 26, 2004 through December 31, 2004
Numerator:			
Net income (loss)	\$ 53,237	\$ 30,205	\$ (17,897)
Less preferred dividends and accretion	(19,616)	(10,973)	—
Numerator for basic and diluted earnings available to common stockholders	\$ 33,621	\$ 19,232	\$ (17,897)
Denominator:			
Weighted average basic common shares outstanding	57,247	40,655	33,196
Unvested restricted stock awards	444	304	—
Weighted average diluted common shares outstanding	57,691	40,959	33,196
Basic earnings (losses) available to common stockholders per common share	\$ 0.59	\$ 0.47	\$ (0.54)
Diluted earnings (losses) available to common stockholders per common share	\$ 0.58	\$ 0.47	\$ (0.54)

Shares of the Company's Series C preferred stock have not been included in the above calculation of earnings per share for the years ended December 31, 2006 and 2005 as their effect would have been anti-dilutive.

COMPREHENSIVE INCOME (LOSS)

The Predecessor reported and displayed comprehensive income (loss) and its components in accordance with Statement No. 130, Reporting Comprehensive Income ("FAS No. 130"). FAS No. 130 requires that the Predecessor's minimum pension liability adjustment be included in other comprehensive income (loss).

SEGMENT REPORTING

Under the provision of Statement No. 131, Disclosure about Segments of an Enterprise and Related Information ("FAS No. 131"), the Company's operations are at this time conducted and aggregated under one segment, hotel operations.

RECENT ACCOUNTING PRONOUNCEMENTS

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 the financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes". The provisions of FIN 48 are effective for the Company's fiscal year beginning January 1, 2007. The Company is currently evaluating the impact of the provisions of FIN 48, and currently cannot estimate the impact to the Company's financial statements.

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 the Company's fiscal year beginning January 1, 2008. The Company is currently evaluating the impact of the provisions of FAS 157, and currently cannot estimate the impact to the Company's financial statements.

3. INVESTMENT IN HOTEL PROPERTIES

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

	December 31, 2006	December 31, 2005
Land	\$ 384,242	\$ 361,222
Buildings and improvements	2,067,930	1,681,617
Fixtures, furniture and equipment	264,870	236,296
Intangibles	35,736	—
Franchise fees	1,382	1,399
Construction in process	30,808	25,786
	2,784,968	2,306,320
Accumulated depreciation and amortization	(307,454)	(252,319)
	\$ 2,477,514	\$ 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 fourth quarter ended December 29, 2006, have been included in the Company's statement of operations.

On March 17, 2006, the Company purchased the 444-room Hilton Times Square located in New York City for \$241.5 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 fourth quarter ended December 31, 2006 have been included in the Company's statement of operations.

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 fourth quarter ended December 31, 2006, have been included in the Company's statement of operations.

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 fourth quarter ended December 31, 2006, have been included in the Company's statement of operations.

On June 23, 2005, the Company purchased interests in six Renaissance hotels as set forth below for approximately \$433.7 million.

Hotel	Location	Number of Rooms
Renaissance Long Beach Hotel	Long Beach, California	373
Renaissance Westchester Hotel	White Plains, New York	357
Renaissance Orlando Resort at SeaWorld Hotel	Orlando, Florida	780
Renaissance Harborplace Hotel	Baltimore, Maryland	622
Renaissance Washington, D.C. Hotel	Washington, D.C.	807
Renaissance Atlanta Concourse Hotel	Atlanta, Georgia	387

The acquisition of the Renaissance Orlando Resort at SeaWorld Hotel represents an 85% interest in a partnership that owns that property, as well as the lender's position in the partnership loan. As a result, all of the economics of the property for the foreseeable future are retained by the Company.

On June 27, 2005, the Company purchased the 203-room Sheraton located in Cerritos, California for approximately \$25.4 million. This hotel's results of operations from the acquisition date of June 27, 2005 through the year ended December 31, 2005 have been included in the Company's statement of operations.

On July 12, 2005, the Company purchased the 444-room Fairmont Hotel located in Newport Beach, California for approximately \$72.0 million, and rebranded the hotel as the Fairmont Newport Beach. This hotel's results of operations from the acquisition date of July 12, 2005 through the year ended December 31, 2005 have been included in the Company's statement of operations.

On July 13, 2005, the Company purchased the remaining 75% interest in the Renaissance Washington, D.C. Hotel for approximately \$140.0 million. The original 25% interest was acquired at a cost of approximately \$20.0 million as part of the six-hotel Renaissance acquisition noted above. The additional 75% interest in this hotel's results of operations from the acquisition date of July 13, 2005 through Marriott's fiscal year end, or December 30, 2005, have been included in the Company's statement of operations.

During the third quarter of 2005, the Company sold two parcels of land for approximately \$0.7 million, generating a net gain of \$92,000.

On October 5, 2005, the Company purchased the 728-room Century Plaza Hotel and Spa located in Century City, California for \$293.0 million and named Hyatt Corporation as manager. This hotel's results of operations from the acquisition date of October 5, 2005 through the year ended December 31, 2005 have been included in the Company's statement of operations.

