

Sunstone Hotel Investors, Inc.
Form 10-Q
August 07, 2013
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from to

Commission file number 001-32319

Sunstone Hotel Investors, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Maryland
(State or Other Jurisdiction of
Incorporation or Organization)

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

120 Vantis, Suite 350
Aliso Viejo, California
(Address of Principal Executive Offices)

92656
(Zip Code)

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

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

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

162,870,635 shares of Common Stock, \$0.01 par value, as of August 1, 2013

Table of Contents

SUNSTONE HOTEL INVESTORS, INC.

QUARTERLY REPORT ON

FORM 10-Q

For the Quarterly Period Ended June 30, 2013

TABLE OF CONTENTS

| | Page |
|--|--|
| <u>PART I FINANCIAL INFORMATION</u> | |
| <u>Item 1.</u> | <u>Financial Statements:</u> |
| | <u>Consolidated Balance Sheets as of June 30, 2013 (unaudited) and December 31, 2012</u> |
| | 1 |
| | <u>Unaudited Consolidated Statements of Operations and Comprehensive Income (Loss) for the Three and Six Months Ended June 30, 2013 and 2012</u> |
| | 2 |
| | <u>Consolidated Statement of Equity as of June 30, 2013 (unaudited) and December 31, 2012</u> |
| | 3 |
| | <u>Unaudited Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2013 and 2012</u> |
| | 4 |
| | <u>Notes to Unaudited Consolidated Financial Statements</u> |
| | 5 |
| <u>Item 2.</u> | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> |
| | 23 |
| <u>Item 3.</u> | <u>Quantitative and Qualitative Disclosures about Market Risk</u> |
| | 45 |
| <u>Item 4.</u> | <u>Controls and Procedures</u> |
| | 45 |
| <u>PART II OTHER INFORMATION</u> | |
| <u>Item 1.</u> | <u>Legal Proceedings</u> |
| | 46 |
| <u>Item 1A.</u> | <u>Risk Factors</u> |
| | 46 |
| <u>Item 2.</u> | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> |
| | 46 |
| <u>Item 3.</u> | <u>Defaults Upon Senior Securities</u> |
| | 46 |
| <u>Item 4.</u> | <u>Mine Safety Disclosures</u> |
| | 46 |
| <u>Item 5.</u> | <u>Other Information</u> |
| | 46 |
| | 4 |

| | | |
|-------------------|-----------------|----|
| <u>Item 6.</u> | <u>Exhibits</u> | 47 |
| <u>SIGNATURES</u> | | 48 |

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

| | June 30, 2013 | December 31, 2012 |
|---|----------------------|--------------------------|
| | (unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 123,217 | \$ 157,217 |
| Cash proceeds held by accommodator | 72,287 | |
| Restricted cash | 76,711 | 78,394 |
| Accounts receivable, net | 34,463 | 27,498 |
| Inventories | 1,200 | 1,377 |
| Prepaid expenses | 6,280 | 10,739 |
| Assets held for sale, net | | 132,335 |
| Total current assets | 314,158 | 407,560 |
| Investment in hotel properties, net | 2,740,949 | 2,681,877 |
| Deferred financing fees, net | 10,453 | 11,931 |
| Goodwill | 9,405 | 9,405 |
| Other assets, net | 42,191 | 25,902 |
| Total assets | \$ 3,117,156 | \$ 3,136,675 |
| LIABILITIES AND EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 24,156 | \$ 22,646 |
| Accrued payroll and employee benefits | 22,417 | 26,738 |
| Dividends payable | 2,300 | 7,437 |
| Other current liabilities | 33,356 | 30,963 |
| Current portion of notes payable | 20,571 | 76,723 |
| Notes payable of assets held for sale | | 27,270 |
| Liabilities of assets held for sale | | 8,228 |
| Total current liabilities | 102,800 | 200,005 |
| Notes payable, less current portion | 1,275,626 | 1,286,666 |
| Capital lease obligations, less current portion | 15,603 | 15,621 |
| Other liabilities | 38,955 | 15,070 |
| Total liabilities | 1,432,984 | 1,517,362 |
| Commitments and contingencies <i>(Note 12)</i> | | |
| Preferred stock, Series C Cumulative Convertible Redeemable Preferred Stock, \$0.01 par value, 4,102,564 shares authorized, zero shares issued and outstanding at June 30, 2013 and | | 100,000 |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

4,102,564 shares issued and outstanding at December 31, 2012, liquidation preference of \$24.375 per share

Equity:

Stockholders' equity:

Preferred stock, \$0.01 par value, 100,000,000 shares authorized.

| | | |
|--|---------------------|---------------------|
| 8.0% Series A Cumulative Redeemable Preferred Stock, zero shares issued and outstanding at June 30, 2013 and 7,050,000 shares issued and outstanding at December 31, 2012, stated at liquidation preference of \$25.00 per share | 176,250 | |
| 8.0% Series D Cumulative Redeemable Preferred Stock, 4,600,000 shares issued and outstanding at June 30, 2013 and December 31, 2012, stated at liquidation preference of \$25.00 per share | 115,000 | 115,000 |
| Common stock, \$0.01 par value, 500,000,000 shares authorized, 160,855,950 shares issued and outstanding at June 30, 2013 and 135,237,438 shares issued and outstanding at December 31, 2012 | 1,609 | 1,352 |
| Additional paid in capital | 1,795,295 | 1,493,397 |
| Retained earnings | 205,788 | 158,376 |
| Cumulative dividends | (489,558) | (475,144) |
| Accumulated other comprehensive loss | | (5,335) |
| Total stockholders' equity | 1,628,134 | 1,463,896 |
| Non-controlling interest in consolidated joint ventures | 56,038 | 55,417 |
| Total equity | 1,684,172 | 1,519,313 |
| Total liabilities and equity | \$ 3,117,156 | \$ 3,136,675 |

See accompanying notes to consolidated financial statements.

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

| | Three Months Ended June 30, 2013 | Three Months Ended June 30, 2012 | Six Months Ended June 30, 2013 | Six Months Ended June 30, 2012 |
|---|-------------------------------------|-------------------------------------|-----------------------------------|-----------------------------------|
| REVENUES | | | | |
| Room | \$ 168,260 | \$ 148,302 | \$ 300,883 | \$ 267,924 |
| Food and beverage | 52,842 | 52,168 | 102,470 | 99,003 |
| Other operating | 13,536 | 12,372 | 26,206 | 24,149 |
| Total revenues | 234,638 | 212,842 | 429,559 | 391,076 |
| OPERATING EXPENSES | | | | |
| Room | 40,537 | 35,521 | 77,991 | 68,956 |
| Food and beverage | 35,058 | 34,032 | 70,154 | 66,882 |
| Other operating | 3,887 | 3,729 | 8,129 | 7,624 |
| Advertising and promotion | 11,240 | 10,193 | 22,505 | 20,094 |
| Repairs and maintenance | 8,275 | 7,593 | 16,649 | 15,076 |
| Utilities | 6,129 | 5,892 | 12,312 | 11,897 |
| Franchise costs | 8,771 | 7,493 | 15,249 | 13,464 |
| Property tax, ground lease and insurance | 19,297 | 17,284 | 37,765 | 32,837 |
| Property general and administrative | 25,288 | 23,611 | 48,894 | 45,521 |
| Corporate overhead | 7,359 | 7,575 | 13,530 | 12,773 |
| Depreciation and amortization | 32,175 | 31,305 | 66,191 | 62,187 |
| Total operating expenses | 198,016 | 184,228 | 389,369 | 357,311 |
| Operating income | 36,622 | 28,614 | 40,190 | 33,765 |
| Interest and other income | 788 | 74 | 1,351 | 137 |
| Interest expense | (17,272) | (19,429) | (34,686) | (38,788) |
| Loss on extinguishment of debt | | | (44) | (191) |
| Income (loss) before income taxes and discontinued operations | 20,138 | 9,259 | 6,811 | (5,077) |
| Income tax provision | (129) | | (6,286) | |
| Income (loss) from continuing operations | 20,009 | 9,259 | 525 | (5,077) |
| Income from discontinued operations | | 2,596 | 48,410 | 3,964 |
| NET INCOME (LOSS) | 20,009 | 11,855 | 48,935 | (1,113) |
| Income from consolidated joint venture attributable to non-controlling interest | (1,226) | (307) | (1,523) | (867) |
| Distributions to non-controlling interest | (8) | (8) | (16) | (16) |
| Preferred stock dividends and redemption charge | (3,510) | (7,437) | (14,413) | (14,874) |
| Undistributed income allocated to unvested restricted stock compensation | (126) | (47) | (264) | |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

| | | | | | | | | |
|--|----|---------|----|---------|----|---------|----|----------|
| INCOME AVAILABLE (LOSS ATTRIBUTABLE) TO COMMON STOCKHOLDERS | \$ | 15,139 | \$ | 4,056 | \$ | 32,719 | \$ | (16,870) |
| COMPREHENSIVE INCOME AVAILABLE (LOSS ATTRIBUTABLE) TO COMMON STOCKHOLDERS | \$ | 15,139 | \$ | 11,972 | \$ | 32,719 | \$ | (996) |
| Basic and diluted per share amounts: | | | | | | | | |
| Income (loss) from continuing operations available (attributable) to common stockholders | \$ | 0.09 | \$ | 0.01 | \$ | (0.10) | \$ | (0.18) |
| Income from discontinued operations | | 0.00 | | 0.02 | | 0.31 | | 0.04 |
| Basic and diluted income available (loss attributable) to common stockholders per common share | \$ | 0.09 | \$ | 0.03 | \$ | 0.21 | \$ | (0.14) |
| Basic and diluted weighted average common shares outstanding | | 160,843 | | 120,029 | | 155,987 | | 118,728 |
| Dividends declared per common share | \$ | | \$ | | \$ | | \$ | |

See accompanying notes to consolidated financial statements.

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

| | Preferred Stock | | Common Stock | | Additional Paid In Capital | Retained Earnings | Cumulative Dividends | Accumulated Comprehensive Loss | Non- Controlling Interest in Other Consolidated Joint Ventures | Total | | |
|--|---------------------------------|------------|---------------------------------|------------|----------------------------------|----------------------|-------------------------|--------------------------------------|---|-----------|---------------------|--------------|
| | Series A Number of Shares | Amount | Series D Number of Shares | Amount | | | | | | | Number of Shares | Amount |
| Balance at December 31, 2012 | 7,050,000 | \$ 176,250 | 4,600,000 | \$ 115,000 | 135,237,438 | \$ 1,352 | \$ 1,493,397 | \$ 158,376 | \$(475,144) | \$(5,335) | \$ 55,417 | \$ 1,519,313 |
| Net proceeds from sale of common stock, (unaudited) | | | | | 25,300,000 | 253 | 294,622 | | | | | 294,875 |
| Vesting of restricted common stock (unaudited) | | | | | 318,512 | 4 | 2,505 | | | | | 2,509 |
| Redemption of Series A and Series C preferred stock (unaudited) | (7,050,000) | (176,250) | | | | | 4,771 | (4,771) | | | | (176,250) |
| Distributions to non-controlling interest (unaudited) | | | | | | | | | | | (902) | (902) |
| Series A preferred dividends at \$0.50 per share through redemption date (unaudited) | | | | | | | | (2,350) | | | | (2,350) |
| Series C preferred dividends at \$0.786 per share through redemption date (unaudited) | | | | | | | | (2,693) | | | | (2,693) |
| Series D preferred dividends and dividends payable at \$1.00 per share year to date (unaudited) | | | | | | | | (4,600) | | | | (4,600) |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

| | | | | | | | | | | |
|--|----|-----------|------------|-------------|----------|--------------|------------|-------------|-----------|--------------|
| Net income (unaudited) | | | | 47,412 | | | | 1,523 | 48,935 | |
| Pension liability adjustment (unaudited) | | | | | | | | 5,335 | 5,335 | |
| Balance at June 30, 2013 (unaudited) | \$ | 4,600,000 | \$ 115,000 | 160,855,950 | \$ 1,609 | \$ 1,795,295 | \$ 205,788 | \$(489,558) | \$ 56,038 | \$ 1,684,172 |

See accompanying notes to consolidated financial statements.

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

| | Six Months Ended June 30, 2013 | Six Months Ended June 30, 2012 |
|--|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income (loss) | \$ 48,935 | \$ (1,113) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Bad debt expense (recovery) | 96 | (55) |
| Gain on sales of hotel properties and other assets, net | (51,625) | (188) |
| Loss on extinguishment of debt | 3,159 | 191 |
| (Gain) loss on derivatives, net | (417) | 499 |
| Depreciation | 62,055 | 62,854 |
| Amortization of franchise fees and other intangibles | 6,421 | 9,260 |
| Amortization and write-off of deferred financing fees | 1,485 | 1,932 |
| Amortization of loan discounts | 3 | 524 |
| Amortization of deferred stock compensation | 2,316 | 1,842 |
| Changes in operating assets and liabilities: | | |
| Restricted cash | (8,875) | (2,364) |
| Accounts receivable | (5,560) | (3,405) |
| Inventories | 1,628 | (44) |
| Prepaid expenses and other assets | 8,149 | 2,945 |
| Accounts payable and other liabilities | 12,697 | 9,733 |
| Accrued payroll and employee benefits | (6,414) | (2,059) |
| Discontinued operations | 432 | (684) |
| Net cash provided by operating activities | 74,485 | 79,868 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Proceeds from sales of hotel properties and other assets | 195,621 | 11 |
| Cash proceeds held by accommodator | (72,287) | |
| Restricted cash replacement reserve | 11,054 | (5,177) |
| Acquisitions of hotel properties and other assets | (59,137) | (29,694) |
| Acquisition deposits | (20,000) | (3,000) |
| Renovations and additions to hotel properties and other assets | (69,089) | (48,483) |
| Payment for interest rate derivative | (12) | |
| Net cash used in investing activities | (13,850) | (86,343) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Redemption of preferred stock | (276,250) | |
| Proceeds from common stock offering | 295,251 | 126,533 |
| Payment of common stock offering costs | (376) | (431) |
| Proceeds from credit facility | 30,000 | 15,000 |
| Payments on notes payable and credit facility | (124,465) | (63,024) |
| Payment for costs related to extinguishment of notes payable | (3,108) | (70) |
| Payments of deferred financing costs | (5) | |
| Dividends paid | (14,780) | (14,874) |
| Distributions to non-controlling interest | (902) | (3,327) |
| Net cash (used in) provided by financing activities | (94,635) | 59,807 |
| Net increase (decrease) in cash and cash equivalents | (34,000) | 53,332 |
| Cash and cash equivalents, beginning of period | 157,217 | 149,198 |
| Cash and cash equivalents, end of period | \$ 123,217 | \$ 202,530 |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

| | | | | |
|--|----|--------|----|--------|
| Cash paid for interest | \$ | 34,858 | \$ | 40,371 |
| Cash paid for income taxes | | 5,115 | \$ | |
| NONCASH INVESTING ACTIVITY | | | | |
| Accounts payable related to renovations and additions to hotel properties and other assets | \$ | 5,093 | \$ | 6,210 |
| Amortization of deferred stock compensation construction activities | \$ | 193 | \$ | 148 |
| NONCASH FINANCING ACTIVITY | | | | |
| Issuance of common stock in connection with acquisition of hotel property | \$ | | \$ | 51,160 |
| Dividends payable | \$ | 2,300 | \$ | 7,437 |

See accompanying notes to consolidated financial statements.

Table of Contents

SUNSTONE HOTEL INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Description of Business

Sunstone Hotel Investors, Inc. (the Company) was incorporated in Maryland on June 28, 2004 in anticipation of an initial public offering of common stock, which was consummated on October 26, 2004. 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 acquiring, owning, asset managing and renovating hotel properties. The Company may also sell certain hotel properties from time to time. The Company operates as a real estate investment trust (REIT) for federal income tax purposes.

As a REIT, certain tax laws limit the amount of non-qualifying income the Company can earn, including income derived directly from the operation of hotels. As a result, the Company leases all of its hotels to its TRS Lessee, which in turn enters into long-term management agreements with third parties to manage the operations of the Company's hotels. As of June 30, 2013, the Company had interests in 27 hotels (the 27 hotels) held for investment. The Company's third-party managers included subsidiaries of Marriott International, Inc. or Marriott Hotel Services, Inc. (collectively, Marriott), managers of 10 of the Company's 27 hotels; a subsidiary of Interstate Hotels & Resorts, Inc., manager of six of the Company's 27 hotels; Highgate Hotels L.P. and an affiliate, manager of three of the Company's 27 hotels; Davidson Hotels & Resorts and Hilton Worldwide, each a manager of two of the Company's 27 hotels; and Crestline Hotels & Resorts, Dimension Development Company, Fairmont Hotels & Resorts (U.S.) and Hyatt Corporation, each a manager of one of the Company's 27 hotels. In addition, as of June 30, 2012, the Company owned BuyEfficient, LLC (BuyEfficient), an electronic purchasing platform that allows members to procure food, operating supplies, furniture, fixtures and equipment.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements as of June 30, 2013 and December 31, 2012, and for the three and six months ended June 30, 2013 and 2012, include the accounts of the Company, the Operating Partnership, the TRS Lessee and their subsidiaries. All significant intercompany balances and transactions have been eliminated. The Company consolidates subsidiaries when it has the ability to direct the activities that most significantly impact the economic performance of the entity. The Company also evaluates its subsidiaries to determine if they should be considered variable interest entities (VIEs). Typically, the entity that has the power to direct the activities that most significantly impact economic performance would consolidate the VIE. The Company considers an entity a VIE if equity investors own an interest therein that does not have the characteristics of a controlling financial interest or if such investors do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. In accordance with the Consolidation Topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC), the Company reviewed its subsidiaries to determine if (i) they should be considered VIEs, and (ii) whether the Company should change its consolidation determination based on changes in the characteristics of these entities.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Non-controlling interests at both June 30, 2013 and December 31, 2012 represent the outside equity interests in various consolidated affiliates of the Company.

The accompanying interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) and in conformity with the rules and regulations of the Securities and Exchange Commission. In the Company s opinion, the interim financial statements presented herein reflect all adjustments, consisting solely of normal and recurring adjustments, which are necessary to fairly present the interim financial statements. These financial statements should be read in conjunction with the financial statements included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2012, filed with the Securities and Exchange Commission on February 25, 2013.

Certain prior year amounts have been reclassified in the consolidated financial statements in order to conform to the current year presentation.

The Company has evaluated subsequent events through the date of issuance of these financial statements.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP 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 differ materially from those estimates.

Table of Contents

Reporting Periods

The results the Company reports in its consolidated statements of operations and comprehensive income (loss) are based on results reported to the Company by its hotel managers. Prior to 2013, Marriott used a fiscal year ending on the Friday closest to December 31 and reported 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. Beginning in 2013, Marriott switched its reporting to a standard monthly calendar; however, Marriott's 2013 calendar contains an additional three days, December 29, 2012 through December 31, 2012. The Company and its other hotel managers use a standard monthly calendar to report their financial information. 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 2013 results of operations for the Marriott-managed hotels are reported on a calendar basis; however, the 2012 results of operations for the Marriott-managed hotels include results from December 31 through March 23 for the first quarter, March 24 through June 15 for the second quarter, June 16 through September 7 for the third quarter, and September 8 through December 28 for the fourth quarter.

Fair Value of Financial Instruments

As of June 30, 2013 and December 31, 2012, the carrying amount of certain financial instruments, including cash and cash equivalents, restricted cash, accounts receivable, accounts payable and accrued expenses were representative of their fair values due to the short-term maturity of these instruments.

The Company follows the requirements of the Fair Value Measurements and Disclosure Topic of the FASB ASC, which establishes a framework for measuring fair value and disclosing fair value measurements by establishing a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below:

- Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 Inputs reflect quoted prices for identical assets or liabilities in markets that are not active; quoted prices for similar assets or liabilities in active markets; inputs other than quoted prices that are observable for the asset or the liability; or inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3 Unobservable inputs reflecting the Company's own assumptions incorporated in valuation techniques used to determine fair value. These assumptions are required to be consistent with market participant assumptions that are reasonably available.