4. DISCONTINUED OPERATIONS

As part of a strategic plan to dispose of non-core hotel assets, the Company or its Predecessor sold 15 hotel properties during 2006, three hotel properties during 2005, and seven hotel properties during 2004. Fifteen properties were sold during 2006 for net proceeds of \$163.3 million, including the receipt of a \$5.6 million note receivable. One of the properties sold during 2006 was classified as "held for sale" on the Company's consolidated balance sheet as of December 31, 2005. This property was

subsequently sold in March, 2006. The Company recognized a net gain on sale of assets of \$9.0 million, and also recognized a \$4.9 million goodwill impairment loss. Three properties and two parcels of land were sold during 2005 for net proceeds of \$31.4 million and a net gain on sale of \$2.3 million. Two hotel properties were sold in the period October 26, 2004 through December 31, 2004, for net proceeds of \$20.8 million and a net gain on sale of \$592,000. Five hotel properties and one parcel of land were sold in the period January 1, 2004 through October 25, 2004, for net proceeds of \$37.6 million and a net loss on sale of \$1.3 million. These 25 hotel properties met the “held for sale” and “discontinued operations” criteria in accordance with FAS No. 144.

The following sets forth the discontinued operations for the years ended December 31, 2006 and 2005, the period October 26, 2004 through December 31, 2004, and the period January 1, 2004 through October 25, 2004 related to hotel properties that have been sold (in thousands):

	Year Ended December 31, 2006	Year Ended December 31, 2005	Period October 26, 2004 through December 31, 2004	Period January 1, 2004 through October 25, 2004
Operating revenues	\$ 51,825	\$ 76,042	\$ 13,661	\$ 87,515
Operating expenses	(39,483)	(58,007)	(11,587)	(70,451)
Interest expense	(446)	(5,801)	(4,355)	(7,668)
Depreciation and amortization	(5,552)	(8,546)	(2,129)	(9,113)
Goodwill and asset impairment loss	(4,920)	—	—	(23,148)
Gain (loss) on sale of hotels	9,048	2,339	592	(1,251)
Benefit from (provision for) income taxes	—	—	—	(115)
Income (loss) from discontinued operations	\$ 10,472	\$ 6,027	\$ (3,818)	\$ (24,231)

The following sets forth the assets and liabilities related to the discontinued operations (in thousands):

	December 31, 2006	December 31, 2005
ASSETS		
Total current assets:	\$ —	\$ 359
Hotel properties 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 consisted of the following (in thousands):

	December 31, 2006	December 31, 2005
Laundry facilities:		
Land	\$ 3,824	\$ 1,600
Buildings and improvements	9,070	4,462
Fixtures, furniture and equipment	4,465	3,796
Construction in progress	89	214
	17,448	10,072
Accumulated depreciation	(3,708)	(2,983)
	13,740	7,089
Land held for investment	933	456
	\$ 14,673	\$ 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. INVESTMENT IN UNCONSOLIDATED JOINT VENTURE

On December 28, 2006 the Company entered into a joint venture agreement with Whitehall Street Global Real Estate Limited Partnership 2005 and Highgate Holdings to acquire the 460-room Doubletree Guest Suites Hotel in New York City, New York. The \$68.5 million investment was funded entirely from cash on hand and is comprised of two parts: (i) a \$28.5 million mezzanine loan, which bears an interest rate of 8.5% on a face value of \$30 million and (ii) a \$40 million equity investment representing a 38% ownership interest in the joint venture. Annual dividends on the equity investment are senior to the returns on equity to both Whitehall and Highgate and begin at 8.0% and grow to 9.25% over a nine year period. In addition, the equity is entitled to receive a pro-rata share of any excess equity distributions to the joint venture. At December 31, 2006, the Company's investment amounted to \$68.7 million. The Company's equity in earnings of the unconsolidated joint venture amounted to \$140,000 for the year ended December 31, 2006.

7. OTHER ASSETS

Other assets consist of the following (in thousands):

	December 31, 2006	December 31, 2005
Property and equipment, net	\$ 1,730	\$ 1,726
Pre-acquisition costs	8,985	7,865
Other receivables	8,485	6,469
Other	2,771	2,720
	<u>\$ 21,971</u>	<u>\$ 18,780</u>

During the third quarter of 2006, the buyer of 13 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. DERIVATIVE FINANCIAL INSTRUMENTS

At December 31, 2005, the Company held interest rate cap agreements to manage its exposure to the interest rate risks related to its floating rate debt. The fair values of the interest rate cap agreements are recorded as deferred financing costs, net on the consolidated balance sheet as of December 31, 2005. The asset balance on the consolidated balance sheet as of December 31, 2006 was zero as these agreements matured in May, 2006. None of the Company's interest rate cap agreements held during 2006, 2005 and 2004 qualified for effective hedge accounting treatment under FAS No. 133. Accordingly, changes in the fair value of the Company's interest rate cap agreements at December 31, 2006, 2005 and 2004, resulted in a net gain of \$1,000, a net loss of \$1,000 and a net loss of \$545,000, respectively. The changes in fair value have been reflected as a decrease in interest expense for the year ended December 31, 2006, and an increase in interest expense for the year ended December 31, 2005, for the period October 26, 2004 through December 31, 2004, and the period January 1, 2004 through October 25, 2004. The following table summarizes the interest rate cap agreements at December 31 (dollars in thousands):

	2005
Notional amount of variable rate debt	\$ 285,354
Fair value of interest rate caps	\$ 3
Interest rate cap rates	4.50%–7.19%
Maturity dates	January 2006 – May 2006

9. DUE TO MANAGEMENT COMPANY AND OTHER CURRENT LIABILITIES

DUE TO MANAGEMENT COMPANY

The Management Company manages 33 of the Company's 49 hotels as of December 31, 2006. The following amounts make up the net liability owed to the Management Company (in thousands):

	December 31, 2006	December 31, 2005
Accrued payroll and employee benefits	\$ 10,088	\$ 10,376
Worker's compensation	6,683	9,254
Accrued pension liability	500	1,489
Management and accounting fees payable	738	646
Other	9	—
Accumulated other comprehensive loss and reimbursements from Management Company	(1,411)	(2,361)
	<u>\$ 16,607</u>	<u>\$ 19,404</u>

OTHER CURRENT LIABILITIES

Other current liabilities consisted of the following (in thousands):

	December 31, 2006	December 31, 2005
Property, sales, and use taxes payable	\$ 11,039	\$ 10,404
Accrued interest mortgage	7,421	6,023
Advanced deposits	6,542	4,479
Worker's compensation	86	469
Other	7,266	8,039
	<u>\$ 32,354</u>	<u>\$ 29,414</u>

10. NOTES PAYABLE

Notes payable consisted of the following at December 31 (in thousands):

	2006	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.	\$ 1,499,828	\$ 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
	1,499,828	1,181,178
	(23,231)	(4,387)
	<u>\$ 1,476,597</u>	<u>\$ 1,176,791</u>
Less: current portion		

We were not in default on any of our loan covenants at December 31, 2006 or 2005.

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.

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 11-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 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 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 December 31, 2006, the Company’s revolving credit facility had no amounts outstanding, and had \$11.6 million backing outstanding irrevocable letters of credit, leaving \$188.4 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.

In April 2005, the Company closed ten individual non cross-collateralized mortgage loans totaling \$276.0 million. The loans are each for a term of ten years and have a fixed rate of 5.34%. The proceeds of these loans were used to repay \$244.3 million of existing mortgage loans.

In June 2005, the Company closed \$250.0 million in four separate mortgage loans, each secured by one hotel, with terms ranging between seven and eleven years and a weighted average fixed interest rate of 5.14%. The proceeds of these loans were used to fund the acquisition of interests in six Renaissance hotels.

In June 2005, the Company assumed a \$9.2 million fixed rate mortgage loan with a maturity date of August 2024 and a fixed interest rate of 8.78% in connection with the acquisition of the Sheraton Cerritos, Cerritos, California.

In July 2005, the Company assumed a \$54.0 million fixed rate mortgage loan with a maturity date of April 2023 and a fixed interest rate of 7.50% in connection with the acquisition of the remaining 75% interest in the Renaissance Washington, D.C.

In October 2005, the Company closed a \$175.0 million fixed rate mortgage loan with a maturity date of December 2014, and a weighted average fixed interest rate of 6.12% in connection with the acquisition of the Hyatt Regency Century Plaza Hotel and Spa, Los Angeles, California.

In December 2005, the Company paid off \$13.1 million of floating rate debt with a maturity date of November 2007.

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

	Year Ended December 31, 2006	Year Ended December 31, 2005	Period October 26, 2004 through December 31, 2004	Period January 1, 2004 through October 25, 2004
Continuing operations:				
Interest expense	\$ 81,663	\$ 50,900	\$ 6,864	\$ 35,157
Deferred financing fees	4,471	3,313	4,072	3,209
(Gain)/Loss on interest rate cap	(1)	1	1	419
Costs associated with early extinguishments of debt	9,976	2,667	5,316	—
	<u>\$ 96,109</u>	<u>\$ 56,881</u>	<u>\$ 16,253</u>	<u>\$ 38,785</u>
Discontinued operations:				
Interest expense	\$ 86	\$ 4,943	\$ 1,171	\$ 6,424
Deferred financing fees	360	682	1,746	1,119
Loss on interest rate cap	—	—	—	125
Costs associated with early extinguishment of debt	—	176	1,438	—
	<u>\$ 446</u>	<u>\$ 5,801</u>	<u>\$ 4,355</u>	<u>\$ 7,668</u>

Aggregate future principal maturities of notes payable at December 31, 2006, are as follows (in thousands):

2007	\$ 23,231
2008	14,842
2009	18,726
2010	102,129
2011	250,927
Thereafter	1,089,973
	<u>\$ 1,499,828</u>

11. INCOME TAXES

The income tax benefit (provision) included in the consolidated and combined statements of operations is as follows (in thousands):

	Year Ended December 31, 2006	Year Ended December 31, 2005	Period October 26, 2004 through December 31, 2004	Period January 1, 2004 through October 25, 2004
Current:				
Federal	\$ —	\$ —	\$ —	\$ (2,141)
State	—	—	—	(515)
	<u>—</u>	<u>—</u>	<u>—</u>	<u>(2,656)</u>
Deferred:				
Federal	5,695	8,619	1,470	249
State	1,438	2,204	376	65
	<u>7,133</u>	<u>10,823</u>	<u>1,846</u>	<u>314</u>
Valuation allowance	(7,133)	(10,823)	(1,846)	2,498
Income tax benefit	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 156</u>

Benefit from (provision for) income taxes applicable to continuing operations and discontinued operations is as follows (in thousands):

	Year Ended December 31, 2006	Year Ended December 31, 2005	Period October 26, 2004 through December 31, 2004	Period January 1, 2004 through October 25, 2004
Benefit from (provision for) continuing operations:				
Current	—	\$ —	\$ —	\$ (2,133)
Deferred	—	—	—	2,404
Benefit from (provision for) continuing operations	<u>—</u>	<u>—</u>	<u>—</u>	<u>271</u>
Benefit from (provision for) discontinued operations:				
Current	—	—	—	—
Deferred	—	—	—	(115)
Benefit from (provision for) discontinued operations	<u>—</u>	<u>—</u>	<u>—</u>	<u>(115)</u>
Benefit from income taxes	<u>—</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 156</u>

For the period January 1, 2004 through October 25, 2004, income tax benefits primarily arose as a result of certain intercompany transactions that resulted in the reduction of deferred income tax liability that was recorded in connection with the November 22, 1999 going private transaction.