As discussed in Note 5, at June 30, 2013, the Company held two interest rate cap agreements and one interest rate swap agreement to manage its exposure to the interest rate risks related to its floating debt. The Company records interest rate protection agreements on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in the consolidated statements of operations and comprehensive income (loss) as they are not designated as hedges. In accordance with the Fair Value Measurements and Disclosure Topic of the FASB ASC, the Company estimates the fair value of its interest rate protection agreements based on quotes obtained from the counterparties, which are based upon the consideration that would be required to terminate the agreements. The Company has valued the derivative interest rate cap agreements using Level 2 measurements as an asset of \$0.1 million and \$48,000 as of June 30, 2013 and December 31, 2012, respectively. The interest rate cap agreements are included in other assets, net, on the accompanying consolidated balance sheets. The Company has valued the derivative interest rate swap agreement using Level 2 measurements as a liability of \$1.3 million and \$1.6 million as of June 30, 2013 and December 31,

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

2012, respectively. The interest rate swap agreement is included in other liabilities on the accompanying consolidated balance sheets.

On an annual basis and periodically when indicators of impairment exist, the Company analyzes the carrying values of its hotel properties and other assets using Level 3 measurements, including a discounted cash flow analysis to estimate the fair value of its hotel properties and other assets taking into account each property's expected cash flow from operations, holding period and estimated proceeds from the disposition of the property. The factors addressed in determining estimated proceeds from disposition included anticipated operating cash flow in the year of disposition and terminal capitalization rate. The Company did not identify any properties or other assets with indicators of impairment during the six months ended June 30, 2013 and 2012.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

On an annual basis and periodically when indicators of impairment exist, the Company also analyzes the carrying value of its goodwill using Level 3 measurements, including a discounted cash flow analysis to estimate the fair value of its reporting units. The Company did not identify any properties with indicators of goodwill impairment during the three and six months ended June 30, 2013 and 2012.

As of June 30, 2013 and December 31, 2012, 68.1% and 69.6%, respectively, of the Company's outstanding debt included in continuing operations had fixed interest rates, including the effect of an interest rate swap agreement. The Company's carrying value of its debt secured by properties not classified as discontinued operations totaled \$1.3 billion and \$1.4 billion as of June 30, 2013 and December 31, 2012, respectively. Using Level 3 measurements, including the Company's weighted average cost of debt ranging from 5.0% to 5.5%, the Company estimates that the fair market value of its debt included in continuing operations totaled \$1.3 billion as of both June 30, 2013 and December 31, 2012.

The following table presents the Company's assets measured at fair value on a recurring and non-recurring basis at June 30, 2013 and December 31, 2012 (in thousands):

| | Fair Value Measurements at Reporting Date | | | |
|--|---|-----------|-----------------|-----------|
| | Total | Level 1 | Level 2 | Level 3 |
| June 30, 2013 (unaudited): | | | | |
| Interest rate cap derivative agreements | \$ 105 | \$ | \$ 105 | \$ |
| Life insurance policy | 1,582 | | 1,582 | |
| Total assets at June 30, 2013 | \$ 1,687 | \$ | \$ 1,687 | \$ |
| December 31, 2012: | | | | |
| Interest rate cap derivative agreements | \$ 48 | \$ | \$ 48 | \$ |
| Life insurance policy | 1,494 | | 1,494 | |
| Total assets at December 31, 2012 | \$ 1,542 | \$ | \$ 1,542 | \$ |

The following table presents the Company's liabilities measured at fair value on a recurring and non-recurring basis at June 30, 2013 and December 31, 2012 (in thousands):

| | Fair Value Measurements at Reporting Date | | | |
|---|---|-----------|-----------------|-----------|
| | Total | Level 1 | Level 2 | Level 3 |
| June 30, 2013 (unaudited): | | | | |
| Interest rate swap derivative agreement | \$ 1,264 | \$ | \$ 1,264 | \$ |
| Retirement benefit agreement | 1,582 | | 1,582 | |
| Total liabilities at June 30, 2013 | \$ 2,846 | \$ | \$ 2,846 | \$ |
| December 31, 2012: | | | | |
| Interest rate swap derivative agreement | \$ 1,636 | \$ | \$ 1,636 | \$ |
| Retirement benefit agreement | 1,494 | | 1,494 | |
| Total liabilities at December 31, 2012 | \$ 3,130 | \$ | \$ 3,130 | \$ |

Accounts Receivable

Accounts receivable primarily represents receivables from hotel guests who occupy hotel rooms and utilize hotel services. Accounts receivable also includes, among other things, receivables from customers who utilize purchase volume rebates through BuyEfficient, as well as tenants who lease space in the Company's hotels. The Company maintains an allowance for doubtful accounts sufficient to cover potential credit losses. The Company's accounts receivable at both June 30, 2013 and December 31, 2012 includes an allowance for doubtful accounts of \$0.2 million.

Table of Contents

Acquisitions of Hotel Properties and Other Entities

Accounting for the acquisition of a hotel property or other entity as a purchase transaction requires an allocation of the purchase price to the assets acquired and the liabilities assumed in the transaction at their respective estimated fair values. The most difficult estimations of individual fair values are those involving long-lived assets, such as property, equipment, intangible assets and any capital lease obligations that are assumed as part of the acquisition of a leasehold interest. During 2012 and the first six months of 2013, the Company used all available information to make these fair value determinations, and engaged an independent valuation specialist to assist in the fair value determination of the long-lived assets acquired and the liabilities assumed in the Company's purchases of the Hilton New Orleans St. Charles, the Hyatt Chicago Magnificent Mile and the Hilton Garden Inn Chicago Downtown/Magnificent Mile. Due to the inherent subjectivity in determining the estimated fair value of long-lived assets, the Company believes that the recording of acquired assets and liabilities is a critical accounting policy.

Assets Held for Sale

The Company considers a hotel or other asset held for sale if it is probable that the sale will be completed within twelve months. A sale is determined to be probable once the buyer completes its due diligence of the asset, there is an executed purchase and sale agreement between the Company and the buyer, and the Company has received a substantial non-refundable deposit. The Company tests hotels or other assets held for sale for impairment each reporting period, and records them at the lower of their carrying amounts or fair value less costs to sell. Once a hotel or other asset is designated as held for sale, depreciation is ceased and the hotel or other asset is included in discontinued operations. As of June 30, 2013, we had no hotels or other assets held for sale. As of December 31, 2012, the Company classified four hotels and a commercial laundry facility as held for sale due to their sale in January 2013.

Deferred Financing Fees

Deferred financing fees consist of loan fees and other financing costs related to the Company's outstanding indebtedness and credit facility commitments, and are amortized to interest expense over the terms of the related debt or commitment. Upon repayment or refinancing of the underlying debt, any related unamortized deferred financing fee is charged to interest expense. Upon any loan modification, any related unamortized deferred financing fee is amortized over the remaining terms of the modified loan.

The Company paid deferred financing fees of \$5,000 during the three and six months ended June 30, 2013 related to the purchase of an interest rate cap derivative agreement on the Hilton San Diego Bayfront mortgage. The Company did not incur or pay any deferred financing fees during either the three or six months ended June 30, 2012.

Total amortization and write-off of deferred financing fees for the three and six months ended June 30, 2013 and 2012 was as follows (in thousands):

| Three Months Ended June 30, 2013 | Three Months Ended June 30, 2012 | Six Months Ended June 30, 2013 | Six Months Ended June 30, 2012 |
|---|---|---|---|
|---|---|---|---|

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

| | (unaudited) | | (unaudited) | | (unaudited) | | (unaudited) |
|---|-------------|----|-------------|----|-------------|----|-------------|
| Continuing operations: | | | | | | | |
| Amortization of deferred financing fees | \$ 725 | \$ | 939 | \$ | 1,483 | \$ | 1,882 |
| Write-off of deferred financing fees | | | 3 | | | | 3 |
| Total deferred financing fees continuing operations | 725 | | 942 | | 1,483 | | 1,885 |
| Discontinued operations: | | | | | | | |
| Amortization of deferred financing fees | | | 23 | | 2 | | 47 |
| Write-off of deferred financing fees | | | | | | | |
| Total deferred financing fees discontinued operations | | | 23 | | 2 | | 47 |
| Total amortization of deferred financing fees | \$ 725 | \$ | 965 | \$ | 1,485 | \$ | 1,932 |

Earnings Per Share

The Company applies the two-class method when computing its earnings per share as required by the Earnings Per Share Topic of the FASB ASC, which requires the net income per share for each class of stock (common stock and convertible preferred stock) to be calculated assuming 100% of the Company's net income is distributed as dividends to each class of stock based on their contractual rights. To the extent the Company has undistributed earnings in any calendar quarter, the Company will follow the two-class method of computing earnings per share.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

The Company follows the requirements of the Earnings Per Share Topic of the FASB ASC, which states that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. For the three and six months ended June 30, 2013, undistributed earnings representing nonforfeitable dividends of \$0.1 million and \$0.3 million, respectively were allocated to the participating securities. For the three and six months ended June 30, 2012, undistributed earnings representing nonforfeitable dividends of \$47,000 and zero, respectively, were allocated to the participating securities.

In accordance with the Earnings Per Share Topic of the FASB ASC, basic earnings available (loss attributable) to common stockholders per common share is computed based on the weighted average number of shares of common stock outstanding during each period. Diluted earnings available (loss attributable) to common stockholders per common share is computed based on the weighted average number of shares of common stock outstanding during each period, plus potential common shares considered outstanding during the period, as long as the inclusion of such awards is not anti-dilutive. Potential common shares consist of unvested restricted stock awards and the incremental common shares issuable upon the exercise of stock options, using the more dilutive of either the two-class method or the treasury stock method.

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

| | Three Months Ended June 30, 2013 (unaudited) | Three Months Ended June 30, 2012 (unaudited) | Six Months Ended June 30, 2013 (unaudited) | Six Months Ended June 30, 2012 (unaudited) |
|---|---|---|---|---|
| Numerator: | | | | |
| Net income (loss) | \$ 20,009 | \$ 11,855 | \$ 48,935 | \$ (1,113) |
| Income from consolidated joint venture attributable to non-controlling interest | (1,226) | (307) | (1,523) | (867) |
| Distributions to non-controlling interest | (8) | (8) | (16) | (16) |
| Preferred stock dividends and redemption charge | (3,510) | (7,437) | (14,413) | (14,874) |
| Undistributed income allocated to unvested restricted stock compensation | (126) | (47) | (264) | |
| Numerator for basic and diluted earnings available (loss attributable) to common stockholders | \$ 15,139 | \$ 4,056 | \$ 32,719 | \$ (16,870) |
| Denominator: | | | | |
| Weighted average basic and diluted common shares outstanding | 160,843 | 120,029 | 155,987 | 118,728 |
| Basic and diluted earnings available (loss attributable) to common stockholders per common share | \$ 0.09 | \$ 0.03 | \$ 0.21 | \$ (0.14) |

The Company's unvested restricted shares associated with its long-term incentive plan and shares associated with common stock options have been excluded from the above calculation of earnings (loss) per share for the three and six months ended June 30, 2013 and 2012, as their inclusion would have been anti-dilutive. Prior to their redemption in May 2013, the shares of the Company's Series C Cumulative Convertible Redeemable Preferred Stock (Series C preferred stock) issuable upon conversion were excluded from the above calculation of earnings (loss) per share for the three and six months ended June 30, 2013 and 2012, as their inclusion would have been anti-dilutive.

Goodwill

The Company follows the requirements of the Intangibles – Goodwill and Other Topic of the FASB ASC, which states that 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 assets is reviewed at least annually for impairment. In addition, when facts and circumstances suggest that the Company's goodwill may be impaired, an interim evaluation of goodwill is prepared. Such review entails comparing the carrying value of the individual hotel property or other asset (the reporting unit) including the allocated goodwill to the fair value determined for that reporting unit (see Fair Value of Financial Instruments for detail on the Company's valuation methodology). If the aggregate carrying value of the reporting unit exceeds the fair value, the goodwill of the reporting unit 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. The Company's annual impairment evaluation is performed each year as of December 31.

Table of Contents

Non-Controlling Interests

The Company's financial statements include entities in which the Company has a controlling financial interest. Non-controlling interest is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. Such non-controlling interests are reported on the consolidated balance sheets within equity, separately from the Company's equity. On the consolidated statements of operations and comprehensive income (loss), revenues, expenses and net income or loss from less-than-wholly-owned subsidiaries are reported at the consolidated amounts, including both the amounts attributable to the Company and non-controlling interests. Income or loss is allocated to non-controlling interests based on their weighted average ownership percentage for the applicable period. The consolidated statements of equity include beginning balances, activity for the period and ending balances for each component of shareholders' equity, non-controlling interests and total equity.

At both June 30, 2013 and December 31, 2012, the non-controlling interest reported in the Company's financial statements includes Hilton Worldwide's 25.0% ownership in the Hilton San Diego Bayfront. In addition, the Company is the sole common stockholder of the captive REIT that owns the Doubletree Guest Suites Times Square; however, there are also preferred investors in the captive REIT whose preferred dividends less administrative fees for the three and six months ended June 30, 2013 and 2012 are represented as distributions to non-controlling interests on the Company's statements of operations and comprehensive income (loss).

Segment Reporting

The Company reports its consolidated financial statements in accordance with the Segment Reporting Topic of the FASB ASC. Currently, the Company operates in one segment, operations held for investment.

Stock Based Compensation

Compensation expense related to awards of restricted shares and performance shares are measured at fair value on the date of grant and amortized over the relevant requisite service period or derived service period.

3. Investment in Hotel Properties

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

| | June 30, 2013 (unaudited) | December 31, 2012 |
|------|--|------------------------------|
| Land | \$ 264,637 | \$ 260,939 |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

| | | |
|---|--------------|--------------|
| Buildings and improvements | 2,655,644 | 2,541,024 |
| Furniture, fixtures and equipment | 366,536 | 329,770 |
| Intangibles | 167,723 | 167,467 |
| Franchise fees | 1,346 | 1,261 |
| Construction in process | 19,822 | 48,388 |
| | 3,475,708 | 3,348,849 |
| Accumulated depreciation and amortization | (734,759) | (666,972) |
| | \$ 2,740,949 | \$ 2,681,877 |

In May 2013, the Company purchased the 250-room Hilton New Orleans St. Charles for a net purchase price of \$59.1 million, including \$0.2 million of proration credits. The acquisition was funded with \$53.2 million of proceeds generated by the Company's January 2013 sale of four hotels and a commercial laundry facility located in Rochester, Minnesota (see Note 4), as well as with proceeds received from the Company's February 2013 issuance of common stock. The Company recorded the acquisition at fair value using an independent third-party analysis, with the purchase price allocated to investment in hotel properties and hotel working capital assets and liabilities. The Company recognized acquisition-related costs of \$0.2 million and \$0.3 million for the three and six months ended June 30, 2013, respectively, which are included in corporate overhead on the Company's consolidated statements of operations and comprehensive income (loss). The results of operations for the Hilton New Orleans St. Charles have been included in the Company's consolidated statements of operations and comprehensive income (loss) from the acquisition date of May 1, 2013 through the second quarter ended June 30, 2013.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

The fair values of the assets acquired and liabilities assumed at the date of acquisition for the Hilton New Orleans St. Charles were allocated based on an independent third-party analysis. The following table summarizes the fair values of assets acquired and liabilities assumed in this acquisition (in thousands):

| | |
|--|------------------|
| Assets: | |
| Investment in hotel properties (1) | \$ 59,001 |
| Cash | 5 |
| Accounts receivable | 48 |
| Prepaid expenses | 322 |
| Total assets acquired | 59,376 |
| Liabilities: | |
| Accrued payroll and employee benefits | 38 |
| Other current liabilities | 196 |
| Total liabilities acquired | 234 |
| Total cash paid for acquisition | \$ 59,142 |

(1) Investment in hotel properties was allocated to land (\$3.7 million), buildings and improvements (\$53.5 million), furniture, fixtures and equipment (\$1.4 million), intangibles (\$0.3 million) related to an above-market in-place lease agreement, and franchise fees (\$0.1 million) related to a franchise agreement. Details of the intangibles and the franchise agreement are as follows (in thousands):

| | June 30, 2013 (unaudited) | Expected Life |
|---|--------------------------------------|----------------------|
| Value at acquisition: | | |
| Above market lease agreement | \$ 27 | 46 months |
| In-place lease agreement | 228 | 46 months |
| Franchise agreement | 85 | 15 years |
| Total intangibles and franchise fees related to the 2013 acquisition | 340 | |
| Accumulated amortization | (10) | |
| | \$ 330 | |

During the three and six months ended June 30, 2013, the Company recorded amortization expense related to its Hilton New Orleans St. Charles intangibles as follows (in thousands):

| | Three Months Ended June 30, 2013 (unaudited) | Six Months Ended June 30, 2013 (unaudited) |
|------------------------------|---|---|
| Above market lease agreement | \$ (1) | \$ (1) |
| In-place lease agreement | 10 | 10 |
| Franchise agreement | 1 | 1 |
| | \$ 10 | \$ 10 |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

The Company acquired one hotel during the six months ended June 30, 2013, and two hotels during 2012: the Hilton New Orleans St. Charles in May 2013; the Hyatt Chicago Magnificent Mile in June 2012; and the Hilton Garden Inn Chicago Downtown/Magnificent Mile in July 2012. Acquired properties are included in the Company's results of operations and comprehensive income (loss) from the date of acquisition. The following unaudited pro forma results of operations reflect the Company's results as if the acquisitions of the Hilton New Orleans St. Charles in May 2013, the Hyatt Chicago Magnificent Mile in June 2012 and the Hilton Garden Inn Chicago Downtown/Magnificent Mile in July 2012 had occurred on January 1, 2012. In the Company's opinion, all significant adjustments necessary to reflect the effects of the acquisitions have been made (in thousands, except per share data):

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

| | Three Months Ended June 30, 2013 (unaudited) | Three Months Ended June 30, 2012 (unaudited) | Six Months Ended June 30, 2013 (unaudited) | Six Months Ended June 30, 2012 (unaudited) |
|--|--|--|--|--|
| Revenues | \$ 235,984 | \$ 226,686 | \$ 434,584 | \$ 415,416 |
| Income available (loss attributable) to common stockholders from continuing operations | \$ 15,587 | \$ 6,269 | \$ 34,067 | \$ (16,918) |
| Income (loss) per diluted share available (attributable) to common stockholders from continuing operations | \$ 0.10 | \$ 0.03 | \$ (0.09) | \$ (0.17) |

For both the three and six months ended June 30, 2013, the Company has included \$1.9 million of revenue and net income of \$0.3 million in its consolidated statements of operations and comprehensive income (loss) related to the Company's May 2013 acquisition. For both the three and six months ended June 30, 2012, the Company has included \$2.7 million of revenue and a net loss of \$0.9 million in its consolidated statements of operations and comprehensive income (loss) related to the Company's 2012 acquisition.

4. Discontinued Operations

In January 2013, the Company sold a four-hotel, 1,222-room portfolio (the Rochester Hotels) and a commercial laundry facility (together with the Rochester Hotels, the Rochester Portfolio) in Rochester, Minnesota, to an unaffiliated third party, for net proceeds of \$195.6 million, of which \$145.7 million was deposited with an accommodator in order to facilitate potential tax-deferred exchanges. The Rochester Hotels include the 660-room Kahler Grand, the 271-room Kahler Inn & Suites, the 202-room Marriott Rochester and the 89-room Residence Inn by Marriott Rochester. The Company recognized a net gain on the sale of \$51.6 million. The Company retained a \$25.0 million preferred equity investment (the Preferred Equity Investment) in the Rochester Hotels that yields an 11% dividend, resulting in a deferred gain on the sale of \$25.0 million. The \$25.0 million gain will be deferred until the Preferred Equity Investment is redeemed. The Preferred Equity Investment is recorded at face value on the Company's consolidated balance sheet net of the deferred gain, resulting in a net book value of zero on the Company's consolidated balance sheet as of June 30, 2013. During the three and six months ended June 30, 2013, the Company recognized \$0.7 million and \$1.2 million, respectively, in dividends on the Preferred Equity Investment, which is included in interest and other income on the Company's consolidated statements of operations and comprehensive income (loss). The Company also provided a \$3.7 million working cash advance to the buyer, resulting in a deferred gain on the sale of \$3.7 million. The \$3.7 million gain will be deferred until the Company is repaid from the Rochester Portfolio's available cash flow. The working cash advance is recorded at face value on the Company's consolidated balance sheet net of the deferred gain, resulting in a net book value of zero on the Company's consolidated balance sheet as of June 30, 2013. In addition, the Company retained a liability not to exceed \$14.0 million related to the Rochester Portfolio's pension plan, which could be triggered in certain circumstances, including termination of the pension plan. The \$14.0 million pension plan liability is included in other liabilities on the Company's consolidated balance sheet as of June 30, 2013. The recognition of the \$14.0 million pension plan liability reduced the Company's gain on the sale of the Rochester Portfolio. The \$14.0 million gain will be recognized, if at all, when and to the extent the Company is released from any potential liability related to the Rochester Portfolio's pension plan. Concurrent with the Rochester Portfolio sale, the Company extinguished the outstanding \$26.7 million mortgage secured by the Kahler Grand for a total cost of \$29.8 million, prepaid the \$0.4 million loan secured by the commercial laundry facility, and recorded a loss on extinguishment of debt of \$3.1 million which is included in discontinued operations. The Company reclassified the Rochester Portfolio's results of operations for January 2013 and the six months ended June 30, 2012, to discontinued operations on its consolidated statements of operations and comprehensive income (loss).