The provision for income taxes differs from the federal statutory rate primarily because (i) a significant portion of income is earned in partnerships, and, as such, is not subject to federal or most state income tax; and (ii) the goodwill associated with impairment losses is not deductible.

For the years ended December 31, 2006 and 2005 and for the period October 26, 2004 through December 31, 2004, the provision for income taxes differs from the federal statutory rate due to minor expenses that are not deductible for tax purposes.

The tax effects of temporary differences giving rise to the deferred tax assets (liabilities) are as follows (in thousands):

	December 31, 2006	December 31, 2005
Deferred tax assets:		
NOL carryover	\$ 19,387	\$ 10,794
State taxes and other	533	140
Other reserves	3,833	5,696
Current deferred tax asset before valuation allowance	<u>23,753</u>	<u>16,630</u>
Deferred tax liabilities:		
Depreciation	(47)	(57)
Other	—	—
	<u>(47)</u>	<u>(57)</u>
Net deferred tax asset	<u>23,706</u>	<u>16,573</u>
Valuation allowance	<u>(23,706)</u>	<u>(16,573)</u>
	<u>\$ —</u>	<u>\$ —</u>

The deferred tax assets at December 31, 2006 and 2005, were primarily due to timing differences in the deductibility of various reserves for tax purposes as compared to book purposes. A valuation allowance is maintained to offset its deferred tax assets due to uncertainties surrounding their realization.

At December 31, 2006 and 2005, the Company had federal net operating loss carryforwards of \$49.3 million and \$21.5 million, respectively, which begin to expire in 2019.

As of December 31, 2006 and 2005, the Company had state net operating loss carryforwards of \$49.3 million and \$21.5 million, respectively, which begin to expire in 2011.

12. 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 Operating Partnership in exchange for preferred 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 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 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, holder 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 common dividend on its common stock increase beyond \$1.34 per share. 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 December 31, 2006 and 2005, the Series C preferred stock carrying value consisted of the following (in thousands):

	December 31, 2006	December 31, 2005
Initial fair value, sales price of \$99.0 million	\$ 99,000	\$ 99,000
Redemption value accretion	296	96
	<u>\$ 99,296</u>	<u>\$ 99,096</u>

13. STOCKHOLDERS' EQUITY

FORMATION AND STRUCTURING TRANSACTIONS

In connection with the formation and structuring transactions in 2004 in connection with the IPO, certain assets were distributed and certain liabilities were assumed by a Predecessor member and certain assets and liabilities were not contributed to the Company. The assets not contributed to the Company by the Predecessor primarily consisted of the Embassy Suites Hotel, Los Angeles, California and the JW Marriott, Cherry Creek, Colorado.

The adjustments for formation and structuring transactions are as follows (in thousands):

Distributions of assets to Predecessor members	\$ (65,328)
Assumption of liabilities by Predecessor members	44,120
Write-off of deferred income taxes	41,064
Other net liabilities assumed by Predecessor members	6,790
	<u>\$ 26,646</u>

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") 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 will 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 October 26, 2004, the Company commenced operations after completing the IPO, which consisted of the sale of 21,294,737 shares of common stock at a price per share of \$17.00, generating gross proceeds of \$362.0 million. The proceeds to the Company, net of underwriters' discount and offering costs, were \$333.5 million. The proceeds from the IPO were used to acquire limited partnership interests in the Operating Partnership held by the Predecessors' members as a result of the IPO for \$195.9 million, repay secured notes payable of \$210.1 million, and purchase a ground lessor's interest in a ground lease under one of the properties that was purchased for \$6.3 million. On November 23, 2004, as a result of the exercise of the underwriters' over-allotment option, the Company sold an additional 3,165,000 shares of common stock resulting in gross proceeds of \$53.8 million (\$50.6 million of net proceeds), which it used to purchase an additional 3,165,000 limited partnership interests in the Operating Partnership from the Predecessor.

On October 26, 2004, the Company granted 67,947 restricted shares of common stock to the Company's executive officers. These shares of common stock were issued under the 2004 Long-Term Incentive Plan.

On October 26, 2004, the Company granted 434,211 restricted stock units to the Company's executive officers and certain employees. These restricted stock units vest over five years beginning on the grant date. These were issued under the 2004 Long-Term Incentive Plan.

On June 10, 2005, the Company and selling stockholders completed a follow-on offering of 12,180,800 shares, including the exercise of the underwriters' over-allotment option, of common stock at a price per share of \$23.40 (before underwriting discounts and offering costs). The public offering consisted of 3,000,000 primary shares, generating gross proceeds of \$70.2 million, and 9,180,800 secondary shares sold by affiliates of Westbrook Partners, LLC. The proceeds to the Company, net of underwriters' discount and offering costs, were \$65.3 million and were used for acquisitions.

On June 23, 2005, the Company completed a private offering to GIC Real Estate, an investment arm of the Government of Singapore, of 3,750,000 and 294,000 shares of common stock at a price per share of \$20.65 and \$21.97, respectively, generating gross proceeds of \$83.9 million. The proceeds to the Company, net of offering costs, were \$83.8 million and were used for acquisitions.

On June 28, 2005, the Company completed a private offering to Security Capital Preferred Growth Incorporated, an investment vehicle advised by Security Capital Research & Management Incorporated, of 300,000 shares of common stock at a price per share of \$22.347, generating net proceeds of \$6.7 million which were used for acquisitions.