Prior to the sale of the Rochester Portfolio, pension liability adjustments related to the Rochester Portfolio's defined benefit retirement plan were recorded as other comprehensive income (loss). The following table details the activity in accumulated other comprehensive loss in January 2013 due to the sale of the Rochester Portfolio (in thousands):

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

| | One Month Ended January 31, 2013 (unaudited) | Affected Line in the Company's Statements of Operations and Comprehensive Income (Loss) |
|--|---|--|
| Beginning balance of accumulated other comprehensive loss | \$ (5,335) | |
| Sale of Rochester Portfolio pension liability adjustment | 5,335 | Income from discontinued operations |
| Ending balance of accumulated other comprehensive loss | \$ | |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

During 2012, the Company sold four hotels and an office building adjacent to one of the sold hotels. In August 2012, the Company sold the Marriott Del Mar located in San Diego, California for net proceeds of \$17.7 million, including the assumption of the existing mortgage secured by the hotel which totaled \$47.1 million on the date of sale, and recognized a gain on the sale of \$25.5 million. In addition, the Company wrote off \$48,000 in deferred financing fees in conjunction with the buyer's assumption of the debt secured by the hotel. The Company reclassified the hotel's results of operations for the first eight months of 2012 to discontinued operations on its consolidated statements of operations and comprehensive income (loss).

In September 2012, the Company sold a portfolio of assets that included the Doubletree Guest Suites Minneapolis, the Hilton Del Mar, the Marriott Troy (located in Minneapolis, Minnesota, San Diego, California, and Troy, Michigan, respectively) and an office building adjacent to the Marriott Troy for net proceeds of \$28.6 million, including the assumptions of three separate mortgages secured by the hotels totaling \$75.6 million, as well as a \$2.2 million liability for deferred management fees payable to the Marriott Troy's third-party manager. The Company recognized a gain on the sale of \$12.7 million. In addition, the Company wrote off \$0.1 million in deferred financing fees in conjunction with the buyer's assumption of the debt secured by the three hotels. The Company reclassified the results of operations for the Doubletree Guest Suites Minneapolis, the Hilton Del Mar, the Marriott Troy and the office building to discontinued operations for the first nine months of 2012 on its consolidated statements of operations and comprehensive income (loss).

In March 2012, the Company recorded additional gain of \$0.2 million on the sale of the Royal Palm Miami Beach, which the Company sold in April 2011. The \$0.2 million gain was comprised of reimbursements to the Company for certain transaction related invoices, and is included in discontinued operations on the Company's consolidated statements of operations and comprehensive income (loss).

The following table sets forth the discontinued operations for the three and six months ended June 30, 2013 and 2012 for the four hotels and the commercial laundry facility sold in 2013, as well as the four hotels and the office building sold in 2012 and the Royal Palm Miami Beach sold in 2011 (in thousands):

| | Three Months Ended June 30, 2013 (unaudited) | Three Months Ended June 30, 2012 (unaudited) | Six Months Ended June 30, 2013 (unaudited) | Six Months Ended June 30, 2012 (unaudited) |
|--|--|--|--|--|
| Operating revenues | \$ | \$ 29,133 | \$ 3,690 | \$ 56,120 |
| Operating expenses | | (20,427) | (3,686) | (40,205) |
| Interest expense | | (2,127) | (99) | (4,271) |
| Depreciation and amortization expense | | (3,983) | | (7,857) |
| Loss on extinguishment of debt | | | (3,115) | |
| Gain on sale of hotels and other assets, net | | | 51,620 | 177 |
| Income from discontinued operations | \$ | \$ 2,596 | \$ 48,410 | \$ 3,964 |

5. Interest Rate Derivative Agreements

At June 30, 2013 and December 31, 2012, the Company held two interest rate cap agreements and one interest rate swap agreement to manage its exposure to the interest rate risks related to its floating rate debt. The first interest rate cap agreement is on the Hilton San Diego Bayfront mortgage, which mortgage bears an interest rate of 3-month LIBOR plus 325 basis points. In April 2013, the Company purchased a new interest rate cap agreement on the Hilton San Diego Bayfront mortgage for a cost of \$12,000 which extended the maturity date from April 2013 to

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

April 2015. The new interest rate cap agreement on the Hilton San Diego Bayfront continues to cap the 3-month LIBOR rate at 3.75%. The notional amount of the related debt capped totaled \$117.0 million at June 30, 2013 and \$120.0 million at December 31, 2012. The second interest rate cap agreement is on the Doubletree Guest Suites Times Square mortgage, which mortgage bears an interest rate of 3-month LIBOR plus 325 basis points. The Doubletree Guest Suites Times Square cap agreement caps the 3-month LIBOR rate at 4.0% until October 2015. The notional amount of the related debt capped totaled \$180.0 million at June 30, 2013.

The interest rate swap agreement is on the JW Marriott New Orleans mortgage. The interest rate swap agreement caps the LIBOR interest rate on the underlying debt at a total interest rate of 5.45%, and the maturity date is in September 2015. The notional amount of the related debt totaled \$40.2 million as of June 30, 2013.

Table of Contents

None of the interest rate derivative agreements qualify for effective hedge accounting treatment. Accordingly, changes in the fair value of the Company's interest rate derivative agreements during the three and six months ended June 30, 2013 resulted in net gains of \$0.3 million and \$0.4 million, respectively, which have been reflected as decreases in interest expense for the three and six months ended June 30, 2013. Changes in the fair value of the Company's interest rate derivative agreements during the three and six months ended June 30, 2012 resulted in net losses of \$0.4 million and \$0.5 million, respectively, which have been reflected as increases in interest expense for the three and six months ended June 30, 2012. As of June 30, 2013 and December 31, 2012, the fair values of the interest rate cap agreements totaled an asset of \$0.1 million and \$48,000, respectively. The interest rate cap agreements are included in other assets, net on the Company's consolidated balance sheets. The fair value of the interest rate swap agreement was a liability of \$1.3 million and \$1.6 million as of June 30, 2013 and December 31, 2012, respectively, and is included in other liabilities on the Company's consolidated balance sheets.

6. Other Assets

Other assets, net consisted of the following (in thousands):

| | June 30, 2013 (unaudited) | December 31, 2012 |
|---|--|------------------------------|
| Acquisition deposits | \$ 20,000 | \$ |
| Property and equipment, net | 2,542 | 2,529 |
| Land held for development | 188 | 188 |
| Intangibles, net | 7,577 | 7,877 |
| Dividends receivable | 229 | |
| Interest rate cap derivative agreements | 105 | 48 |
| Cash trap receivables | 4,443 | 8,208 |
| Other receivables | 4,115 | 4,130 |
| Other | 2,992 | 2,922 |
| | \$ 42,191 | \$ 25,902 |

During the first six months of 2013, the Company paid refundable deposits totaling \$20.0 million towards the July 2013 acquisition of the Boston Park Plaza (see Note 13).

Property and equipment, net consisted of the following (in thousands):

| | June 30, 2013 (unaudited) | December 31, 2012 |
|-----------------------------|--|------------------------------|
| Cost basis | \$ 10,554 | \$ 10,153 |
| Accumulated depreciation | (8,012) | (7,624) |
| Property and equipment, net | \$ 2,542 | \$ 2,529 |

The Company's other assets, net as of June 30, 2013 and December 31, 2012, include BuyEfficient's intangible assets totaling \$7.6 million and \$7.9 million, respectively, net of accumulated amortization related to certain trademarks, customer and supplier relationships and intellectual

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

property related to internally developed software. These intangibles are amortized using the straightline method over their useful lives ranging between seven to 20 years. Accumulated amortization totaled \$1.5 million and \$1.2 million at June 30, 2013 and December 31, 2012, respectively. Amortization expense totaled \$0.1 million for both the three months ended June 30, 2013 and 2012, and \$0.3 million for both the six months ended June 30, 2013 and 2012.

The Company's other assets, net as of June 30, 2013 include \$0.2 million in dividends to be received for the month of June on the Preferred Equity Investment. During the three and six months ended June 30, 2013, the Company recognized a total of \$0.7 million and \$1.2 million, respectively, in dividends on the Preferred Equity Investment, which are included in interest and other income on the Company's consolidated statements of operations and comprehensive income (loss).

In conjunction with the Company's third quarter 2012 sales of the Marriott Del Mar, the Hilton Del Mar and the Marriott Troy, the mortgages secured by these hotels were assumed by the buyers of the hotels. These mortgages contain "cash trap" provisions that were triggered in prior years due to the decline in the performance of the three hotels. Once triggered, substantially all of the excess cash flow from operations generated by the three hotels was deposited directly into lockbox accounts and then swept into cash management accounts for the benefit of the lenders. Cash was distributed to the Company only after certain items were paid, including deposits into leasing and maintenance reserve accounts and the payment of debt service, insurance, taxes, operating expenses, and extraordinary capital expenditures and leasing expenses. During the three and six months ended June 30, 2013, a total of \$3.8 million was returned to the Company related to the mortgages secured by the Marriott Del Mar and the Marriott Troy. The remaining \$4.4 million continues to be held by the lender associated with the mortgage secured by the Hilton Del Mar. The remaining cash will be returned to the Company once the lender releases the cash to the buyer, which is expected to occur within the near term.

Table of Contents**7. Notes Payable**

Notes payable consisted of the following (in thousands):

| | June 30, 2013 (unaudited) | December 31, 2012 |
|---|---------------------------------|----------------------|
| Notes payable requiring payments of interest and principal, with fixed rates ranging from 4.97% to 6.60%; maturing at dates ranging from May 2015 through May 2021. The notes are collateralized by first deeds of trust on 13 hotel properties at both June 30, 2013, and December 31, 2012. | \$ 883,085 | \$ 890,668 |
| Note payable requiring payments of interest and principal, bearing a blended rate of 3-month LIBOR plus 325 basis points; maturing in April 2016. The note is collateralized by a first deed of trust on one hotel property. | 233,112 | 234,724 |
| Note payable requiring payments of interest only through October 2013, and interest and principal thereafter, with a blended interest rate of 3-month LIBOR plus 325 basis points; maturing in October 2018. The note is collateralized by a first deed of trust on one hotel property. | 180,000 | 180,000 |
| Senior Notes, with a fixed interest rate of 4.60%, maturing in July 2027. Repurchased and redeemed in January 2013. The notes were guaranteed by the Company and certain of its subsidiaries. | | 58,000 |
| | 1,296,197 | 1,363,392 |
| Less: discount on Senior Notes | | (3) |
| | 1,296,197 | 1,363,389 |
| Less: current portion | (20,571) | (76,723) |
| | \$ 1,275,626 | \$ 1,286,666 |

In January 2013, the Company validly tendered, accepted and repurchased \$42.0 million of the Senior Notes, and redeemed the remaining \$16.0 million of the Senior Notes. The Company funded the total \$58.0 million in Senior Note repurchases and redemptions with available cash, leaving no future amounts outstanding related to the Senior Notes.

Concurrent with the Rochester Portfolio sale in January 2013, the Company extinguished the outstanding \$26.7 million mortgage secured by the Kahler Grand for a total cost of \$29.8 million, prepaid the \$0.4 million loan secured by the commercial laundry facility, and recorded a loss on extinguishment of debt of \$3.1 million which is included in discontinued operations.

In February 2012, the Company used its existing cash to repurchase \$4.5 million in aggregate principal amount of the Senior Notes for \$4.57 million. After the repurchase, such Senior Notes were cancelled. The Company wrote off \$47,000 in deferred financing fees and \$0.1 million of the Senior Notes discount, and recognized a loss of \$0.2 million on this early extinguishment of debt.

In April 2012, the Company used existing cash to repay the remaining balance on its \$32.2 million non-recourse mortgage secured by the Renaissance Long Beach, which was scheduled to mature in July 2012. The Company wrote off \$3,000 in deferred financing fees in connection with the repayment of this debt.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

In August 2012, the buyer of the Marriott Del Mar assumed the \$47.1 million existing mortgage secured by the hotel, and the Company wrote off \$48,000 in related deferred financing fees.

In September 2012, the buyer of the portfolio that included the Doubletree Guest Suites Minneapolis, the Hilton Del Mar, the Marriott Troy and an office building adjacent to the Marriott Troy assumed \$75.6 million in existing mortgages secured by the three hotels in the portfolio, and the Company wrote off \$0.1 million in related deferred financing fees.

In September 2012, the Company amended and restated its \$150.0 million senior unsecured revolving credit facility, which was scheduled to mature in November 2013. The pricing on the amended revolving credit facility was reduced and the 1% LIBOR floor was eliminated. The maturity of the credit facility was extended by two years to November 2015 with an option to extend to November 2016. The amended credit facility's interest rate is based on a pricing grid with a range of 175 to 350 basis points, which represents a reduction from the previous grid that ranged from 325 to 425 basis points over LIBOR depending on the Company's leverage ratio. The credit facility also includes an accordion option that allows the Company to request additional lender commitments up to a total of \$350.0 million. The Company paid \$1.3 million in deferred financing fees in conjunction with this amendment, which will be amortized over the term of the amended credit facility.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

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

| | Three Months Ended June 30, 2013 (unaudited) | Three Months Ended June 30, 2012 (unaudited) | Six Months Ended June 30, 2013 (unaudited) | Six Months Ended June 30, 2012 (unaudited) |
|---|--|--|--|--|
| Interest expense | \$ 16,807 | \$ 17,806 | \$ 33,617 | \$ 35,880 |
| (Gain) loss on derivatives | (260) | 423 | (417) | 499 |
| Accretion of Senior Notes | | 258 | 3 | 524 |
| Amortization of deferred financing fees | 725 | 939 | 1,483 | 1,882 |
| Write-off of deferred financing fees | | 3 | | 3 |
| | \$ 17,272 | \$ 19,429 | \$ 34,686 | \$ 38,788 |

8. Other Current Liabilities and Other Liabilities

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

| | June 30, 2013 (unaudited) | December 31, 2012 |
|---------------------------------------|---------------------------------|----------------------|
| Property, sales and use taxes payable | \$ 16,434 | \$ 13,254 |
| Income tax payable | 125 | 125 |
| Accrued interest | 3,744 | 4,901 |
| Advance deposits | 8,362 | 6,938 |
| Management fees payable | 837 | 2,346 |
| Other | 3,854 | 3,399 |
| | \$ 33,356 | \$ 30,963 |

Other liabilities consisted of the following (in thousands):

| | June 30, 2013 (unaudited) | December 31, 2012 |
|---|---------------------------------|----------------------|
| Deferred gain on sale of asset | \$ 14,000 | \$ |
| Interest rate swap derivative agreement | 1,264 | 1,636 |
| Income tax payable | 1,456 | |
| Deferred revenue | 7,057 | 1,089 |
| Deferred rent | 10,868 | 9,459 |
| Deferred incentive management fees | 1,470 | |
| Other | 2,840 | 2,886 |
| | \$ 38,955 | \$ 15,070 |

In conjunction with the Rochester Portfolio sale, the Company retained a \$14.0 million liability related to the Rochester Portfolio's pension plan, which could be triggered in certain circumstances, including termination of the pension plan. Accordingly, the Company has deferred \$14.0 million of gain on the sale of the Rochester Portfolio, which \$14.0 million in gain will be recognized, if at all, when and to the extent the

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Company is released from any potential liability related to the Rochester Portfolio's pension plan.

The Company's other liabilities include a long-term income tax payable of \$1.5 million. Based on the Company's ongoing evaluations of its uncertain tax positions related to the year ended December 31, 2012, and as a result of its recent resolution of outstanding issues with the IRS, the Company adjusted for an unrecognized tax benefit of \$1.5 million during the first quarter of 2013, which is included in the Company's consolidated statement of operations and comprehensive income (loss).

In June 2013, the Company received a \$6.5 million incentive from Hyatt Franchising L.L.C. for rebranding the Company's Hyatt Chicago Magnificent Mile from a Wyndham to a Hyatt. The Company is amortizing this incentive on a straightline basis over the remaining 25-year term of its franchise agreement with Hyatt. The Company includes the \$0.3 million portion of the incentive to be recognized during the next 12 months in accounts payable and accrued expenses, and includes the long-term portion of \$6.2 million in other liabilities in its consolidated balance sheets.

Table of Contents

The Company's other liabilities also include deferred incentive management fees of \$1.4 million related to one of its hotels that is currently undergoing a major room renovation. Per the Company's management agreement with the hotel's third-party manager, payment of the incentive management fees will be deferred until such time as the hotel's adjusted cash flow, as defined in the management agreement, surpasses a certain threshold.

9. Series C Cumulative Convertible Redeemable Preferred Stock

In May 2013, the Company redeemed all 4,102,564 shares of its Series C preferred stock for an aggregate redemption price of \$101.1 million, including \$1.1 million in accrued dividends. In accordance with the FASB's Emerging Issues Task Force Topic D-42, an additional redemption charge of \$0.1 million was recognized related to the original issuance costs of the Series C preferred stock, which were previously included in additional paid in capital. The Company redeemed the Series C preferred shares using cash received from its February 2013 common stock offering. After the redemption date, the Company has no outstanding shares of Series C preferred stock, and all rights of the holders of such shares were terminated.

10. Stockholders' Equity

Series A Cumulative Redeemable Preferred Stock

In March 2013, the Company redeemed all 7,050,000 shares of its 8.0% Series A Cumulative Redeemable Preferred Stock (Series A preferred stock) for an aggregate redemption price of \$178.6 million, including \$2.3 million in accrued dividends. In accordance with the FASB's Emerging Issues Task Force Topic D-42, an additional redemption charge of \$4.6 million was recognized related to the original issuance costs of the Series A preferred stock, which were previously included in additional paid in capital. The Company redeemed the Series A preferred shares using cash received from its February 2013 common stock offering. After the redemption date, the Company has no outstanding shares of Series A preferred stock, and all rights of the holders of such shares were terminated. Because the redemption of the Series A preferred stock is a redemption in full, trading of the Series A preferred stock on the New York Stock Exchange ceased after the redemption date.

Series D Cumulative Redeemable Preferred Stock

The Company's 4,600,000 shares of 8.0% Series D Cumulative Redeemable Preferred Stock (Series D preferred stock) have a liquidation preference of \$25.00 per share. On or after April 6, 2016, the Series D 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, but not including, the redemption date. Upon the occurrence of a change of control of the Company, (i) the Company may, at its option, redeem the Series D preferred stock in whole or in part and within 120 days after the first date on which such change of control occurred, by paying \$25.00 per share, plus any accrued and unpaid dividends to, but not including, the redemption date, and (ii) holders of Series D preferred stock will have the right (unless, prior to the change of control conversion date, the Company has provided or provides notice of its election to redeem the Series D preferred stock) to convert some or all of their shares of Series D preferred stock into shares of the Company's common stock. Holders of Series D preferred stock generally have no voting rights. However, if the Company is in arrears on dividends on the Series D preferred stock for six or more quarterly periods, whether or not consecutive, holders of the Series D 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

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

directors until all unpaid dividends and the dividend for the then-current period with respect to the Series D preferred stock have been paid or declared and a sum sufficient for the payment thereof set aside for payment. The Series D preferred stock has no maturity date and the Company is not required to redeem the Series D preferred stock at any time, unless the Company decides, at its option, to exercise its redemption right or, under circumstances where the holders of Series D preferred stock decide to convert the Series D preferred stock. If the Company does not exercise its right to redeem the Series D preferred stock upon a change of control, holders of the Series D preferred stock have the right to convert some or all of their shares into a number of the Company's common shares based on a defined formula subject to a cap of 22,571,280 common shares.