On September 20, 2005, the Company and selling stockholders completed a follow-on offering of 6,700,000 shares of common stock at a price per share of \$24.34 (before underwriting discounts and offering costs). The public offering consisted of 5,993,554 primary shares, generating gross proceeds of \$145.9 million and 706,446 secondary shares sold by affiliates of Westbrook Partners, LLC. The proceeds to the Company, net of underwriters' discount and offering costs, were \$142.2 million and were used for acquisitions.

On November 17, 2005, the Company announced that the minority interest holders in the Operating Partnership priced an offering of 3,699,572 shares of the Company's common stock, representing all of the remaining shares held by the minority interest holders, including shares issued upon conversion of membership units in the Operating Partnership. The offering consisted solely of secondary shares held by the minority interest holders.

On December 27, 2005, the Company completed a private offering to Security Capital Preferred Growth Incorporated, an investment vehicle advised by Security Capital Research & Management Incorporated, of 599,355 shares of common stock at a price per share of \$23.85, generating net proceeds of \$14.3 million which were used for acquisitions.

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.

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 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. The Forward Sale Agreement expires in July 2007. As of December 31, 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. The forward sale agreement is accounted for as an equity instrument and does not qualify as a derivative liability.

OPERATING PARTNERSHIP UNITS

The outstanding units of limited partnership interest were redeemable for cash, or at the option of the Company, for a like number of shares of common stock of the Company.

In November 2004, 3,165,000 units of limited partnership interest were converted to common shares through the exercise of the over-allotment option.

In November 2005, 3,699,572 units of limited partnership interest held by the limited partners representing minority interests on the balance sheet were converted to common shares and sold in a public offering, eliminating the limited partners' interest in the Company.

As of December 31, 2006, the Operating Partnership had 57,775,089 units outstanding, all of which are held by the Company.

14. LONG-TERM INCENTIVE PLAN

The Company has a Long-Term Incentive Plan ("LTIP") which provides for the granting to directors, officers and eligible employees of incentive or nonqualified share options, restricted shares, deferred shares, share purchase rights and share appreciation rights in tandem with options, or any combination thereof. The Company has reserved 2,100,000 common shares for issuance under the LTIP.

Restricted shares and restricted share units granted pursuant to the LTIP 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 years ended December 31, 2006 and 2005, and for the period October 26, 2004 through December 31, 2004, the Company's expense related to these restricted shares and restricted share units was \$5.2 million, \$2.6 million, and \$2.2 million, respectively.

The following is a summary of non-vested stock grant activity:

	2006		2005		2004	
	Shares	Weighted Average Price	Shares	Weighted Average Price	Shares	Weighted Average Price
Outstanding at beginning of year	454,413	\$ 17.56	434,211	\$ 17.00	—	\$ —
Awarded	333,665	28.76	76,458	20.92	539,474	17.00
Vested	(124,444)	19.44	(46,782)	17.95	(105,263)	17.00
Forfeited	(36,793)	27.84	(9,474)	17.00	—	—
Outstanding at end of year	626,841	22.55	454,413	17.56	434,211	17.00

At December 31, 2006, there were no options, deferred shares, share purchase rights, or share appreciation rights issued or outstanding under the LTIP.

15. COMMITMENTS AND CONTINGENCIES

FRANCHISE AGREEMENTS

The Company has entered into various license and franchise agreements related to certain hotel properties. The franchise agreements require the Company to, among other things, pay various monthly fees that are calculated based on specified percentages of certain specified revenues. The franchise agreements generally contain specific standards for, and restrictions and limitations on, the operation and maintenance of the hotels which are established by the franchisors to maintain uniformity in the system created by each such franchisor. Such standards generally regulate the appearance of the hotel, quality and type of goods and services offered, signage and protection of trademarks. Compliance with such standards may from time to time require significant expenditures for capital improvements which will be borne by the Company.

Total franchise costs incurred by the Company and the Predecessor during the years ended December 31, 2006 and 2005, the period October 26, 2004 through December 31, 2004, and the period January 1, 2004 through October 25, 2004 were \$37.8 million, \$27.5 million, \$4.1 million, and \$22.9 million, respectively. Of the total franchise costs, franchise royalties totaled \$16.4 million, \$15.0 million, \$2.2 million, and \$12.7 million, respectively. The remaining franchise costs include advertising, reservation and priority club assessments. Franchise costs included in discontinued operations totaled \$3.9 million, \$5.7 million, \$1.0 million, and \$6.0 million, respectively for the years ended December 31, 2006 and 2005, for the period October 26, 2004 through December 31, 2004, and the period January 1, 2004 through October 25, 2004.

In connection with the IPO, the Company obtained franchisor consents from the Company's various franchisors, which, among other things, required the Company to execute new franchise agreements and pay certain fees totaling \$1.7 million, which were expensed during the period October 26, 2004 through December 31, 2004.

RENOVATION AND CONSTRUCTION COMMITMENTS

At December 31, 2006 and 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 December 31, 2006 and 2005 totaled \$26.2 million and \$28.2 million, respectively.

OPERATING LEASES

At December 31, 2006, the Company was obligated under the terms of ten ground or air leases and a lease on the corporate facility, which mature from dates ranging from 2010 through 2096, excluding renewal options. Payments on one of the ground leases and the air lease require payments of \$1.00 annually. Future minimum payments under the terms of the operating leases in effect at December 31, 2006 are as follows (in thousands):

2007	\$ 4,849
2008	4,903
2009	4,957
2010	4,602
2011	4,238
Thereafter	295,787
	<u>\$ 319,336</u>

Rent expense incurred pursuant to these ground lease agreements for the years ended December 31, 2006 and 2005, the period October 26, 2004 through December 31, 2004, and the period January 1, 2004 through October 25, 2004, totaled \$7.7 million, \$4.8 million, \$0.5 million, and \$3.2 million, respectively. Rent expense included in property tax, ground lease and insurance totaled \$7.2 million and \$3.8 million for the years ended December 31, 2006 and 2005, \$0.4 million for the period October 26, 2004 through December 31, 2004, and \$2.3 million for the period January 1, 2004 through October 25, 2004. Rent expense included in discontinued operations totaled \$0.5 million and \$1.0 million for the years ended December 31, 2006 and 2005, respectively, \$0.1 million for the period October 26, 2004 through December 31, 2004, and \$0.9 million for the period January 1, 2004 through October 25, 2004.

Rent expense incurred pursuant to the lease on the corporate facility for the years ended December 31, 2006 and 2005, the period October 26, 2004 through December 31, 2004, and the period January 1, 2004 through October 25, 2004, totaled \$0.5 million, \$0.4 million, \$0.1 million, and \$0.6 million, respectively, and was included in general and administrative expenses in the accompanying statements of operations.

EMPLOYMENT AGREEMENTS

As of December 31, 2006, the Company has employment agreements with certain executive employees, which expire through October 2009. The terms of the agreements stipulate payments of base salaries and bonuses.

Approximate minimum future obligations under employment agreements are as follows as of December 31, 2006 (in thousands):

2007	\$ 1,231
2008	754
2009	628
	<u>\$ 2,613</u>

LOANS

In connection with the November 22, 1999 going private transaction, the Predecessor entered into a promissory note in favor of one of its executives, due October 1, 2009, in a principal amount of \$650,000, with interest payable at the rate of 8% per year. Concurrently, the executive entered into a promissory note in favor of a subsidiary of the Predecessor, due October 1, 2009, in a principal amount of \$650,000, with interest payable at the rate of 8% per year. Neither of these notes has been materially modified since the inception date. These notes were not contributed to the Company as a part of the formation and structuring transactions.

On July 1, 2003, the Predecessor loaned one of its executives \$100,000 for relocation expenses pursuant to a promissory note with interest payable at the rate of 6% per year and a maturity of April 21, 2007. The Predecessor has agreed to waive 25% of the original principal and accrued interest due to it on each succeeding April 21. In June 2004, the remaining \$75,000 principal amount of the note was forgiven by the Predecessor.

LITIGATION

During 2003, a suit against the Predecessor 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 the Company's formerly owned hotels. On September 18, 2006, the Company entered into a memorandum of understanding to settle this litigation for \$537,500. The Company expects that all of this amount will be covered by its liability insurance. The Company will not admit any wrongdoing in connection with the settlement. If the settlement is not finalized, the Company intends to continue to defend this matter vigorously.

Additionally, the Company is involved from time to time in various claims and other legal actions in the ordinary course of business. Management does not believe that the resolution of such additional matters will have a material adverse effect on the Company's financial position or results of operations when resolved.

COLLECTIVE BARGAINING AGREEMENTS

The Company is subject to exposure to collective bargaining agreements at certain hotels operated by the Management Company. At December 31, 2006, the percentage of Management Company employees covered by such collective bargaining agreements represents approximately 13.9% of the total number of employees.

DEFINED BENEFIT RETIREMENT PLAN OBLIGATION

In connection with the formation and structuring transactions, the Predecessor Companies sold their property management company, Sunstone Hotel Properties, Inc. ("SHP") to Interstate Hotels and Resorts, Inc. ("IHR"). IHR assumed certain liabilities of SHP including the defined benefit retirement plan. In accordance with the management agreement with IHR, the Company is still responsible for the costs of the defined benefit retirement plan.

The benefits expected to be paid in each of the next five years, and in the aggregate for the five years thereafter as of December 31, 2006 are as follows (in thousands):

2007	\$ 282
2008	289
2009	318
2010	321
2011	344
Thereafter	1,989
	<u>\$ 3,543</u>

401(K) SAVINGS AND RETIREMENT PLAN

Beginning in 2005, the Company's employees may participate, subject to eligibility, in the Company's 401(k) Savings and Retirement Plan (the "401(k) Plan"). Employees are eligible to participate in the 401(k) Plan after attaining 21 years of age and performing six months of service. Three percent of eligible employee annual base earnings is contributed by the Company as a Safe Harbor elective contribution. Safe Harbor contributions made by the Company for the years ended December 31, 2006 and 2005 were \$171,000 and \$132,000, respectively.

The Company is also responsible for the Management Company's 401(k) Plan, and matches up to three percent of the Management Company's employee contributions at 50 percent. Employees are eligible to participate in the Management Company's 401(k) Plan after attaining 21 years of age and performing one year of service and working at least 1,000 hours. Matching contributions made by the Company for the years ended December 31, 2006 and 2005, the period October 26, 2004 through December 31, 2004, and by the Predecessor for the period January 1, 2004 through October 25, 2004 totaled \$855,000, \$568,000, \$85,000, and \$495,000, respectively.

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 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 December 31, 2006 and 2005, the Company had \$11.6 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. There have been no draws made through December 31, 2006.

16. TRANSACTIONS WITH AFFILIATES

MANAGEMENT FEES

On January 30, 2004, the Predecessor entered into a management agreement with an affiliate to provide management services for the hotel located in Beverly Hills, California owned by the affiliate. The agreement was to expire January 30, 2009 and included successive one-year renewal options. Pursuant to the agreement, the Company was to receive from the affiliate a base management fee of 2.5% of gross operating revenues, as defined. In connection with the Company's initial public offering, this agreement was cancelled and a new agreement was entered into with the Management Company.