Common Stock

In February 2013, the Company issued 25,300,000 shares of its common stock, including the underwriters' over-allotment of 3,300,000 shares, for net proceeds of approximately \$294.9 million. The Company used \$279.7 million of these proceeds to redeem all of its Series A preferred stock in March 2013, and its Series C preferred stock in May 2013, including accrued interest, and used an additional \$6.0 million towards the acquisition of the Hilton New Orleans St. Charles. The Company will use the remaining proceeds for potential future acquisitions, capital investment in the Company's portfolio and other general corporate purposes, including working capital.

Table of Contents

In June 2012, the Company issued 5,454,164 shares of its common stock to the seller of the Wyndham Chicago (which the Company rebranded the Hyatt Chicago Magnificent Mile) in connection with the Company's acquisition of the hotel. The Company incurred offering costs of \$0.1 million related to this transaction.

In June 2012, the Company issued 12,143,273 shares of its common stock for net proceeds of approximately \$126.2 million. The Company used a portion of these proceeds to fund the purchase of the Hilton Garden Inn Chicago Downtown/Magnificent Mile in July 2012, and will use the remaining proceeds for potential future acquisitions, capital investment in the Company's portfolio, including the renovation of the Hyatt Chicago Magnificent Mile, and other general corporate purposes, including working capital.

11. Long-Term Incentive Plan

Stock Grants

Restricted shares granted pursuant to the Company's Long-Term Incentive Plan (LTIP) generally vest over periods from three to five years from the date of grant. In August 2011, the Company granted both time-based and performance-based shares to Kenneth E. Cruse upon Mr. Cruse's appointment as the Company's Chief Executive Officer. The time-based shares, representing 60.0% of the total shares granted, will vest on a pro-rata basis commencing on the third anniversary of the grant date, and will vest in equal amounts on each of the third, fourth and fifth anniversary of the grant date. The remaining 40.0% of the total shares granted to Mr. Cruse are subject to performance- or market-based, cliff vesting on the fifth anniversary of the grant date, depending on the satisfaction of the following measures: the Company's total stockholder return (TSR); the Company's TSR relative to companies in the NAREIT Equity Index; and the ratio of the Company's total net debt to the Company's adjusted EBITDA.

The Company's compensation expense related to these restricted shares and performance awards for the three and six months ended June 30, 2013 and 2012 were as follows (in thousands):

| | Three Months Ended June 30, 2013 (unaudited) | Three Months Ended June 30, 2012 (unaudited) | Six Months Ended June 30, 2013 (unaudited) | Six Months Ended June 30, 2012 (unaudited) |
|---|---|---|---|---|
| Compensation expense, including forfeitures | \$ 1,838 | \$ 1,311 | \$ 3,440 | \$ 2,751 |

The Company's total compensation expense differs from the vesting of restricted common stock amount presented in the Company's consolidated statement of equity due to the fact that the Company withholds and uses a portion of its restricted shares granted pursuant to its LTIP for purposes of remitting withholding and payroll taxes in connection with the release of restricted common shares to plan participants (net-settle). In addition, the Company capitalizes all restricted shares granted to certain of those employees who work on the design and construction of its hotels. The Company's total compensation expense in relation to its vesting of restricted common stock presented in the Company's consolidated statement of equity for the six months ended June 30, 2013 is as follows (in thousands):

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

| | Six Months Ended June 30, 2013 (unaudited) | |
|--|---|---------|
| Total compensation expense, including forfeitures | \$ | 3,440 |
| Net-settle adjustment | | (1,124) |
| Amortization related to shares issued to design and construction employees | | 193 |
| Vesting of restricted stock presented on statement of equity | \$ | 2,509 |

12. Commitments and Contingencies

Management Agreements

Management agreements with the Company's third-party hotel managers require the Company to pay between 2% and 3.5% of total revenue of the managed hotels to the third-party managers each month as a basic management fee. Total basic management fees incurred by the Company during the three and six months ended June 30, 2013 and 2012 were included in the Company's consolidated statements of operations and comprehensive income (loss) as follows (in thousands):

| | Three Months Ended June 30, 2013 (unaudited) | | Three Months Ended June 30, 2012 (unaudited) | | Six Months Ended June 30, 2013 (unaudited) | | Six Months Ended June 30, 2012 (unaudited) | |
|---|---|-------|---|-------|---|--------|---|--------|
| Continuing operations – property general and administrative expense, and corporate overhead expense | \$ | 6,463 | \$ | 5,791 | \$ | 11,818 | \$ | 10,686 |
| Discontinued operations | | | | 616 | | 65 | | 1,182 |
| | \$ | 6,463 | \$ | 6,407 | \$ | 11,883 | \$ | 11,868 |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

In addition to basic management fees, provided that certain operating thresholds are met, the Company may also be required to pay incentive management fees to certain of its third-party managers. Total incentive management fees incurred by the Company during the three and six months ended June 30, 2013 and 2012 were included in the Company's consolidated statements of operations and comprehensive income (loss) as follows (in thousands):

| | Three Months Ended June 30, 2013 (unaudited) | Three Months Ended June 30, 2012 (unaudited) | Six Months Ended June 30, 2013 (unaudited) | Six Months Ended June 30, 2012 (unaudited) |
|---|---|---|---|---|
| Continuing operations – property general and administrative expense | \$ 682 | \$ 884 | \$ 1,486 | \$ 1,560 |
| Discontinued operations | | 201 | | 358 |
| | \$ 682 | \$ 1,085 | \$ 1,486 | \$ 1,918 |

License and Franchise Agreements

The Company has entered into license and franchise agreements related to certain of its hotel properties. The license and franchise agreements require the Company to, among other things, pay monthly fees that are calculated based on specified percentages of certain revenues. The license and 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 the Company to make significant expenditures for capital improvements.

Total license and franchise costs incurred by the Company during the three and six months ended June 30, 2013 and 2012 were included in the Company's consolidated statements of operations and comprehensive income (loss) as follows (in thousands):

| | Three Months Ended June 30, 2013 (unaudited) | Three Months Ended June 30, 2012 (unaudited) | Six Months Ended June 30, 2013 (unaudited) | Six Months Ended June 30, 2012 (unaudited) |
|---|---|---|---|---|
| Continuing operations – franchise costs | \$ 8,771 | \$ 7,493 | \$ 15,249 | \$ 13,464 |
| Discontinued operations | | 936 | 73 | 1,697 |
| | \$ 8,771 | \$ 8,429 | \$ 15,322 | \$ 15,161 |

Total license and franchise costs included royalties of \$2.9 million and \$2.6 million, respectively, for the three months ended June 30, 2013 and 2012, and \$5.0 million and \$4.7 million, respectively, for the six months ended June 30, 2013 and 2012. The remaining costs included advertising, reservation and priority club assessments.

Renovation and Construction Commitments

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

At June 30, 2013, the Company had various contracts outstanding with third parties in connection with the renovation of certain of its hotel properties aimed at maintaining the appearance and quality of its hotels. The remaining commitments under these contracts at June 30, 2013 totaled \$26.3 million.

Capital Leases

The Hyatt Chicago Magnificent Mile is subject to a building lease which expires in December 2097. The Company evaluated the terms of the lease agreement and determined the lease to be a capital lease pursuant to the Leases Topic of the FASB ASC. Upon acquisition of the hotel in June 2012, the Company recorded a capital asset related to its leasehold interest of \$58.8 million to buildings and improvements, based upon the estimated fair value of the right to use the leased property for the then remaining term of 85.6 years, and a capital lease obligation of \$15.6 million, based upon the fair value of the remaining rent payments. In addition to minimum rent, the capital lease is subject to percentage rent equal to 4.0% of the hotel's gross room revenues over a certain threshold.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

The Company leases certain printers and copiers which leases have been determined to be capital leases pursuant to the Leases Topic of the FASB ASC. All of the leases expire in December 2014.

Assets under capital lease were included in investment in hotel properties, net on the Company's consolidated balance sheets as follows (in thousands):

| | June 30, 2013 (unaudited) | December 31, 2012 |
|-----------------------------------|---------------------------------|----------------------|
| Buildings and improvements | \$ 58,799 | \$ 58,799 |
| Furniture, fixtures and equipment | 104 | 104 |
| | 58,903 | 58,903 |
| Accumulated depreciation | (1,614) | (871) |
| | \$ 57,289 | \$ 58,032 |

Future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of June 30, 2013 are as follows (in thousands):

| | |
|---|-----------|
| 2013 | \$ 1,437 |
| 2014 | 1,429 |
| 2015 | 1,403 |
| 2016 | 1,403 |
| 2017 | 1,403 |
| Thereafter | 111,517 |
| Total minimum lease payments (1) | 118,592 |
| Less: Amount representing interest (2) | (102,954) |
| Present value of net minimum lease payments (3) | \$ 15,638 |

(1) Minimum lease payments do not include percentage rent which may be paid under the Hyatt Chicago Magnificent Mile building lease on the basis of 4.0% of the hotel's gross room revenues over a certain threshold. No percentage rent was due for either the three or six months ended June 30, 2013.

(2) Interest includes the amount necessary to reduce net minimum lease payments to present value calculated at the Company's incremental borrowing rate at lease inception.

(3) The present value of net minimum lease payments are reflected in the Company's consolidated balance sheets as a current obligation of \$35,000 and as long-term obligations of \$15.6 million as of both June 30, 2013 and December 31, 2012. The current obligations are included in accounts payable and accrued expenses, and the long-term obligations are included in capital lease obligations, less current portion.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Ground, Building and Air Leases

Total rent expense incurred pursuant to ground, building and air lease agreements for the three and six months ended June 30, 2013 and 2012 was included in the Company's consolidated statements of operations and comprehensive income (loss) as follows (in thousands):

| | Three Months Ended June 30, 2013 (unaudited) | Three Months Ended June 30, 2012 (unaudited) | Six Months Ended June 30, 2013 (unaudited) | Six Months Ended June 30, 2012 (unaudited) |
|---|---|---|---|---|
| Continuing operations property tax, ground lease and insurance | \$ 4,355 | \$ 4,296 | \$ 8,586 | \$ 8,460 |
| Discontinued operations | | 7 | | 14 |
| | \$ 4,355 | \$ 4,303 | \$ 8,586 | \$ 8,474 |

Rent expense incurred pursuant to leases on the corporate facility totaled \$0.1 million for both the three months ended June 30, 2013 and 2012, and \$0.2 million for both the six months ended June 30, 2013 and 2012, and was included in corporate overhead expense.

Table of Contents**Concentration of Risk**

The concentration of the Company's hotels in California, New York and Illinois exposes the Company's business to economic conditions, competition and real and personal property tax rates unique to these states. As of June 30, 2013, the Company's 27 hotels were concentrated in California, New York and Illinois as follows:

| | California (unaudited) | New York (unaudited) | Illinois (unaudited) |
|---|-----------------------------------|---------------------------------|---------------------------------|
| Number of hotels | 8 | 3 | 3 |
| Percentage of total rooms | 31% | 11% | 10% |
| Percentage of total revenue for the three months ended June 30, 2013 | 29% | 16% | 9% |
| Percentage of total revenue for the six months ended June 30, 2013 | 30% | 14% | 7% |

Other

The Company has provided customary 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 indemnified parties for damages related to certain environmental matters. There is no term or damage limitation on these indemnities; however, if an environmental matter arises, the Company could have recourse against other previous owners or a claim against its environmental insurance policies.

At June 30, 2013, the Company had \$3.7 million of outstanding irrevocable letters of credit to guaranty the Company's financial obligations related to the building lease for the Hyatt Chicago Magnificent Mile and to workers' compensation insurance programs from prior policy years. The beneficiaries of these letters of credit may draw upon these letters of credit in the event of a contractual default by the Company relating to each respective obligation. No draws have been made through June 30, 2013. Effective July 3, 2013, the \$2.8 million letter of credit related to the building lease for the Hyatt Chicago Magnificent Mile was cancelled, leaving \$0.9 million of outstanding irrevocable letters of credit.

13. Subsequent Events

On July 2, 2013, the Company completed its previously announced acquisition of the 1,053-room Boston Park Plaza for a gross purchase price of \$250.0 million, excluding prorations and closing costs. The acquisition was structured as a tax-deferred exchange and was funded with a combination of cash on hand, the remainder of the cash proceeds held by the accommodator, and the assumption of a \$119.2 million non-recourse loan secured by the hotel with a fixed interest rate of 4.402% and a maturity date in February 2018. The Company is currently evaluating the accounting for this acquisition.

Table of Contents

Cautionary Statement

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and includes this statement for purposes of complying with these safe harbor provisions. Forward-looking statements, which are based on certain assumptions and describe the Company's future plans, strategies and expectations, are generally identifiable by use of the words believe, expect, intend, anticipate, estimate, project or similar expressions. You should not rely on forward-looking statements because they involve known and unknown risks, uncertainties and other factors that are, in some cases, beyond the Company's control and which could materially affect actual results, performances or achievements. Accordingly, there is no assurance that the Company's expectations will be realized. In evaluating these statements, you should specifically consider the risks outlined in detail in our Annual Report on Form 10-K, filed with the Securities and Exchange Commission on February 25, 2013, under the caption Risk Factors and elsewhere in this Quarterly Report on Form 10-Q, including, but not limited to, the following factors:

- general economic and business conditions affecting the lodging and travel industry, internationally, nationally and locally, including a U.S. recession or global economic slowdown;
- our need to operate as a REIT and comply with other applicable laws and regulations;
- rising hotel operating expenses, including the impact of the Patient Protection and Affordable Care Act;
- relationships with and requirements of franchisors and hotel brands;
- relationships with and the performance of the managers of our hotels;
- the ground, building or air leases for ten of the 27 hotels held for investment as of June 30, 2013;
- our ability to complete acquisitions and dispositions;
- competition for the acquisition of hotels;

- **performance of hotels after they are acquired;**
- **competition from hotels not owned by us;**
- **the need for renovations of and other capital expenditures for our hotels;**
- **the impact of renovations on hotel operations and delays in renovations or other developments;**
- **changes in our business strategy or acquisition or disposition plans;**
- **our level of debt, including secured, unsecured, fixed and variable rate debt;**
- **financial and other covenants in our debt and preferred stock;**
- **impairments to our hotels and goodwill;**
- **volatility in the capital markets and the effect on lodging demand or our ability to obtain capital on favorable terms or at all;**
and
- **other events beyond our control.**

These factors may cause our actual events to differ materially from the expectations expressed or implied by any forward-looking statement. Except as otherwise required by the federal securities laws, the Company disclaims any obligations or undertaking to publicly release any updates or revisions to any forward-looking statement contained herein (or elsewhere) to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Table of Contents

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

Overview

Sunstone Hotel Investors, Inc. (the Company, we or us) is a Maryland corporation. We operate as a self-managed and self-administered real estate investment trust (REIT). A REIT is a legal entity that directly or indirectly owns real estate assets. REITs generally are not subject to federal income taxes at the corporate level as long as they pay stockholder dividends equivalent to 100% of their taxable income. REITs are required to distribute to stockholders at least 90% of their taxable income. We own, directly or indirectly, 100% of the interests of Sunstone Hotel Partnership, LLC (the Operating Partnership), which is the entity that directly or indirectly owns our hotel properties. We also own 100% of the interests of our taxable REIT subsidiary, Sunstone Hotel TRS Lessee, Inc., which leases all of our hotels from the Operating Partnership, and engages independent third-parties to manage our hotels. In addition, we own BuyEfficient, LLC (BuyEfficient), an electronic purchasing platform that allows members to procure food, operating supplies, furniture, fixtures and equipment.

We own primarily upper upscale hotels in the United States. As of June 30, 2013, we had interests in 27 hotels (the 27 hotels), which are currently held for investment. Of the 27 hotels, we classify 25 as upscale or upper upscale and two as luxury as defined by Smith Travel Research, Inc. All of our 27 hotels are operated under nationally recognized brands such as Marriott, Hilton, Hyatt, Fairmont and Sheraton, which are among the most respected and widely recognized brands in the lodging industry. We believe the largest and most stable segment of travelers prefer the consistent service and quality associated with nationally recognized brands.

We seek to own hotels in urban locations that benefit from significant barriers to entry by competitors. All of our 27 hotels are considered business, convention, or airport hotels, as opposed to resort or leisure hotels. The hotels comprising our 27 hotel portfolio average 440 rooms in size.

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

- *Proactive Portfolio Management.* The leaders of each of our core disciplines function as a portfolio management team. The portfolio management team's purpose is to strategically maximize the long-term value of our assets by enhancing our portfolio quality and scale, optimizing our exposure to key markets, and improving the effectiveness and efficiency of our decision making. Accordingly, the team is responsible for developing a portfolio-wide strategy related to brand and operator relationships, asset quality and scale, target markets, capital investments, and portfolio capitalizations. Our portfolio strategy may also include the disposition of certain hotels.
- *Intensive Asset Management.* Through all phases of the lodging cycle, our strategy emphasizes internal growth and value enhancements through proactive asset management, which entails working closely with our third-party hotel operators to develop and implement long-term strategic plans for each hotel designed to enhance revenues, minimize operational expenses and asset risk, maximize the appeal of our

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

hotels to travelers and maximize our return on invested capital. We also focus on improving the appeal and growth potential of our existing hotels through internally-managed hotel renovations.

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

Table of Contents

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

During the past three years and continuing into 2013, demand for lodging in the U.S. has increased, which has resulted in improved hotel revenues and profits. In light of increasing demand for lodging and generally muted supply of new hotel development, we believe we are currently in the middle phase of a cyclical lodging recovery. Hotels acquired during the early stages of past cyclical recoveries have benefited from multi-year increases in profitability, which in many cases created long-term value in excess of investment hurdles. Accordingly, during the past three years, we selectively acquired interests in seven hotels: the Doubletree Guest Suites Times Square in January 2011; the JW Marriott New Orleans in February 2011; the Hilton San Diego Bayfront in April 2011; the Hyatt Chicago Magnificent Mile in June 2012; the Hilton Garden Inn Chicago Downtown/Magnificent Mile in July 2012; the Hilton New Orleans St. Charles in May 2013; and the Boston Park Plaza in July 2013. Based on our purchase prices, the combined asset value of these seven hotels totals \$1.4 billion, or \$321,000 per key. In addition, we purchased the outside 50.0% equity interest in our BuyEfficient joint venture in January 2011. Our acquisition program is aimed at generating attractive risk-adjusted returns on our investment dollars, and therefore we may target lodging assets outside of the typical branded, urban, upper upscale profile represented by our existing portfolio in order to capitalize on opportunities which may arise. We intend to select the brands and operators for our hotels that we believe will lead to the highest returns.

On May 1, 2013, we purchased the 250-room Hilton New Orleans St. Charles for a net purchase price of \$59.1 million, including \$0.2 million of proration credits. The acquisition was funded with \$53.2 million of proceeds generated by our January 2013 sale of four hotels and a commercial laundry facility located in Rochester, Minnesota, as well as with proceeds received from our February 2013 issuance of common stock. The sale proceeds were held by the accommodator in order to facilitate a tax-deferred exchange.

The scope of our acquisitions program may include large hotel portfolios or hotel loans. Future acquisitions may be funded by our issuance of additional debt or equity securities, including our common and preferred OP units, or by draws on our \$150.0 million senior corporate credit facility. However, in light of our current financial objectives, we expect to fund the majority of our near-term acquisitions with a greater proportion of equity capital than debt capital.

We have from time to time divested of assets that no longer fit our target profile, will not offer long-term returns in excess of our cost of capital, or that have high risk relative to their anticipated return expectations. In connection with this strategy, during the past three years, we sold 10 hotels: the Royal Palm Miami Beach in April 2011; the Valley River Inn located in Eugene, Oregon in October 2011; the Marriott Del Mar in August 2012; the Doubletree Guest Suites Minneapolis, the Hilton Del Mar, and the Marriott Troy in September 2012; and the Kahler Grand, the Kahler Inn & Suites, the Marriott Rochester and the Residence Inn by Marriott Rochester (the Rochester Hotels) in January 2013. Based on our sales prices, the combined asset value of these 10 hotels totals \$547.2 million, or \$306,000 per key. In addition, during the past three years, we sold the following non-hotel assets: a commercial laundry facility located in Salt Lake City, Utah in July 2011; an office building adjacent to the Marriott Troy in September 2012; and a commercial laundry facility located in Rochester, Minnesota in January 2013.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

In January 2013, we sold the Rochester Hotels and a commercial laundry facility (together with the Rochester Hotels, the Rochester Portfolio) in Rochester, Minnesota, to an unaffiliated third party, for net proceeds of \$195.6 million, of which \$145.7 million was deposited with an accommodator in order to facilitate potential tax-deferred exchanges. As of June 30, 2013, a total of \$73.2 million of the cash held by the accommodator has been used to fund tax-deferred exchanges, including \$53.2 million used to fund the majority of the purchase of the Hilton New Orleans St. Charles, and \$20.0 million used to pay refundable deposits towards the July 2013 acquisition of the Boston Park Plaza. The Rochester Hotels include the 660-room Kahler Grand, the 271-room Kahler Inn & Suites, the 202-room Marriott Rochester and the 89-room Residence Inn by Marriott Rochester. We recognized a net gain on

Table of Contents

the sale of \$51.6 million. We retained a \$25.0 million preferred equity investment (the Preferred Equity Investment) in the Rochester Hotels that yields an 11% dividend, resulting in a deferred gain on the sale of \$25.0 million. The \$25.0 million gain will be deferred until the Preferred Equity Investment is repaid. We also provided a \$3.7 million working cash advance to the buyer, resulting in a deferred gain on the sale of \$3.7 million. The \$3.7 million gain will be deferred until we are repaid from the Rochester Portfolio's available cash flow. In addition, we retained a \$14.0 million liability related to the Rochester Portfolio's pension plan, which could be triggered in certain circumstances, including termination of the pension plan. The recognition of the \$14.0 million pension plan liability reduced our gain on the sale of the Rochester Portfolio. The \$14.0 million gain will be recognized, if at all, when and to the extent we are released from any potential liability related to the Rochester Portfolio's pension plan. Concurrent with the Rochester Portfolio sale, we extinguished the outstanding \$26.7 million mortgage secured by the Kahler Grand for a total cost of \$29.8 million, prepaid the \$0.4 million loan secured by the commercial laundry facility, and recorded a loss on extinguishment of debt of \$3.1 million which is included in discontinued operations.

In January 2013, we validly tendered, accepted and repurchased \$42.0 million of our Operating Partnership's 4.60% exchangeable senior notes (the Senior Notes) pursuant to a tender offer, and redeemed the remaining \$16.0 million of the Senior Notes. We funded the total \$58.0 million in Senior Note redemptions with available cash, leaving no future amounts outstanding related to the Senior Notes. We recognized a loss of \$44,000 on this early extinguishment of debt.

In February 2013, we issued 25,300,000 shares of our common stock, including the underwriters' over-allotment of 3,300,000 shares, for net proceeds of \$294.9 million. We used these proceeds to redeem all of our 8.0% Series A Cumulative Redeemable Preferred Stock (Series A preferred stock) and all of our Series C Cumulative Convertible Redeemable Preferred Stock (Series C preferred stock), as well as to partially fund our acquisitions of the Hilton New Orleans St. Charles and the Boston Park Plaza.

In March 2013, we used a portion of the proceeds we received from our February 2013 common stock offering to redeem all 7,050,000 shares of our Series A preferred stock for an aggregate redemption price of \$178.6 million, including \$2.3 million in accrued dividends. An additional redemption charge of \$4.6 million was recognized related to the original issuance costs of the Series A preferred stock, which were previously included in additional paid in capital. After the redemption date, we have no outstanding shares of Series A preferred stock, and all rights of the holders of such shares were terminated. Because the redemption of the Series A preferred stock is a redemption in full, trading of the Series A preferred stock on the New York Stock Exchange ceased after the redemption date.

In May 2013, we used a portion of the proceeds we received from our February 2013 common stock offering to redeem all 4,102,564 shares of our Series C preferred stock for an aggregate redemption price of \$101.1 million, including \$1.1 million in accrued dividends. An additional redemption charge of \$0.1 million was recognized related to the original issuance costs of the Series C preferred stock, which were previously included in additional paid in capital. After the redemption date, we have no outstanding shares of Series C preferred stock, and all rights of the holders of such shares were terminated.

As of June 30, 2013, the weighted average term to maturity of our debt is approximately four years, and 68.1% of our debt is fixed rate with a weighted average interest rate of 5.6%. The weighted average interest rate on all of our debt, which includes our variable-rate debt obligations based on variable rates at June 30, 2013, is 4.9%.

Operating Activities

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Operating Performance Indicators. The following performance indicators are commonly used in the hotel industry:

- *Occupancy*;
- *Average daily room rate*, or ADR;
- *Revenue per available room*, or RevPAR, which is the product of occupancy and ADR, and does not include food and beverage revenue, or other operating revenue;
- *Comparable RevPAR*, which we define as the RevPAR generated by hotels we owned as of the end of the reporting period, but excluding those hotels that we classified as held for sale. For hotels that were not owned for the entirety of the comparison periods, comparable RevPAR is calculated using RevPAR generated during periods of prior ownership. We refer to this subset of our hotels used to calculate comparable RevPAR as our Comparable Portfolio. Currently our Comparable Portfolio includes all 27 hotels in which we have interests as of June 30, 2013. In addition, our Comparable Portfolio includes prior ownership results for the Hyatt Chicago Magnificent Mile, the Hilton Garden Inn Chicago Downtown/Magnificent Mile and the Hilton New Orleans St. Charles. We intend to exclude the Boston Park Plaza from calculating Comparable RevPAR in 2013 due to the addition of 12 rooms in September 2012, and an additional 100 rooms in January 2013;

Table of Contents

- *RevPAR index*, which is the quotient of a hotel's RevPAR divided by the average RevPAR of its competitors, multiplied by 100. A RevPAR index in excess of 100 indicates a hotel is achieving higher RevPAR than its competitors. In addition to absolute RevPAR index, we monitor changes in RevPAR index;
- *Operating flow through*, which is the comparison between reporting periods of the change in hotel EBITDA divided by the change in hotel revenues;
- *EBITDA*, which is net income (loss) excluding: non-controlling interests; interest expense; provision for income taxes, including income taxes applicable to sale of assets; and depreciation and amortization;
- *Adjusted EBITDA*, which includes EBITDA but excludes: amortization of deferred stock compensation; the impact of any gain or loss from asset sales; impairment charges; prior year property taxes, and any other identified adjustments;
- *Funds from operations*, or FFO, which includes net income (loss) excluding non-controlling interests, gains and losses from sales of property, plus real estate-related depreciation and amortization (excluding amortization of deferred financing costs) and real-estate related impairment losses, and after adjustment for unconsolidated partnerships and joint ventures; and
- *Adjusted FFO*, which includes FFO but excludes penalties, written-off deferred financing costs, non-real estate-related impairment losses and any other identified adjustments.

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 the product of the number of rooms sold and the ADR;
- *Food and beverage revenue*, which is comprised of revenue realized in the hotel food and beverage outlets as well as banquet and catering events; and
- *Other operating revenue*, which includes ancillary hotel revenue and other items primarily driven by occupancy such as telephone, transportation, parking, spa, entertainment and other guest services. Additionally, this category includes, among other things, operating revenue from BuyEfficient and hotel space leased by third parties.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Expenses. Our 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 includes the corresponding expense of other operating revenue, advertising and promotion, repairs and maintenance, utilities, and franchise costs;
- *Property tax, ground lease and insurance expense*, which includes the expenses associated with property tax, ground lease and insurance payments, each of which is primarily a fixed expense, but property tax is subject to regular revaluations based on the specific tax regulations and practices of each municipality;
- *Property general and administrative expense*, which includes our property-level general and administrative expenses, such as payroll and related costs, contract and professional fees, credit and collection expenses and management fees. Additionally, this category includes general and administrative expenses for BuyEfficient;
- *Corporate overhead expense*, which includes our corporate-level expenses, such as payroll and related costs, amortization of deferred stock compensation, acquisition and due diligence costs, contract and professional fees, investor relations expenses, stock exchange fees, association fees, corporate insurance, legal, conference and travel expenses and office rent; and
- *Depreciation and amortization expense*, which includes depreciation on our hotel buildings, improvements, furniture, fixtures and equipment, along with amortization on our franchise fees and certain intangibles. Additionally, this category includes depreciation and amortization related to both our corporate office and BuyEfficient's furniture, fixtures, equipment and intangibles.

Table of Contents

Other Revenue and Expense. Other revenue and expense consists of the following:

- *Interest and other income*, which includes interest we have earned on our restricted and unrestricted cash accounts and the Preferred Equity Investment, as well as any gains or losses we have recognized on sales of assets other than hotels;
- *Interest expense*, which includes interest expense incurred on our outstanding fixed and variable-rate debt, capital lease obligation, accretion of the Senior Notes, amortization of deferred financing fees, any write-offs of deferred financing fees, gains or losses on derivatives and any loan penalties and fees incurred on our debt;
- *Loss on extinguishment of debt*, which includes the loss we recognized on the repurchase and cancellation of the Senior Notes;
- *Income tax provision*, which includes federal and state income taxes charged to the Company and any adjustments to unrecognized tax positions, along with any related interest and penalties incurred;
- *Income from consolidated joint venture attributable to non-controlling interest*, which includes net income attributable to the outside 25.0% interest in the joint venture that owns the Hilton San Diego Bayfront;
- *Distributions to non-controlling interest*, which includes preferred dividends earned by investors from an entity that owns the Doubletree Guest Suites Times Square, including related administrative fees;
- *Preferred stock dividends and redemption charge*, which includes dividends earned on our Series A preferred stock and Series C preferred stock up until their redemptions in March 2013 and May 2013, respectively, and 8.0% Series D Cumulative Redeemable Preferred Stock (Series D preferred stock), as well as redemption charges for preferred stock redemptions made in excess of net carrying values; and
- *Undistributed income allocated to unvested restricted stock compensation*, which includes undistributed income allocated to unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) pursuant to the two-class method.

Factors Affecting Our Operating Results. The primary factors affecting our operating results include overall demand for hotel rooms, the pace of new hotel development, or supply, and the relative performance of our operators in increasing revenue and controlling hotel operating expenses.

- *Demand.* The demand for lodging generally fluctuates with the overall economy. Since 2010, following a two year cyclical trough, we continue to see signs of improving demand trends. In 2012, Comparable Portfolio RevPAR increased 5.7% as compared to 2011, with a 270 basis point increase in portfolio occupancy. These improving demand trends continued in the first six months of 2013. As a result, our Comparable Portfolio RevPAR increased 2.1% in the first quarter of 2013 as compared to the same period in 2012, and 2.2% in the second quarter of 2013 as compared to the same period in 2012. We saw these increases in RevPAR during the first and second quarters of 2013, even as occupancy declined 140 basis points during the first quarter and 80 basis points during the second quarter due to the fact that several of our hotels were under major room renovations during the first six months of 2013. Consistent with prior trends, we anticipate that lodging demand will continue to improve as the U.S. economy continues to strengthen. Historically, cyclical troughs are followed by extended periods of relatively strong demand, resulting in a cyclical lodging growth phase. While growth is not expected to be uniform, we expect hotel demand to remain strong over the next several quarters if the U.S. economy continues to grow and employment levels continue to improve.

- *Supply.* The addition of new competitive hotels affects the ability of existing hotels to drive RevPAR and profits. The development of new hotels is largely driven by construction costs and expected performance of existing hotels. The recession and credit crisis which occurred in 2008 and 2009, served to restrict credit and tighten lending standards, which resulted in a curtailment of funding for new hotel construction projects. Moreover, with same-property hotel profitability still below peak levels and hotel trading values generally well below replacement cost, new supply in many markets is difficult to justify economically. Accordingly, we believe hotel development will be constrained until such time as the construction financing markets recover, and operating trends and trading values of existing hotels improve to levels where developer return targets can be achieved. Given the one-to-three-year timeline needed to construct a typical hotel that

Table of Contents

would compete with our hotels, we expect a window of several years during which aggregate U.S. hotel supply, as indicated by the number of new hotel room openings, will be below historical levels. On a market-by-market basis, some markets may experience new hotel room openings at or greater than historic levels, including in both New York City and Chicago where there are currently higher-than-average supplies of new hotel room openings. In addition, lenders are seeking higher yielding instruments, which may lead to riskier lending practices, including lending on new hotel construction.

- *Revenues and expenses.* We believe that marginal improvements in RevPAR index, even in the face of declining revenues, are a good indicator of the relative quality and appeal of our hotels, and our operators' effectiveness in maximizing revenues. Similarly, we also evaluate our operators' effectiveness in minimizing incremental operating expenses in the context of increasing revenues or, conversely, in reducing operating expenses in the context of declining revenues.

With respect to improving RevPAR index, we continue to work with our hotel operators to optimize revenue management initiatives while taking into consideration market demand trends and the pricing strategies of competitor hotels in our markets. We also develop capital investment programs designed to ensure each of our hotels is well renovated and positioned to appeal to groups and individual travelers fitting target guest profiles. Increased capital investment in our properties may lead to short-term revenue disruption and negatively impact RevPAR index. Our revenue management initiatives are generally oriented towards maximizing ADR even if the result may be lower occupancy than may be achieved through lower ADR. Increases in RevPAR attributable to increases in ADR may be accompanied by minimal additional expenses, while increases in RevPAR attributable to higher occupancy may result in higher variable expenses such as housekeeping, labor and utilities expense. Thus, increases in RevPAR associated with higher ADR may result in higher hotel EBITDA margins. Increases in RevPAR associated with higher occupancy may result in more muted hotel EBITDA margin improvement. Our Comparable Portfolio RevPAR index, which was negatively impacted by several capital investment programs at our hotels, decreased 180 basis points during the first six months of 2013 as compared to the same period in 2012.

With respect to maximizing operating flow through, we continue to work with our operators to identify operational efficiencies designed to reduce expenses while minimally affecting guest experience. Key asset management initiatives include optimizing hotel staffing levels, increasing the efficiency of the hotels, such as installing energy efficient management and inventory control systems, and selectively combining food and beverage outlets. Our operational efficiency initiatives may be difficult to implement, as most categories of variable operating expenses, such as utilities and housekeeping labor costs, fluctuate with changes in occupancy. Furthermore, our hotels operate with significant fixed costs, such as general and administrative expense, insurance, property taxes, and other expenses associated with owning hotels, over which our operators have little control. We have experienced either currently or in the past, increases in hourly wages, employee benefits (especially health insurance), utility costs and property insurance, which have negatively affected our operating margins. Moreover, there are limits to how far our operators can reduce expenses without affecting brand standards or the competitiveness of our hotels. Our Comparable Portfolio operating flow through was 28.2% based on changes in hotel EBITDA and hotel revenues from the first six months of 2013 as compared to the same period in 2012.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

Operating Results. The following table presents our unaudited operating results for our total portfolio for the three months ended June 30, 2013 and 2012, including the amount and percentage change in the results between the two periods. The table presents the results of operations included in the consolidated statements of operations and comprehensive income (loss), and includes the 27 hotels (11,886 rooms) as of June 30, 2013 and 25 hotels (11,275 rooms) as of June 30, 2012, as well as discontinued operations for 8 hotels (2,350 rooms) as of June 30, 2012. No hotels were classified as discontinued operations for the three months ended June 30, 2013.

| | 2013 | Three Months Ended June 30, | | % Change |
|---|--|-----------------------------|-----------|----------|
| | | 2012 | \$ Change | |
| | (unaudited, dollars in thousands, except statistical data) | | | |
| REVENUES | | | | |
| Room | \$ 168,260 | \$ 148,302 | \$ 19,958 | 13.5% |
| Food and beverage | 52,842 | 52,168 | 674 | 1.3% |
| Other operating | 13,536 | 12,372 | 1,164 | 9.4% |
| Total revenues | 234,638 | 212,842 | 21,796 | 10.2% |
| OPERATING EXPENSES | | | | |
| Hotel operating | 133,194 | 121,737 | 11,457 | 9.4% |
| Property general and administrative | 25,288 | 23,611 | 1,677 | 7.1% |
| Corporate overhead | 7,359 | 7,575 | (216) | (2.9)% |
| Depreciation and amortization | 32,175 | 31,305 | 870 | 2.8% |
| Total operating expenses | 198,016 | 184,228 | 13,788 | 7.5% |
| Operating income | 36,622 | 28,614 | 8,008 | 28.0% |
| Interest and other income | 788 | 74 | 714 | 964.9% |
| Interest expense | (17,272) | (19,429) | 2,157 | 11.1% |
| Income before income taxes and discontinued operations | 20,138 | 9,259 | 10,879 | 117.5% |
| Income tax provision | (129) | | (129) | (100.0)% |
| Income from continuing operations | 20,009 | 9,259 | 10,750 | 116.1% |
| Income from discontinued operations | | 2,596 | (2,596) | (100.0)% |
| Net income | 20,009 | 11,855 | 8,154 | 68.8% |
| Income from consolidated joint venture attributable to non-controlling interest | (1,226) | (307) | (919) | (299.3)% |
| Distributions to non-controlling interest | (8) | (8) | | |
| Preferred stock dividends and redemption charge | (3,510) | (7,437) | 3,927 | 52.8% |
| Undistributed income allocated to unvested restricted stock compensation | (126) | (47) | (79) | (168.1)% |
| Income available to common stockholders | \$ 15,139 | \$ 4,056 | \$ 11,083 | 273.2% |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

The following table presents our unaudited operating results for our total portfolio for the six months ended June 30, 2013 and 2012, including the amount and percentage change in the results between the two periods. The table presents the results of operations included in the consolidated statements of operations and comprehensive income (loss), and includes the 27 hotels (11,886 rooms) as of June 30, 2013 and 25 hotels (11,275 rooms) as of June 30, 2012, as well as discontinued operations for four hotels (1,222 rooms) as of June 30, 2013 and 8 hotels (2,350 rooms) as of June 30, 2012.

| | 2013 | Six Months Ended June 30, 2012 | | \$ Change | % Change |
|---|--|-----------------------------------|-----------|-----------|----------|
| | (unaudited, dollars in thousands, except statistical data) | | | | |
| REVENUES | | | | | |
| Room | \$ 300,883 | \$ 267,924 | \$ 32,959 | 12.3% | |
| Food and beverage | 102,470 | 99,003 | 3,467 | 3.5% | |
| Other operating | 26,206 | 24,149 | 2,057 | 8.5% | |
| Total revenues | 429,559 | 391,076 | 38,483 | 9.8% | |
| OPERATING EXPENSES | | | | | |
| Hotel operating | 260,754 | 236,830 | 23,924 | 10.1% | |
| Property general and administrative | 48,894 | 45,521 | 3,373 | 7.4% | |
| Corporate overhead | 13,530 | 12,773 | 757 | 5.9% | |
| Depreciation and amortization | 66,191 | 62,187 | 4,004 | 6.4% | |
| Total operating expenses | 389,369 | 357,311 | 32,058 | 9.0% | |
| Operating income | 40,190 | 33,765 | 6,425 | 19.0% | |
| Interest and other income | 1,351 | 137 | 1,214 | 886.1% | |
| Interest expense | (34,686) | (38,788) | 4,102 | 10.6% | |
| Loss on extinguishment of debt | (44) | (191) | 147 | 77.0% | |
| Income (loss) before income taxes and discontinued operations | 6,811 | (5,077) | 11,888 | 234.2% | |
| Income tax provision | (6,286) | | (6,286) | (100.0)% | |
| Income (loss) from continuing operations | 525 | (5,077) | 5,602 | 110.3% | |
| Income from discontinued operations | 48,410 | 3,964 | 44,446 | 1,121.2% | |
| Net income (loss) | 48,935 | (1,113) | 50,048 | 4,496.7% | |
| Income from consolidated joint venture attributable to non-controlling interest | (1,523) | (867) | (656) | (75.7)% | |
| Distributions to non-controlling interest | (16) | (16) | | | |
| Preferred stock dividends and redemption charge | (14,413) | (14,874) | 461 | 3.1% | |
| Undistributed income allocated to unvested restricted stock compensation | (264) | | (264) | (100.0)% | |
| Income available (loss attributable) to common | \$ 32,719 | \$ (16,870) | \$ 49,589 | 293.9% | |

stockholders

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

Operating Statistics. The following table includes comparisons of the key operating metrics for our 27 hotel Comparable Portfolio, which includes prior ownership results for the Hyatt Chicago Magnificent Mile, the Hilton Garden Inn Chicago Downtown/Magnificent Mile and the Hilton New Orleans St. Charles.

| Three Months Ended June 30, 2013 | | | Three Months Ended June 30, 2012 | | | Change | | |
|-------------------------------------|-----------|-----------|-------------------------------------|-----------|-----------|----------|--------|------|
| Occ% | ADR | RevPAR | Occ% | ADR | RevPAR | ADR | RevPAR | |
| 83.0% | \$ 188.89 | \$ 156.78 | 83.8% | \$ 183.05 | \$ 153.40 | (80) bps | 3.2% | 2.2% |

| Six Months Ended June 30, 2013 | | | Six Months Ended June 30, 2012 | | | Change | | |
|-----------------------------------|-----------|-----------|-----------------------------------|-----------|-----------|-----------|--------|------|
| Occ% | ADR | RevPAR | Occ% | ADR | RevPAR | ADR | RevPAR | |
| 78.7% | \$ 179.22 | \$ 141.05 | 79.8% | \$ 173.06 | \$ 138.10 | (110) bps | 3.6% | 2.1% |

Non-GAAP Financial Measures. We use the following non-GAAP financial measures that we believe are useful to investors as key supplemental measures of our operating performance: EBITDA, Adjusted EBITDA, FFO and Adjusted FFO. These measures should not be considered in isolation or as a substitute for measures of performance in accordance with GAAP. EBITDA, Adjusted EBITDA, FFO and Adjusted FFO, as calculated by us, may not be comparable to other companies that do not define such terms exactly as the Company. These non-GAAP measures are used in addition to and in conjunction with results presented in accordance with GAAP. They should not be considered as alternatives to operating profit, cash flow from operations, or any other operating performance measure prescribed by GAAP. These non-GAAP financial measures reflect additional ways of viewing our operations that we believe, when viewed with our GAAP results and the reconciliations to the corresponding GAAP financial measures, provide a more complete understanding of factors and trends affecting our business than could be obtained absent this disclosure. We strongly encourage investors to review our financial information in its entirety and not to rely on a single financial measure.