On March 30, 2004, the Predecessor entered into a management agreement with an affiliate to provide management services for the hotel located in Nashville, Tennessee owned by an affiliate. The agreement was to expire March 30, 2009 and included successive one-year renewal options. Pursuant to the agreement, the Company was to receive from the affiliate a base management fee of 2.5% of gross operating revenues, as defined. In connection with the Company's initial public offering, this agreement was cancelled and a new agreement was entered into with the Management Company.

On May 22, 2002, the Predecessor entered into a management agreement with an affiliate to provide management services for the hotel property located in Nashville, Tennessee owned by Westbrook Real Estate Partners, L.L.C. ("Westbrook"). Two of the Company's former board members are managing principals of Westbrook. The agreement was to expire on May 22, 2007 and included successive one-year renewal options. Pursuant to the agreement, the Predecessor was to receive from Westbrook a base management fee of 4.0% of gross operating revenues, as defined. This agreement was terminated in February 2004 following the sale of the hotel.

On May 29, 2002, the Company entered into eight asset management agreements with an affiliate to provide asset management services for the hotel properties owned by Westbrook. The agreements were to expire on May 29, 2007 and included successive one-year renewal options. Pursuant to the agreements, the Company was to receive an asset management fee of 1.0% of gross operating revenues, as defined. At December 31, 2004, none of the agreements were in effect due to the sale of all eight properties to an unaffiliated third party.

For the period October 26, 2004 through December 31, 2004, and the period January 1, 2004 through October 25, 2004 aggregate management fees and asset management fees earned from affiliates totaled \$4,000 and \$330,000, respectively. The Company did not earn any management fees for either of the years ended December 31, 2006 or 2005.

ACCOUNTING FEE

Prior to the Company's IPO, the Company received an accounting fee from certain affiliates equal to \$10 per available room per month. Aggregate accounting fees earned from affiliates totaled \$40,000 for the period January 1, 2004, through October 25, 2004. No accounting fees were earned by the Company during 2006, 2005, or during the period October 26, 2004 through December 31, 2004.

ACQUISITION FEES

During the period January 1, 2004 through October 1, 2004, in connection with successful acquisitions of hotel properties by certain affiliated companies, the Predecessor received aggregate acquisition fees in the amount of \$318,000, in exchange for rendering services in connection with such acquisitions. Such acquisition fees were recognized as revenue and were included in management and other fees from affiliates. No acquisition fees were earned in 2006, 2005, or during the period October 26, 2004 through December 31, 2004.

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 December 31, 2006 and 2005, amounts owed to the Company by its affiliates amounted to \$1.4 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 \$253,000, \$393,000, \$4,000 and \$743,000, respectively, for the years ended December 31, 2006 and 2005, the period October 26, 2004 through December 31, 2004, and the period January 1, 2004 through October 25, 2004.

17. QUARTERLY RESULTS (UNAUDITED)

The combined and consolidated quarterly results for the years ended December 31, 2006 and 2005, of the Company are as follows (in thousands):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
REVENUES — CONTINUING OPERATIONS				
2006	\$ 197,564	\$ 230,407	\$ 226,094	\$ 248,991
2005	101,298	113,316	161,060	210,804
OPERATING INCOME — CONTINUING OPERATIONS				
2006	26,166	41,484	33,343	33,533
2005	12,300	17,664	19,202	30,575
NET INCOME				
2006	17,825	22,052	1,536	11,824
2005	1,797	8,532	7,885	11,991
EARNINGS (LOSS) PER SHARE — BASIC AND DILUTED				
2006	\$ 0.25	\$ 0.29	\$ (0.06)	\$ 0.11
2005	\$ 0.04	\$ 0.17	\$ 0.09	\$ 0.16

Net income (loss) per share is computed independently for each of the quarters presented and therefore may not sum to the annual amount for the year. Previously reported revenues and operating income have been adjusted to account for current discontinued operations in accordance with Statement No. 144.

CONTRACT INTERPRETATION ISSUE

During the fourth quarter of 2005, the Company favorably resolved its contract interpretation issue with a customer who operates under a contract with the United States government, and fully reversed \$2.1 million in bad debt reserve which had been recorded by the Company in the second quarter of 2005.

18. SUBSEQUENT EVENTS

On January 4, 2007, the Company acquired the 499-room LAX Renaissance hotel located in Los Angeles, California for approximately \$65.0 million and named Marriott International as manager. The acquisition was initially funded through a draw on the Company's unsecured revolving credit facility that will be repaid through a partial settlement of the forward equity agreement.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND STOCKHOLDERS

SUNSTONE HOTEL INVESTORS, INC.:

We have audited the accompanying consolidated balance sheets of Sunstone Hotel Investors, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders' equity, and cash flows for the years ended December 31, 2006 and 2005, and for the period from October 26, 2004 (commencement of operations) through December 31, 2004, the related combined statements of operations, members' equity, and cash flows of the Sunstone Predecessor Company for the period January 1, 2004 through October 25, 2004. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Sunstone Hotel Investors, Inc. and subsidiaries at December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for the years ended December 31, 2006 and 2005, the period from October 26, 2004 (commencement of operations) through December 31, 2004, and the period from January 1, 2004 through October 25, 2004, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Sunstone Hotel Investors, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 6, 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP

Irvine, California
February 6, 2007

MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the New York Stock Exchange ("NYSE") under the symbol "SHO". On January 31, 2007, the last reported price per share of common stock on the NYSE was \$28.29. The table below sets forth the high and low closing price per share of our common stock as reported on the NYSE and the cash dividends per share of common stock we declared with respect to each period.