EBITDA is a commonly used measure of performance in many industries. We believe EBITDA is useful to investors in evaluating our operating performance because this measure helps investors evaluate and compare the results of our operations from period to period by removing the impact of our capital structure (primarily interest expense) and our asset base (primarily depreciation and amortization) from our operating results. We also believe the use of EBITDA facilitates comparisons between us and other lodging REITs, hotel owners who are not REITs and other capital-intensive companies. In addition, certain covenants included in our indebtedness use EBITDA as a measure of financial compliance. We also use EBITDA as a measure in determining the value of hotel acquisitions and dispositions.

Historically, we have adjusted EBITDA when evaluating our performance because we believe that the exclusion of certain additional items described below provides useful information to investors regarding our operating performance and that the presentation of Adjusted EBITDA, when combined with the primary GAAP presentation of net income, is beneficial to an investor's complete understanding of our operating performance. We adjust EBITDA for the following items, which may occur in any period, and refer to this measure as Adjusted EBITDA:

- *Amortization of deferred stock compensation:* we exclude the non-cash expense incurred with the amortization of deferred stock compensation as this expense does not reflect the underlying performance of our hotels.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

- *Amortization of favorable and unfavorable contracts:* we exclude the non-cash amortization of the favorable management contract asset and the unfavorable tenant lease liability recorded in conjunction with our acquisition of the Hilton Garden Inn Chicago Downtown/Magnificent Mile, along with the favorable tenant lease asset recorded in conjunction with our acquisition of the Hilton New Orleans St. Charles. The amortization of favorable and unfavorable contracts does not reflect the underlying performance of our hotels.
- *Ground rent adjustments:* we exclude the non-cash expense incurred from straightlining our ground lease obligations as this expense does not reflect the underlying performance of our hotels. We do however, include an adjustment for the cash ground lease expense recorded on the Hyatt Chicago Magnificent Mile's building lease. Upon acquisition of this hotel, we determined that the building lease was a capital lease, and, therefore, we include a portion of the capital lease payment each month in interest expense. We include an adjustment for ground lease expense on capital leases in order to more accurately reflect the operating performance of the Hyatt Chicago Magnificent Mile.
- *Real estate transactions:* we exclude the effect of gains and losses on the disposition of depreciable assets because we believe that including them in Adjusted EBITDA is not consistent with reflecting the ongoing performance of our assets. In addition, material gains or losses from the depreciated value of the disposed assets could be less important to investors given that the depreciated asset value often does not reflect its market value.
- *Gains or losses from debt transactions:* we exclude the effect of finance charges and premiums associated with the extinguishment of debt, including the acceleration of deferred financing costs from the original issuance of the debt being redeemed or retired because, like interest expense, their removal helps investors evaluate and compare the results of our operations from period to period by removing the impact of our capital structure.
- *Acquisition costs:* under GAAP, costs associated with completed acquisitions are expensed in the year incurred. We exclude the effect of these costs because we believe they are not reflective of the ongoing performance of the Company.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

- *Consolidated partnership adjustments:* we deduct the non-controlling partner's pro rata share of any EBITDA adjustments related to our consolidated Hilton San Diego Bayfront partnership.

- *Cumulative effect of a change in accounting principle:* infrequently, the FASB promulgates new accounting standards that require the consolidated statement of operations to reflect the cumulative effect of a change in accounting principle. We exclude these one-time adjustments because they do not reflect our actual performance for that period.

- *Impairment losses:* we exclude the effect of impairment losses because we believe that including them in Adjusted EBITDA is not consistent with reflecting the ongoing performance of our remaining assets. In addition, we believe that impairment charges, which are based off of historical cost account values, are similar to gains (losses) on dispositions and depreciation expense, both of which are also excluded from Adjusted EBITDA.

- *Other adjustments:* we exclude other adjustments such as lawsuit settlement costs (or the reversal of these costs), prior year property tax assessments and/or credits, management company transition costs, and departmental closing costs, including severance, because we do not believe these costs reflect our actual performance for that period and/or the ongoing operations of our hotels.

The following table reconciles our unaudited net income (loss) to EBITDA and Adjusted EBITDA for our hotel portfolio for the three and six months ended June 30, 2013 and 2012.

| | Three Months Ended June 30, 2013 (in thousands) | Three Months Ended June 30, 2012 (in thousands) | Six Months Ended June 30, 2013 (in thousands) | Six Months Ended June 30, 2012 (in thousands) |
|---|---|---|---|---|
| Net income (loss) | \$ 20,009 | \$ 11,855 | \$ 48,935 | \$ (1,113) |
| Operations held for investment: | | | | |
| Depreciation and amortization | 32,175 | 31,305 | 66,191 | 62,187 |
| Amortization of lease intangibles | 1,028 | 1,028 | 2,056 | 2,056 |
| Interest expense | 17,272 | 19,429 | 34,686 | 38,788 |
| Income tax provision | 129 | | 6,286 | |
| Non-controlling interests: | | | | |
| Income from consolidated joint venture attributable to non-controlling interest | (1,226) | (307) | (1,523) | (867) |
| Depreciation and amortization | (903) | (1,420) | (2,338) | (2,839) |
| Interest expense | (592) | (623) | (1,169) | (1,250) |
| Discontinued operations: | | | | |
| Depreciation and amortization | | 3,983 | | 7,857 |
| Amortization of lease intangibles | | 7 | | 14 |
| Interest expense | | 2,127 | 99 | 4,271 |
| EBITDA | 67,892 | 67,384 | 153,223 | 109,104 |
| Operations held for investment: | | | | |
| | 1,241 | 896 | 2,316 | 1,842 |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

| | | | | |
|--|-----------|-----------|------------|------------|
| Amortization of deferred stock compensation | | | | |
| Amortization of favorable and unfavorable contracts, net | 115 | | 229 | |
| Non-cash straightline lease expense | 342 | 693 | 1,035 | 1,389 |
| Capital lease obligation interest cash ground rent | (351) | (117) | (702) | (117) |
| Gain on sale of assets | (5) | | (5) | (11) |
| Loss on extinguishment of debt | | | 44 | 191 |
| Closing costs completed acquisitions | 690 | 1,339 | 837 | 1,375 |
| Lawsuit settlement costs, net | 358 | 255 | 358 | 158 |
| Prior year property tax assessments, net | 106 | 1,061 | 106 | 1,061 |
| Non-controlling interests: | | | | |
| Non-cash straightline lease expense | (112) | (113) | (225) | (226) |
| Prior year property tax assessments | | (265) | | (265) |
| Discontinued operations: | | | | |
| Gain on sale of assets | | | (51,620) | (177) |
| Loss on extinguishment of debt | | | 3,115 | |
| Lawsuit settlement costs reversal | | | | (48) |
| | 2,384 | 3,749 | (44,512) | 5,172 |
| Adjusted EBITDA | \$ 70,276 | \$ 71,133 | \$ 108,711 | \$ 114,276 |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

Adjusted EBITDA was \$70.3 million and \$71.1 million for the three months ended June 30, 2013 and 2012, respectively, and \$108.7 million and \$114.3 million for the six months ended June 30, 2013 and 2012, respectively. Adjusted EBITDA decreased \$0.8 million and \$5.6 million in the second quarter and first six months of 2013, respectively, as compared to the same periods in 2012, as additional earnings generated by the Hilton New Orleans St. Charles acquired in 2013 and the two hotels we acquired in 2012 (the Hyatt Chicago Magnificent Mile and the Hilton Garden Inn Chicago Downtown/Magnificent Mile), were offset by a decrease in earnings caused by major room renovations at four of our hotels: the Hilton Times Square; the Hyatt Chicago Magnificent Mile; the Hyatt Regency Newport Beach; and the Renaissance Westchester.

We believe that the presentation of FFO provides useful information to investors regarding our operating performance because it is a measure of our operations without regard to specified non-cash items such as real estate depreciation and amortization, amortization of lease intangibles, any real estate impairment loss and any gain or loss on sale of real estate assets, all of which are based on historical cost accounting and may be of lesser significance in evaluating our current performance. We believe the use of FFO facilitates comparisons between us and other lodging REITs.

We also present Adjusted FFO when evaluating our operating performance because we believe that the exclusion of certain additional items described below provides useful supplemental information to investors regarding our ongoing operating performance, and may facilitate comparisons of operating performance between periods and our peer companies. We adjust FFO for the following items, which may occur in any period, and refer to this measure as Adjusted FFO:

- *Amortization of favorable and unfavorable contracts:* we exclude the non-cash amortization of the favorable management contract asset and the unfavorable tenant lease liability recorded in conjunction with our acquisition of the Hilton Garden Inn Chicago Downtown/Magnificent Mile, along with the favorable tenant lease asset recorded in conjunction with our acquisition of the Hilton New Orleans St. Charles. The amortization of favorable and unfavorable contracts does not reflect the underlying performance of our hotels.
- *Non-cash ground rent adjustments:* we exclude the non-cash expense incurred from straightlining our ground lease obligations as this expense does not reflect the underlying performance of our hotels.
- *Gains or losses from debt transactions:* we exclude the effect of finance charges and premiums associated with the extinguishment of debt, including the acceleration of deferred financing costs from the original issuance of the debt being redeemed or retired. We also exclude the non-cash gains or losses on our derivatives, as well as the original issuance costs associated with the redemption of preferred stock. We believe that these items are not reflective of our ongoing finance costs.
- *Acquisition costs:* under GAAP, costs associated with completed acquisitions are expensed in the year incurred. We exclude the effect of these costs because we believe they are not reflective of the ongoing performance of the Company.
- *Impairment losses:* we exclude the effect of non-real estate impairment losses because we believe that including them in Adjusted FFO is not consistent with reflecting the ongoing performance of our remaining assets.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

- *Consolidated partnership adjustments:* we deduct the non-controlling partner's pro rata share of any FFO adjustments related to our consolidated Hilton San Diego Bayfront partnership.

- *Other adjustments:* we exclude other adjustments such as lawsuit settlement costs (or the reversal of these costs), prior year property tax assessments and/or credits, management company transition costs, departmental closing costs, including severance, and income tax provisions because we do not believe these costs reflect our actual performance for that period and/or the ongoing operations of our hotels.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

The following table reconciles our unaudited net income (loss) to FFO and Adjusted FFO for our hotel portfolio for the three and six months ended June 30, 2013 and 2012.

| | Three Months Ended June 30, 2013 (in thousands) | Three Months Ended June 30, 2012 (in thousands) | Six Months Ended June 30, 2013 (in thousands) | Six Months Ended June 30, 2012 (in thousands) |
|---|---|---|---|---|
| Net income (loss) | \$ 20,009 | \$ 11,855 | \$ 48,935 | \$ (1,113) |
| Preferred stock dividends and redemption charge | (3,510) | (7,437) | (14,413) | (14,874) |
| Operations held for investment: | | | | |
| Real estate depreciation and amortization | 31,831 | 31,006 | 65,503 | 61,581 |
| Amortization of lease intangibles | 1,028 | 1,028 | 2,056 | 2,056 |
| Gain on sale of assets | (5) | | (5) | (11) |
| Non-controlling interests: | | | | |
| Income from consolidated joint venture attributable to non-controlling interest | (1,226) | (307) | (1,523) | (867) |
| Real estate depreciation and amortization | (903) | (1,420) | (2,338) | (2,839) |
| Discontinued operations: | | | | |
| Real estate depreciation and amortization | | 3,983 | | 7,857 |
| Amortization of lease intangibles | | 7 | | 14 |
| Gain on sale of assets | | | (51,620) | (177) |
| FFO | 47,224 | 38,715 | 46,595 | 51,627 |
| Operations held for investment: | | | | |
| Amortization of favorable and unfavorable contracts, net | 115 | | 229 | |
| Non-cash straightline lease expense | 342 | 693 | 1,035 | 1,389 |
| Write-off of deferred financing fees | | 3 | | 3 |
| Non-cash interest related to (gain) loss on derivatives, net | (260) | 423 | (417) | 499 |
| Loss on extinguishment of debt | | | 44 | 191 |
| Closing costs completed acquisitions | 690 | 1,339 | 837 | 1,375 |
| Lawsuit settlement costs, net | 358 | 255 | 358 | 158 |
| Prior year property tax assessments, net | 106 | 1,061 | 106 | 1,061 |
| Income tax provision | 129 | | 6,286 | |
| Preferred stock redemption charge | 130 | | 4,771 | |
| Non-controlling interests: | | | | |
| Non-cash straightline lease expense | (112) | (113) | (225) | (226) |
| Non-cash interest related to loss on derivative | (1) | | (1) | (1) |
| Prior year property tax assessments | | (265) | | (265) |
| Discontinued operations: | | | | |
| Loss on extinguishment of debt | | | 3,115 | |
| Lawsuit settlement costs reversal | | | | (48) |
| | 1,497 | 3,396 | 16,138 | 4,136 |
| Adjusted FFO | \$ 48,721 | \$ 42,111 | \$ 62,733 | \$ 55,763 |

Adjusted FFO was \$48.7 million and \$42.1 million for the three months ended June 30, 2013 and 2012, respectively, and \$62.7 million and \$55.8 million for the six months ended June 30, 2013 and 2012, respectively. Adjusted FFO increased \$6.6 million and \$7.0 million in the

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

second quarter and first six months of 2013, respectively, as compared to the same periods in 2012 primarily due to additional earnings generated by the Hilton New Orleans St. Charles acquired in 2013 and the two hotels we acquired in 2012 (the Hyatt Chicago Magnificent Mile and the Hilton Garden Inn Chicago Downtown/Magnificent Mile), combined with a decrease in interest expense due to reduced loan balances. These increases to Adjusted FFO were partially offset by a decrease in earnings caused by major room renovations at four of our hotels: the Hilton Times Square; the Hyatt Chicago Magnificent Mile; the Hyatt Regency Newport Beach; and the Renaissance Westchester.

Room revenue. Room revenue increased \$20.0 million, or 13.5%, for the three months ended June 30, 2013 as compared to the three months ended June 30, 2012. We acquired the Hilton New Orleans St. Charles in May 2013, the Hyatt Chicago Magnificent Mile in June 2012 and the Hilton Garden Inn Chicago Downtown/Magnificent Mile in July 2012. These three recently acquired hotels (the three recently acquired hotels) contributed additional room revenue of \$10.8 million during the three months ended June 30,

Table of Contents

2013. Room revenue at the Hyatt Chicago Magnificent Mile was negatively impacted during the second quarter of 2013 by a major renovation, which caused 7,646 room nights to be out of service during the second quarter of 2013, displacing approximately \$1.5 million in room revenue based on the hotel achieving a potential 84.6% occupancy rate and RevPAR of \$174.94 without the renovation. In addition, room revenue during the second quarter of 2013 increased as compared to the same period in 2012 due to a change in the financial reporting calendar used by one of our third-party managers, subsidiaries of Marriott International, Inc. or Marriott Hotel Services, Inc. (collectively, "Marriott"), who manage 10 of our 27 hotels. Beginning in 2013, Marriott switched from using a 13-fiscal period accounting calendar to a standard 12-month calendar, which caused there to be an additional seven days and approximately \$6.3 million more in room revenue for the Marriott-managed hotels during the second quarter of 2013 as compared to the second quarter of 2012. Room revenue generated by the 24 hotels we owned prior to January 1, 2012 (our existing portfolio) increased \$2.9 million during the second quarter of 2013 as compared to the second quarter of 2012 due to an increase in ADR (\$3.0 million) partially offset by a decrease in occupancy (\$0.1 million). Room revenue in our existing portfolio was negatively impacted during the second quarter of 2013 by major room renovations at three hotels in our existing portfolio (the three renovation hotels): the Hilton Times Square; the Hyatt Regency Newport Beach; and the Renaissance Westchester. These major room renovations caused a total of 5,171 room nights to be out of service during the second quarter of 2013, displacing approximately \$0.9 million in room revenue based on the three renovation hotels achieving a combined potential 86.1% occupancy rate and RevPAR of \$194.10 without the renovations.

Room revenue increased \$33.0 million, or 12.3%, for the six months ended June 30, 2013 as compared to the six months ended June 30, 2012. The three recently acquired hotels generated additional room revenue of \$15.7 million during the six months ended June 30, 2013. Room revenue at the Hyatt Chicago Magnificent Mile was negatively impacted during the first six months of 2013 by a major renovation, which caused 13,601 room nights to be out of service during the first half of 2013, displacing approximately \$2.4 million in room revenue based on the hotel achieving a potential 74.9% occupancy rate and RevPAR of \$127.70 without the renovation. In addition, Marriott's change from using a 13-fiscal period accounting calendar to a standard 12-month calendar caused there to be an additional 16 days and approximately \$11.7 million more in room revenue for the Marriott-managed hotels during the first six months of 2013 as compared to the same period in 2012. Room revenue generated by our existing portfolio increased \$5.6 million during the first six months of 2013 as compared to the same period in 2012 due to an increase in ADR (\$7.6 million), partially offset by a decrease in occupancy (\$2.0 million). Room revenue in our existing portfolio was negatively impacted during the first six months of 2013 by the three renovations hotels as a total of 26,686 room nights were out of service during the first six months of 2013, displacing approximately \$5.2 million in room revenue based on the three renovation hotels achieving a combined potential 81.6% occupancy rate and RevPAR of \$169.76 without the renovations.

Food and beverage revenue. Food and beverage revenue increased \$0.7 million, or 1.3%, for the three months ended June 30, 2013 as compared to the three months ended June 30, 2012. The three recently acquired hotels contributed an additional \$1.1 million to food and beverage revenue during the second quarter of 2013, though food and beverage revenue generated by the Hyatt Chicago Magnificent Mile was negatively affected by the hotel's major renovation. Marriott's additional seven days in the second quarter of 2013 generated approximately \$2.6 million in food and beverage revenue for the Marriott-managed hotels during the second quarter of 2013 as compared to the second quarter of 2012. Food and beverage revenue in our existing portfolio decreased \$3.0 million for the three months ended June 30, 2013 as compared to the three months ended June 30, 2012, primarily due to decreased banquet revenue at several of our hotels. Although the number of group room nights increased 2,968 during the second quarter of 2013 as compared to the second quarter of 2012, the type of group shifted from corporate and citywide business with a higher number of banquet functions to associations with fewer banquet functions. In addition, revenue at our outlets decreased due to lower occupancy in many of our hotels, combined with the negative impact of the three renovation hotels.