	High	Low	Distributions
2005:			
First Quarter	\$ 22.49	\$ 20.20	\$ 0.285
Second Quarter	\$ 25.01	\$ 21.20	\$ 0.285
Third Quarter	\$ 25.90	\$ 23.75	\$ 0.285
Fourth Quarter	\$ 27.15	\$ 22.00	\$ 0.300
2006:			
First Quarter	\$ 29.57	\$ 26.71	\$ 0.300
Second Quarter	\$ 31.20	\$ 27.37	\$ 0.300
Third Quarter	\$ 30.50	\$ 27.96	\$ 0.300
Fourth Quarter	\$ 30.64	\$ 26.25	\$ 0.320

We pay quarterly cash dividends to common stockholders at the discretion of our Board of Directors. The amount of each quarterly cash dividend depends on our funds from operations, financial condition and capital requirements, annual distribution requirements under the REIT provisions of the Internal Revenue Code and such other factors our Board of Directors deems relevant.

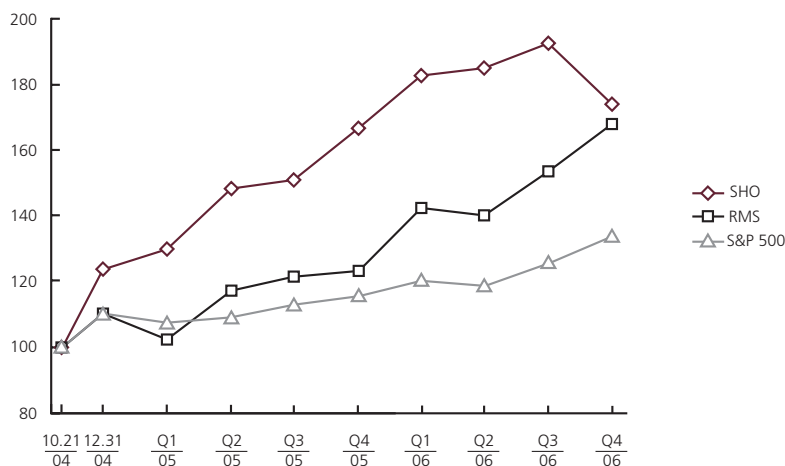
As of February 1, 2007, we had approximately 101 holders of record of our common stock. In order to comply with certain requirements related to our qualification as a REIT, our charter limits the number of common shares that may be owned by any single person or affiliated group to 9.8% of the outstanding common shares.

Information relating to compensation plans under which equity securities of the Company are authorized for issuance is set forth in Part III, Item 12 of our Form 10-K for the year ended December 31, 2006, which can be obtained from the Company without charge by contacting Sunstone Hotel Investors, Inc., 903 Calle Amanecer, Suite 100, San Clemente, CA 92673-6212

HISTORICAL PERFORMANCE COMPARISON

October 21, 2004 to December 31, 2006

Sunstone Hotel Investors, Inc. / S&P 500 Composite Stock Index / Morgan Stanley REIT Index



CORPORATE INFORMATION

BOARD OF DIRECTORS

LEWIS N. WOLFF
Chairman
Wolff Urban Development, LLC

ROBERT A. ALTER
Chief Executive Officer
Sunstone Hotel Investors, Inc.

Z. JAMIE BEHAR
Managing Director
General Motors Investment
Management Corporation

ANTHONY W. DONA
Partner,
Thackeray Partners

KEITH P. RUSSELL
President,
Russell Financial, Inc.

THOMAS A. LEWIS JR.
Chief Executive Officer
Realty Income Corporation

KEITH M. LOCKER
Chief Executive Officer
and President,
Inlet Capital, LLC

EXECUTIVE OFFICERS

ROBERT A. ALTER
Chief Executive Officer

JON D. KLINE
President

GARY A. STOUGAARD
Executive Vice President &
Chief Investment Officer

KENNETH E. CRUSE
Senior Vice President &
Chief Financial Officer

ANNUAL MEETING OF STOCKHOLDERS

The Annual Meeting will be held at 1:00 P.M. on May 1, 2007 at:
Long Beach Renaissance
111 East Ocean Blvd
Long Beach, CA 90802

TRANSFER AGENT

AMERICAN STOCK TRANSFER
& TRUST CO.
59 Maiden Lane
New York, NY 10038
(800) 937-5449

STOCK LISTING

Common Stock of the Company is traded on the New York Stock Exchange under the symbol "SHO". Series A Preferred Stock of the Company is traded on the New York Stock Exchange under the symbol "SHO PR A"

INDEPENDENT AUDITORS

Ernst & Young LLP

FORM 10-K AND OTHER MATERIALS

A copy of the Company's Annual Report on Form 10-K as filed with the Securities and Exchange Commission is available free of charge to its stockholders. Such requests should be made to:

INVESTOR RELATIONS

Sunstone Hotel Investors, Inc.
903 Calle Amanecer, Suite 100
San Clemente, CA 92673-6212
(949) 369-4204

investorrelations@sunstonehotels.com
www.sunstonehotels.com

CEO AND CFO CERTIFICATIONS

In 2006, the Company's Chief Executive Officer (CEO) provided to the New York Stock Exchange the annual CEO certification regarding the Company's compliance with the New York Stock Exchange's corporate governance listing standards. In addition, all required certifications by the Company's CEO and Chief Financial Officer regarding the quality of the Company's public disclosures in its fiscal 2006 reports were included in the Company's filings with the U.S. Securities and Exchange Commission.



SUNSTONE HOTEL INVESTORS, INC. ★ 903 CALLE AMANECER, SUITE 100 ★ SAN CLEMENTE, CA 92673 ★ 949 369 4000