Food and beverage revenue increased \$3.5 million, or 3.5%, for the six months ended June 30, 2013 as compared to the six months ended June 30, 2012. The three recently acquired hotels contributed an additional \$1.7 million to food and beverage revenue during the first six months of 2013, though food and beverage revenue generated by the Hyatt Chicago Magnificent Mile was negatively affected by the hotel's major renovation. Marriott's additional 16 days in the first six months of 2013 generated approximately \$4.0 million in food and beverage revenue for the Marriott-managed hotels during the first six months of 2013 as compared to the first six months of 2012. Food and beverage revenue in our existing portfolio decreased \$2.2 million during the first six months of 2013 as compared to the same period in 2012, primarily due to the same reasons described above in the discussion regarding the second quarter.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Other operating revenue. Other operating revenue increased \$1.2 million, or 9.4%, for the three months ended June 30, 2013 as compared to the three months ended June 30, 2012. The three recently acquired hotels contributed an additional \$0.5 million to other operating revenue during the second quarter of 2013. In addition, BuyEfficient's revenue increased \$0.1 million during the second quarter of 2013 as compared to the same period in 2012 due to increased transaction and development fees. Other operating revenue in our existing portfolio increased \$0.6 million in the three months ended June 30, 2013 as compared to the three months ended June 30, 2012, as increased parking, spa, cancellation and attrition revenue were slightly offset by decreased telephone revenue.

Table of Contents

Other operating revenue increased \$2.1 million, or 8.5%, for the six months ended June 30, 2013 as compared to the six months ended June 30, 2012. Our three recently acquired hotels contributed an additional \$0.9 million to other operating revenue during the first six months of 2013. In addition, BuyEfficient's revenue increased \$0.3 million during the first six months of 2013 as compared to the same period in 2012 due to increased transaction and development fees. Other operating revenue in our existing portfolio increased \$0.9 million during the first six months of 2013 as compared to the same period in 2012, primarily due to the same reasons described above in the discussion regarding the second quarter.

Hotel operating expenses. Hotel operating expenses, which are comprised of room, food and beverage, advertising and promotion, repairs and maintenance, utilities, franchise costs, property tax, ground lease and insurance, and other hotel operating expenses increased \$11.5 million, or 9.4%, during the three months ended June 30, 2013 as compared to the three months ended June 30, 2012. The three recently acquired hotels contributed an additional \$7.7 million to hotel operating expenses during the second quarter of 2013. Hotel operating expenses in our existing portfolio increased \$3.8 million during the three months ended June 30, 2013 as compared to the same period in 2012. This increase in hotel operating expenses is primarily related to the corresponding increase in room revenue, combined with the Marriott-managed hotels' seven additional days in the second quarter of 2013 as compared to the same period in 2012. In addition, hotel operating expenses in our existing portfolio increased during the three months ended June 30, 2013 as compared to the same period in 2012 due to increases in property and liability insurance premiums. These increases were partially offset by a decrease in property taxes during the second quarter of 2013 as compared to the same period in 2012 due to a \$1.9 million estimated supplemental property tax assessment recorded in 2012 on the Hilton San Diego Bayfront, which was offset by smaller assessments recorded at several of our hotels in 2013.

Hotel operating expenses increased \$23.9 million, or 10.1%, during the six months ended June 30, 2013 as compared to the six months ended June 30, 2012. The three recently acquired hotels contributed \$13.9 million to hotel operating expenses during the first six months of 2013. Hotel operating expenses in our existing portfolio increased \$10.0 million during the first six months of 2013 as compared to the same period in 2012, primarily due to the same reasons described above in the discussion regarding the second quarter, except property taxes increased during the first six months of 2013 as compared to the same period in 2012 due to increased property taxes assessments at many of our hotels.

Property general and administrative expense. Property general and administrative expense increased \$1.7 million, or 7.1%, during the three months ended June 30, 2013 as compared to the three months ended June 30, 2012. The three recently acquired hotels contributed an additional \$1.2 million to property general and administrative expense during the second quarter of 2013. Property general and administrative expense in our existing portfolio increased \$0.5 million during the three months ended June 30, 2013 as compared to the three months ended June 30, 2012, primarily due to the Marriott-managed hotels' seven additional days in the second quarter of 2013 as compared to the same period in 2012, combined with increased management fees and credit and collection expenses due to the increase in revenue, partially offset by decreased payroll and related costs and contract and professional fees.

Property general and administrative expense increased \$3.4 million, or 7.4%, during the six months ended June 30, 2013 as compared to the six months ended June 30, 2012. The three recently acquired hotels contributed \$2.2 million to property general and administrative expense during the first six months of 2013. In addition, BuyEfficient contributed an additional \$0.2 million in property general and administrative expense during the first six months of 2013 as compared to the same period in 2012 due to increases in payroll and related expenses, including deferred stock compensation expense. Property general and administrative expense in our existing portfolio increased \$1.0 million during the six months ended June 30, 2013 as compared to the six months ended June 30, 2012, primarily due to increased payroll and related costs, management fees, and credit and collection expenses due to the increase in revenue, partially offset by decreased contract and professional fees.

Corporate overhead expense. Corporate overhead expense decreased \$0.2 million, or 2.9%, during the three months ended June 30, 2013 as compared to the three months ended June 30, 2012, primarily due to a \$1.2 million decrease in acquisition and due diligence costs. During the

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

second quarter of 2013, we incurred acquisition and due diligence costs of \$0.7 million related to our completed acquisitions. During the second quarter of 2012, we incurred acquisition and due diligence costs of \$1.3 million related to our completed acquisitions, and an additional \$0.6 million related to in-process-or-abandoned projects. This decrease was partially offset by the following increases: payroll and related expenses (\$0.3 million); deferred stock compensation (\$0.3 million); contract and professional fees (\$0.2 million); investor relations (\$0.1 million); and legal (\$0.1 million).

Corporate overhead expense increased \$0.8 million, or 5.9%, during the six months ended June 30, 2013 as compared to the six months ended June 30, 2012, primarily due to the following increases: payroll and related expenses (\$0.8 million); deferred stock compensation (\$0.4 million); contract and professional fees (\$0.4 million); investor relations (\$0.1 million); legal (\$0.3 million); and conferences and travel (\$0.1 million). These increases were partially offset by a \$1.2 million decrease in acquisition and due diligence costs. During the first six months of 2013, we incurred acquisition and due diligence costs of \$0.8 million related to our completed acquisitions. During the first six months of 2012, we incurred acquisition and due diligence costs of \$1.4 million related to our completed acquisitions, and an additional \$0.6 million related to in-process-or-abandoned projects. In addition, donations expense decreased \$0.1 million during the first six months of 2013 as compared to the same period in 2012.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

Depreciation and amortization expense. Depreciation and amortization increased \$0.9 million, or 2.8%, for the three months ended June 30, 2013 as compared to the three months ended June 30, 2012. The three recently acquired hotels contributed an additional \$2.4 million to depreciation and amortization during the second quarter of 2013. Depreciation and amortization expense in our existing portfolio decreased \$1.5 million during the three months ended June 30, 2013 as compared to the three months ended June 30, 2012 primarily due to the fact that the advanced bookings recorded in connection with our purchases of the JW Marriott New Orleans and the Hilton San Diego Bayfront were fully amortized as of February 2013 and April 2013, respectively. This decrease in amortization was partially offset by additional depreciation recognized on hotel renovations and purchases of furniture, fixtures and equipment (FF&E) for our existing portfolio.

Depreciation and amortization increased \$4.0 million, or 6.4%, for the six months ended June 30, 2013 as compared to the six months ended June 30, 2012. Our three recently acquired hotels contributed \$5.1 million to depreciation and amortization during the first six months of 2013. Depreciation and amortization expense in our existing portfolio decreased \$1.1 million during the first six months of 2013 as compared to the same period in 2012 primarily due to the same reasons described above in the discussion regarding the second quarter.

Interest and other income. Interest and other income totaled \$0.8 million for the three months ended June 30, 2013, and \$0.1 million for the three months ended June 30, 2012. In the second quarter of 2013, we recognized \$0.7 million in interest on the Preferred Equity Investment, and \$0.1 million in other miscellaneous income. In the second quarter of 2012, we recognized \$0.1 million in interest and other miscellaneous income.

Interest and other income totaled \$1.4 million for the six months ended June 30, 2013, and \$0.1 million for the six months ended June 30, 2012. In the first six months of 2013, we recognized \$1.2 million in interest on the Preferred Equity Investment, and \$0.2 million in other miscellaneous income. In the first six months of 2012, we recognized \$0.1 million in interest and other miscellaneous income.

Interest expense. We incurred interest expense as follows (in thousands):

| | Three Months Ended June 30, 2013 | Three Months Ended June 30, 2012 | Six Months Ended June 30, 2013 | Six Months Ended June 30, 2012 |
|---|-------------------------------------|-------------------------------------|-----------------------------------|-----------------------------------|
| Interest expense | \$ 16,807 | \$ 17,806 | \$ 33,617 | \$ 35,880 |
| (Gain) loss on derivatives | (260) | 423 | (417) | 499 |
| Accretion of Senior Notes | | 258 | 3 | 524 |
| Amortization of deferred financing fees | 725 | 939 | 1,483 | 1,882 |
| Write-off of deferred financing fees | | 3 | | 3 |
| | \$ 17,272 | \$ 19,429 | \$ 34,686 | \$ 38,788 |

Interest expense decreased \$2.2 million, or 11.1%, during the three months ended June 30, 2013 as compared to the same period during 2012. Interest expense on our debt and capital lease obligations decreased \$1.0 million during the second quarter of 2013 as compared to the second quarter of 2012 due to reduced loan balances. In April 2012, we repaid a \$32.2 million loan secured by the Renaissance Long Beach, and in January 2013, we repurchased \$58.0 million of our Senior Notes. These decreases in our debt obligations and related decreases in interest expense were partially offset by an increase in capital lease obligations and related interest expense due to our acquisition of the Hyatt Chicago Magnificent Mile, which included the assumption of a building lease that we determined should be accounted for as a capital lease. Interest

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

expense related to our derivatives decreased \$0.7 million during the second quarter of 2013 as compared to the second quarter of 2012 due to our recording a net gain on our interest rate cap and swap agreements in 2013 as compared to a loss during the same period in 2012. Interest expense related to the accretion of our Senior Notes decreased \$0.3 million during the second quarter of 2013 as compared to the same period in 2012 due to the fact that the Senior Notes were fully accreted to their face value as of the first put date in January 2013. Interest expense related to amortization of deferred financing fees decreased \$0.2 million during the second quarter of 2013 as compared to the same period in 2012 due to the repayment of the loan secured by the Renaissance Long Beach in April 2012, combined with the fact that the deferred financing fees related to the Senior Notes were fully amortized as of the first put date in January 2013, partially offset by an increase in deferred financing fees incurred to amend our line of credit in September 2012.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

Interest expense decreased \$4.1 million, or 10.6%, during the six months ended June 30, 2013 as compared to the same period during 2012. Interest expense on our debt and capital lease obligations decreased \$2.3 million during the first six months of 2013 as compared to the first six months of 2012 due to reduced loan balances. In April 2012, we repaid a \$32.2 million loan secured by the Renaissance Long Beach, and in January 2013, we repurchased \$58.0 million of our Senior Notes. These decreases in our debt obligations and related decreases in interest expense were partially offset by an increase in capital lease obligations and related interest expense due to our acquisition of the Hyatt Chicago Magnificent Mile, which included the assumption of a building lease that we determined should be accounted for as a capital lease. Interest expense related to our derivatives decreased \$0.9 million during the first six months of 2013 as compared to the first six months of 2012 due to our recording a net gain on our interest rate cap and swap agreements in 2013 as compared to a loss during the same period in 2012. Interest expense related to the accretion of our Senior Notes decreased \$0.5 million during the first six months of 2013 as compared to the same period in 2012 due to the fact that the Senior Notes were fully accreted to their face value as of the first put date in January 2013. Interest expense related to amortization of deferred financing fees decreased \$0.4 million during the first six months of 2013 as compared to the same period in 2012 due to the repayment of the loan secured by the Renaissance Long Beach in April 2012, combined with the fact that the deferred financing fees related to the Senior Notes were fully amortized as of the first put date in January 2013, partially offset by an increase in deferred financing fees incurred to amend our line of credit in September 2012.

Our weighted average interest rate per annum on debt included in our continuing operations, including our variable-rate debt obligations, was approximately 4.9% at June 30, 2013 and 5.0% at June 30, 2012. Approximately 68.1% and 69.7% of our outstanding notes payable included in our continuing operations had fixed interest rates at June 30, 2013 and 2012, respectively.

Loss on extinguishment of debt. Loss on extinguishment of debt totaled zero and \$44,000 for the three and six months ended June 30, 2013, respectively, and zero and \$0.2 million for the three and six months ended June 30, 2012, respectively. During the first six months of 2013, we recognized a loss of \$44,000 due to the repurchase and redemption of the remaining \$58.0 million aggregate principal amount of the Senior Notes. During the first six months of 2012, we recognized a loss of \$0.2 million due to the repurchase and cancellation of \$4.5 million in aggregate principal amount of the Senior Notes.

Income tax provision. Income tax provision totaled \$0.1 million and \$6.3 million for the three and six months ended June 30, 2013, respectively, and zero for both the three and six months ended June 30, 2012. During the first quarter of 2013, we recognized income tax expense of \$4.7 million due to a resolution reached with the Internal Revenue Service (IRS). The Company leases its hotels to the TRS Lessee and its subsidiaries, which are subject to federal and state income taxes. In the first quarter of 2013, the IRS issued a notice of proposed adjustment to us, challenging certain aspects of our leases with our TRS Lessee and its subsidiaries. Though we believe our leases comply with all Code requirements, we determined that the costs associated with defending our position were greater than the benefits that might result therefrom. As such, we accrued \$4.7 million in March 2013 related to the IRS 's audit of tax years 2008, 2009 and 2010, including \$0.6 million in accrued interest. We recorded additional income tax expense of \$1.5 million during the first quarter of 2013 based on the ongoing evaluations of our uncertain tax positions related to the year ended December 31, 2012, and as a result of our recent resolution of outstanding issues with the IRS. During the second quarter of 2013, we recorded additional tax expense of \$0.1 million related to estimated 2013 federal and state income tax resulting from the use of net operating loss carryforwards.

Income from discontinued operations. As described under Investing Activities Dispositions and in accordance with the Property, Plant and Equipment Topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC), income from discontinued operations included the results of operations, along with any losses on extinguishment of debt and gains on sales for the following properties:

| Properties: | Rooms: | Disposition Date: |
|------------------|--------|-------------------|
| 2013: | | |
| Kahler Grand (1) | 660 | January 25, 2013 |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

| | | |
|---|-------|--------------------|
| Kahler Inn & Suites | 271 | January 25, 2013 |
| Marriott Rochester | 202 | January 25, 2013 |
| Residence Inn by Marriott Rochester | 89 | January 25, 2013 |
| Textile Care Services Rochester | | January 25, 2013 |
| 2012: | | |
| Doubletree Guest Suites Minneapolis | 229 | September 14, 2012 |
| Hilton Del Mar | 257 | September 14, 2012 |
| Marriott Troy | 350 | September 14, 2012 |
| Office building adjacent to the Marriott Troy | | September 14, 2012 |
| Marriott Del Mar | 284 | August 23, 2012 |
| Total rooms | 2,342 | |

-
- (1) During the third quarter of 2012, the Company subtracted eight rooms from the Kahler Grand, bringing the hotel room count to 660.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

Income from discontinued operations for the six months ended June 30, 2013 includes activity for the four hotels and one commercial laundry facility sold in January 2013. Income from discontinued operations for both the three and six months ended June 30, 2012 includes activity for four hotels and one commercial laundry facility sold in 2013, along with the four hotels and one office building sold during 2012. Income from discontinued operations for the six months ended June 30, 2012 also includes property tax refunds and reimbursements for certain transaction-related invoices for the Royal Palm Miami Beach, which we sold in April 2011. Income from discontinued operations is as follows (in thousands):

| | Three Months Ended June 30, 2013 | Three Months Ended June 30, 2012 | Six Months Ended June 30, 2013 | Six Months Ended June 30, 2012 |
|--|-------------------------------------|-------------------------------------|-----------------------------------|-----------------------------------|
| Operating revenues | \$ | \$ 29,133 | \$ 3,690 | \$ 56,120 |
| Operating expenses | | (20,427) | (3,686) | (40,205) |
| Interest expense | | (2,127) | (99) | (4,271) |
| Depreciation and amortization expense | | (3,983) | | (7,857) |
| Loss on extinguishment of debt | | | (3,115) | |
| Gain on sale of assets | | | 51,620 | 177 |
| | \$ | \$ 2,596 | \$ 48,410 | \$ 3,964 |

Income from consolidated joint venture attributable to non-controlling interest. Income from consolidated joint venture attributable to non-controlling interest totaled \$1.2 million and \$1.5 million for the three and six months ended June 30, 2013, respectively, and \$0.3 million and \$0.9 million for the three and six months ended June 30, 2012, respectively. Consistent with the Presentation Topic of the FASB ASC, our net income (loss) for the three and six months ended June 30, 2013 and 2012 includes 100% of the net income generated by the entity that owns the Hilton San Diego Bayfront. The outside 25.0% interest in the entity that owns the Hilton San Diego Bayfront earned net income of \$1.2 million and \$1.5 million for the three and six months ended June 30, 2013, respectively, and \$0.3 million and \$0.9 million for the three and six months ended June 30, 2012, respectively.

Distributions to non-controlling interest. Distributions to non-controlling interest totaled \$8,000 and \$16,000 for the three and six months ended June 30, 2013, respectively, and \$8,000 and \$16,000 for the three and six months ended June 30, 2012, respectively. We are the sole common stockholder of the captive REIT that owns the Doubletree Guest Suites Times Square. Preferred dividends earned by investors from the entity that owns the Doubletree Guest Suites Times Square, net of related administrative fees totaled \$8,000 and \$16,000 for the three and six months ended June 30, 2013, respectively, and \$8,000 and \$16,000 for the three and six months ended June 30, 2012, respectively.

Preferred stock dividends and redemption charge. Preferred stock dividends and redemption charge totaled \$3.5 million and \$14.4 million for the three and six months ended June 30, 2013, respectively, as compared to \$7.4 million and \$14.9 million for the three and six months ended June 30, 2012, respectively. On March 1, 2013, we redeemed all 7,050,000 shares of our Series A preferred stock, and on May 31, 2013, we redeemed all 4,102,564 shares of our Series C preferred stock. These redemptions caused a decrease in preferred stock dividends of \$4.0 million during the second quarter of 2013 as compared to the same period in 2012. This decrease was partially offset by the recognition during the second quarter of 2013 of a \$0.1 million redemption charge on our Series C preferred stock related to the original issuance costs of the Series C preferred stock, which were previously included in additional paid in capital. For the six months ended June 30, 2013, preferred stock dividends decreased \$5.2 million as compared to the same period in 2012 due to our Series A and Series C preferred stock redemptions. These decreases in preferred stock dividends were partially offset by a \$4.6 million redemption charge recognized on our Series A preferred stock and a \$0.1 million redemption charge recognized on our Series C preferred stock related to the original issuance costs of these shares, which were previously included in additional paid in capital.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Undistributed income allocated to unvested restricted stock compensation. In accordance with the Earnings Per Share Topic of the FASB ASC, unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. As such, undistributed income of \$0.1 million and \$0.3 million for the three and six months ended June 30, 2013, respectively, and \$47,000 and zero for the three and six months ended June 30, 2012, respectively, were allocated to the participating securities.

Investing Activities

Acquisitions. We believe we are in the middle phase of a potentially prolonged cyclical lodging industry recovery. Accordingly, we further believe that hotels acquired over the next several quarters are likely to benefit from a multi-year recovery in hotel profitability, and may create long-term value in excess of our investment hurdles. Therefore, we selectively acquired one hotel during the six months ended June 30, 2013, and two hotels during 2012: the Hilton New Orleans St. Charles in May 2013; the Hyatt Chicago Magnificent Mile in June 2012; and the Hilton Garden Inn Chicago Downtown/Magnificent Mile in July 2012. In addition, we acquired the Boston Park Plaza in July 2013.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

On May 1, 2013, we purchased the 250-room Hilton New Orleans St. Charles for a net purchase price of \$59.1 million, including \$0.2 million of proration credits. The acquisition was funded with \$53.2 million of proceeds generated by our January 2013 sale of the Rochester Portfolio, as well as with proceeds received from our February 2013 issuance of common stock. The sale proceeds were held by the accommodator in order to facilitate a tax-deferred exchange.

On July 2, 2013, we acquired the 1,053-room Boston Park Plaza for a gross purchase price of \$250.0 million, excluding prorations and closing costs. The acquisition was funded with a combination of cash on hand and the remainder of the cash proceeds held by the accommodator, plus the assumption of a \$119.2 million non-recourse loan secured by the hotel with a fixed interest rate of 4.402% and a maturity date in February 2018.

While our primary focus is on acquiring branded, urban, upper-upscale hotels, our acquisition program is aimed at generating attractive risk-adjusted returns on our investment dollars, and therefore we may target lodging assets outside of the typical branded, urban, upper upscale profile represented by our existing portfolio in order to capitalize on opportunities which may arise. We intend to select the brands and operators for our hotels that we believe will lead to the highest returns. Additionally, the scope of our acquisitions program may include large hotel portfolios or hotel loans. Future acquisitions may be funded by our issuance of additional debt or equity securities, including our common and preferred OP units, or by draws on our \$150.0 million senior corporate credit facility entered into in November 2010 and amended in September 2012. However, in light of our current financial objectives, we expect to fund any near term acquisitions with a greater proportion of equity capital than debt capital.

Dispositions. We have from time to time divested of assets that no longer fit our target profile, will not offer long-term returns in excess of our cost of capital, or that have high risk relative to their anticipated returns. In connection with this strategy, during 2012 and the first six months of 2013, we sold eight hotels: the Marriott Del Mar in August 2012; the Doubletree Guest Suites Minneapolis, the Hilton Del Mar, and the Marriott Troy in September 2012; and the Rochester Hotels in January 2013. In addition, we sold an office building adjacent to the Marriott Troy in September 2012, and the commercial laundry facility included with the Rochester Portfolio in January 2013.

In January 2013, we sold the Rochester Portfolio to an unaffiliated third party, for net proceeds of \$195.6 million, of which \$145.7 million was deposited with an accommodator in order to facilitate potential tax-deferred exchanges. As of June 30, 2013, a total of \$73.2 million of the cash held by the accommodator has been used to fund tax-deferred exchanges, including \$53.2 million used to fund the majority of the purchase of the Hilton New Orleans St. Charles, and \$20.0 million used to pay refundable deposits towards the July 2013 acquisition of the Boston Park Plaza. We recognized a net gain on the sale of \$51.6 million. We retained a \$25.0 million Preferred Equity Investment in the Rochester Hotels that yields an 11% dividend, resulting in a deferred gain on the sale of \$25.0 million. The \$25.0 million gain will be deferred until the Preferred Equity Investment is repaid. We also provided a \$3.7 million working cash advance to the buyer, resulting in a deferred gain on the sale of \$3.7 million. The \$3.7 million gain will be deferred until we are repaid from the Rochester Portfolio's available cash flow. In addition, we retained a \$14.0 million liability related to the Rochester Portfolio's pension plan, which could be triggered in certain circumstances, including termination of the pension plan. The recognition of the \$14.0 million pension plan liability reduced our gain on the sale of the Rochester Portfolio. The \$14.0 million gain will be recognized, if at all, when and to the extent we are released from any potential liability related to the Rochester Portfolio's pension plan. Concurrent with the Rochester Portfolio sale, we extinguished the outstanding \$26.7 million mortgage secured by the Kahler Grand for a total cost of \$29.8 million, prepaid the \$0.4 million loan secured by the commercial laundry facility, and recorded a loss on extinguishment of debt of \$3.1 million which is included in discontinued operations.

Liquidity and Capital Resources

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Historical. During the periods presented, our sources of cash included our operating activities, working capital, sales of hotel properties and other assets, proceeds from our credit facility and proceeds from our common stock offerings. Our primary uses of cash were for acquisitions of hotel properties, capital expenditures for hotels, operating expenses, repayment of notes payable (including repurchases of Senior Notes) and our credit facility, repurchases of our preferred stock, dividends on our preferred stock and distributions to our joint venture partners. We cannot be certain that traditional sources of funds will be available in the future.

Operating activities. Our net cash provided by or used in operating activities fluctuates primarily as a result of changes in RevPAR and operating cash flow of our hotels. Our net cash provided by or used in operating activities may also be affected by changes in our portfolio resulting from hotel acquisitions, dispositions or renovations. Net cash provided by operating activities was \$74.5 million for the six months ended June 30, 2013 as compared to \$79.9 million for the six months ended June 30, 2012. This decrease was primarily due to an increase in restricted cash related to operating activities during the first six months of 2013 as compared to the same period in 2012.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

Investing activities. Our net cash provided by or used in investing activities fluctuates primarily as a result of acquisitions, dispositions and renovations of hotels. Net cash used in investing activities during the first six months of 2013 as compared to the first six months of 2012 was as follows (in thousands):

| | Six Months Ended June 30, 2013 | | Six Months Ended June 30, 2012 | |
|--|-----------------------------------|----------|-----------------------------------|----------|
| Proceeds from sales of hotel properties and other assets | \$ | 195,621 | \$ | 11 |
| Cash proceeds held by accommodator | | (72,287) | | |
| Restricted cash replacement reserve | | 11,054 | | (5,177) |
| Acquisitions of hotel properties and other assets | | (59,137) | | (29,694) |
| Acquisition deposits | | (20,000) | | (3,000) |
| Renovations and additions to hotel properties and other assets | | (69,089) | | (48,483) |
| Payment for interest rate derivative | | (12) | | |
| | \$ | (13,850) | \$ | (86,343) |

Net cash used in investing activities was \$13.9 million during the six months ended June 30, 2013 as compared to \$86.3 million for the six months ended June 30, 2012. During the six months ended June 30, 2013, we received proceeds of \$195.6 million from the sale of the Rochester Portfolio, of which \$59.1 million was used to fund our May 2013 tax-deferred exchange for the Hilton New Orleans St. Charles and \$20.0 million was used to pay deposits towards our July 2013 tax-deferred exchange for the Boston Park Plaza. As of June 30, 2013, \$72.3 million remained with the accommodator, which funds were used in July 2013 to fund a portion of our tax-deferred exchange for the Boston Park Plaza. During the first six months of 2013, we also decreased our restricted cash by \$11.1 million, paid \$69.1 million for renovations and additions to our portfolio and paid \$12,000 for an interest rate cap agreement on our variable-rate mortgage secured by the Hilton San Diego Bayfront.

During the six months ended June 30, 2012, we received proceeds of \$11,000 from the sale of surplus FF&E. This cash inflow was offset by the following cash outflows: \$5.2 million as we increased the balance in our restricted cash replacement reserve accounts; \$29.7 million paid to acquire the Hyatt Chicago Magnificent Mile, partially offset by \$21,000 of unrestricted cash received upon acquisition; \$3.0 million paid as a deposit towards our July 2012 acquisition of the Hilton Garden Inn Chicago Downtown/Magnificent Mile; and \$48.5 million for renovations and additions to our portfolio.

Financing activities. Our net cash provided by or used in financing activities fluctuates primarily as a result of our issuance of common stock and our issuance and repayment of notes payable (including the repurchase of Senior Notes) and our credit facility, and our issuance and repurchase of other forms of capital, including preferred equity. Net cash used in financing activities was \$94.6 million for the six months ended June 30, 2013 compared to net cash provided of \$59.8 million for the six months ended June 30, 2012. Net cash used in financing activities during the six months ended June 30, 2013 consisted of the following cash outflows: a total of \$276.3 million paid to redeem all of our Series A and Series C preferred stock; \$124.5 million in principal payments on our notes payable and credit facility, including \$58.0 million to repurchase our Senior Notes, \$26.7 million to extinguish the existing mortgage on the Kahler Grand, \$0.4 million to prepay the existing mortgage on the commercial laundry facility included in the Rochester Portfolio, \$30.0 million to repay a draw on our credit facility and \$9.3 million of principal payments on our notes payable; \$3.1 million in costs incurred on our repurchase of the Senior Notes, our extinguishment of the Kahler Grand mortgage and our repayment of the commercial laundry mortgage; \$14.8 million in preferred dividends to our stockholders; \$0.9 million in distributions to the non-controlling interests in our hotels; and \$5,000 in deferred financing costs paid in connection with our purchase of the interest rate cap agreement on our variable-rate mortgage secured by the Hilton San Diego Bayfront. These cash outflows were partially offset by \$294.9 million in net proceeds received from our issuance of common stock and \$30.0 million in proceeds received from our credit facility.

Net cash provided by financing activities for the six months ended June 30, 2012 consisted of \$126.1 million in net proceeds received from the issuance of common stock, including \$126.2 million in net proceeds received from our common stock offering offset by \$0.1 million in fees

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

related to shares issued to the seller of the Hyatt Chicago Magnificent Mile, and \$15.0 million in proceeds received from a draw on our credit facility. These cash inflows were partially offset by \$63.0 million in principal payments on our notes payable and credit facility, including \$32.2 million to repay the existing mortgage secured by the Renaissance Long Beach, \$15.0 million to repay a draw on our credit facility, \$4.5 million to repurchase a portion of our Senior Notes and \$11.3 million of principal payments on our notes payable. In addition, we paid \$0.1 million in fees related to the repurchase a portion of our Senior Notes, \$14.9 million in preferred dividends to our stockholders, and \$3.3 million in distributions to the non-controlling interests in our hotels.

Table of Contents

Future. We expect our primary uses of cash to be for acquisitions of hotels, including possibly hotel portfolios, capital investments in our hotels, operating expenses, repayment of principal on our notes payable and credit facility, interest expense, dividends and redemptions of our preferred stock. We expect our primary sources of cash will continue to be our operating activities, working capital, notes payable, dispositions of hotel properties, and proceeds from public and private offerings of debt securities and common and preferred stock. Our financial objectives include the measured improvement of our credit ratios, maintenance of appropriate levels of liquidity, and a gradual reduction in our financial leverage. In light of our leverage objectives, in the near term, we expect to fund acquisitions largely through the issuance of equity in order to grow the quality and scale of our portfolio while reducing leverage. Consistent with this strategy, we issued common stock during 2012 to fund our acquisitions of both the Hyatt Chicago Magnificent Mile and the Hilton Garden Inn Chicago Downtown/Magnificent Mile in July 2012. 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 alternate sources of capital in an effort to minimize our capital costs and maximize our financial flexibility. However, when needed, the capital markets may not be available to us on favorable terms or at all.

We believe that our current cash balance, our cash flow from operations, our access to capital markets and our unencumbered properties will provide us with sufficient liquidity to meet our current operating expenses and other expenses directly associated with our business (including payment of dividends on our capital stock, if declared) for the foreseeable future, and in any event for at least the next 12 months.

Debt. Concurrent with the Rochester Portfolio sale in January 2013, we extinguished the outstanding \$26.7 million mortgage secured by the Kahler Grand for a total cost of \$29.8 million, prepaid the \$0.4 million loan secured by the commercial laundry facility, and recorded a loss on extinguishment of debt of \$3.1 million which is included in discontinued operations.

In January 2013, we validly tendered, accepted and repurchased \$42.0 million of Senior Notes pursuant to a tender offer, and we redeemed the remaining \$16.0 million of the Senior Notes. We funded the total \$58.0 million in Senior Note redemptions with available cash, leaving no future amounts outstanding related to the Senior Notes. We recognized a loss of \$44,000 on this extinguishment of debt.

As of June 30, 2013, we had \$1.3 billion of debt, \$199.9 million of cash and cash equivalents, including restricted cash, and total assets of \$3.1 billion. We believe that by controlling debt levels, staggering maturity dates and maintaining a highly flexible capital structure, we can maintain lower capital costs than more highly leveraged companies, or companies with limited flexibility due to restrictive corporate-level financial covenants.

As of June 30, 2013, all of our outstanding debt had fixed interest rates, except the \$233.1 million non-recourse mortgage on the Hilton San Diego Bayfront and the \$180.0 million non-recourse mortgage on the Doubletree Guest Suites Times Square, both of which are subject to interest rate cap agreements. The interest rate cap agreement on the Hilton San Diego Bayfront mortgage matures in April 2015, and caps the 3-month LIBOR rate at 3.75%. The interest rate cap agreement on the Doubletree Guest Suites Times Square mortgage matures in October 2015, and caps the 3-month LIBOR rate at 4.0%. All of our mortgage debt is in the form of single asset loans. We currently 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, and as evidenced by our 2009 secured debt restructuring program, in instances where asset values have declined to levels below the principal amount of the associated mortgage, non-recourse single asset mortgages may limit the degradation in value experienced by our stockholders by shifting a portion of asset risk to our secured lenders.

As of June 30, 2013, the weighted average term to maturity of our debt is approximately 4 years, and 68.1% of our debt is fixed rate with a weighted average interest rate of 5.6%. Including our variable-rate debt obligations based on the variable rates at June 30, 2013, the weighted

average interest rate on our debt is 4.9%.

We may in the future seek to obtain mortgages on one or all of our 12 unencumbered hotels, all but three of which are currently held by subsidiaries whose interests are pledged to our credit facility at June 30, 2013: Courtyard by Marriott Los Angeles, Fairmont Newport Beach, Hilton Garden Inn Chicago Downtown/Magnificent Mile (not pledged to our credit facility), Hilton New Orleans St. Charles (not pledged to our credit facility), Hyatt Chicago Magnificent Mile (not pledged to our credit facility), Hyatt Regency Newport Beach, Marriott Quincy, Marriott Portland, Renaissance Long Beach, Renaissance Los Angeles Airport, Renaissance Westchester and Sheraton Cerritos. These 12 hotels had an aggregate of 4,196 rooms as of June 30, 2013, and generated \$114.9 million in revenue during the first six months of 2013, including revenue generated prior to our ownership, as applicable. Should we obtain secured financing on any or all of our 12 unencumbered hotels, the amount of capital available through our credit facility may be reduced.

Table of Contents

Cash Balance. As of June 30, 2013, our unrestricted cash balance was \$123.2 million. Adjusting for the funds we used in July 2013 to purchase the Boston Park Plaza, our unrestricted pro forma cash balance as of June 30, 2013 was \$64.7 million, which exceeds all of our pending debt maturities through May 2015. By minimizing our need to access external capital by maintaining higher than typical cash balances, our financial security and flexibility are meaningfully enhanced because we are able to fund our business needs and debt maturities partially with our cash. As we believe the lodging cycle is in the first half of a potentially prolonged cyclical recovery, we may deploy a portion of our excess cash balance in 2013 towards debt repayments and repurchases (such as the repurchase of our Senior Notes in January 2013, and our redemptions of all issued and outstanding shares of the Series A and Series C preferred stock in March 2013 and May 2013, respectively), selective acquisitions and capital investments in our portfolio. While our primary focus is on acquiring branded, urban, upper upscale hotels, our acquisition program is aimed at generating attractive risk-adjusted returns on our investment dollars, and therefore we may target lodging assets outside of the typical branded, urban, upper upscale profile represented by our existing portfolio in order to capitalize on opportunities which may arise. Additionally, the scope of our acquisitions program may include large hotel portfolios or hotel loans.

Contractual Obligations

The following table summarizes our payment obligations and commitments as of June 30, 2013 (in thousands):

| | Total | Payment due by period | | | |
|---|---------------------|-----------------------|-------------------|-------------------|----------------------|
| | | Less than 1 year | 1 to 3 years | 3 to 5 years | More than 5 years |
| Notes payable | \$ 1,296,197 | \$ 20,571 | \$ 515,864 | \$ 331,718 | 428,044 |
| Interest obligations on notes payable (1) | 267,486 | 62,982 | 114,827 | 54,628 | 35,049 |
| Capital lease obligations | 15,638 | 35 | 28 | 2 | 15,573 |
| Interest obligations on capital leases | 102,954 | 1,402 | 2,804 | 2,804 | 95,944 |
| Operating lease obligations | 561,944 | 10,367 | 20,908 | 25,597 | 505,072 |
| Construction commitments | 26,252 | 26,252 | | | |
| Employment obligations | 3,456 | 1,331 | 2,040 | 85 | |
| Total | \$ 2,273,927 | \$ 122,940 | \$ 656,471 | \$ 414,834 | \$ 1,079,682 |

(1) Interest on variable-rate debt obligations is calculated based on the variable rates at June 30, 2013 and includes the effect of our interest rate derivative agreements.

Capital Expenditures and Reserve Funds

We believe we maintain each of our hotels in good repair and condition and in general conformity with applicable franchise and management agreements, ground, building and air 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 for renovation and development. We invested \$69.1 million in our portfolio during the first six months of 2013. As of June 30, 2013, we have contractual construction commitments totaling \$26.3 million. If we acquire, renovate or develop additional hotels in the future, our capital expenditures will increase.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

With respect to our hotels that are operated under management or franchise agreements with major national hotel brands and for all of our hotels subject to first mortgage liens, we are obligated to maintain an 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 zero and 5.0% of the respective hotel's total annual revenue. As of June 30, 2013, \$36.1 million was held in FF&E reserve accounts for future capital expenditures at the 27 hotels. According to certain loan agreements, reserve funds are to be held by the lenders or managers in restricted cash accounts, and we are not required to spend the entire amount in such reserve accounts each year.

Off-Balance Sheet Arrangements

Our off-balance sheet arrangement consists of our ownership interest in the Preferred Equity Investment. For further discussion of the Preferred Equity Investment and its effect on our financial condition, results of operations and cash flows, see Note 4 to the consolidated financial statements.

Seasonality and Volatility

As is typical of the lodging industry, we experience some seasonality in our business as indicated in the table below. Revenue for certain of our hotels is generally affected by seasonal business patterns (*e.g.*, the first quarter is strong in Orlando, the second quarter is strong for the Mid-Atlantic business hotels, and the fourth quarter is strong for New York City). Quarterly revenue also may be adversely affected by renovations, our managers' effectiveness in generating business and by events beyond our control, such as

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

extreme weather conditions, terrorist attacks or alerts, public health concerns, airline strikes or reduced airline capacity, economic factors and other considerations affecting travel. Quarterly revenues prior to 2013 were also impacted by the 13-fiscal period accounting calendar used by Marriott. Beginning in 2013, Marriott, the third-party manager of 10 of our 27 hotels will switch to a standard 12-month fiscal calendar, which will shift the operating results for approximately 20 calendar days from the fourth quarter to the first three quarters. Revenues for our 27 hotel Comparable Portfolio by quarter for 2011, 2012 and 2013 were as follows (dollars in thousands):

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Total |
|--|------------------|-------------------|------------------|-------------------|------------|
| 2011 Comparable Portfolio revenues(1) | \$ 177,039 | \$ 208,953 | \$ 194,223 | \$ 228,180 | \$ 808,395 |
| 2011 Revenues as a percentage of total | 21.9% | 25.8% | 24.1% | 28.2% | 100.0% |
| 2012 Comparable Portfolio revenues(1) | \$ 187,347 | \$ 225,141 | \$ 206,772 | \$ 234,497 | \$ 853,757 |
| 2012 Revenues as a percentage of total | 21.9% | 26.4% | 24.2% | 27.5% | 100.0% |
| 2013 Comparable Portfolio revenues(1) | \$ 197,112 | \$ 234,296 | | | |

(1) Includes all 27 hotel properties in which we have interests as of June 30, 2013. Also includes the following prior ownership results: the Hilton New Orleans St. Charles for all of 2011 and 2012, and during the periods in 2013 before our acquisition of the hotel; the Hyatt Chicago Magnificent Mile and the Hilton Garden Inn Chicago Downtown/Magnificent Mile for all of 2011 and during the periods in 2012 before our acquisitions of the hotels; and the Doubletree Guest Suites Times Square, the JW Marriott New Orleans and the Hilton San Diego Bayfront during the periods in 2011 before our acquisitions of the hotels.

Inflation

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

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (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 consolidated financial statements.

- ***Impairment of long-lived assets and goodwill.*** We periodically review each property and any related goodwill 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. We perform a Level 3 analysis of fair value, using a 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 and terminal capitalization rate. Our judgment is required in determining the discount rate applied to estimated cash flows, growth rate of the properties, operating income of the properties, the need for capital expenditures, as well as specific market and economic conditions.

We account for goodwill in accordance with the Intangibles – Goodwill and Other Topic of the FASB ASC, which states that goodwill has an indefinite useful life that should not be amortized but should be reviewed annually for impairment, or more frequently if events or changes in circumstances indicate that goodwill might be impaired, as well as the Fair Value Measurements and Disclosures Topic of the FASB ASC for financial and nonfinancial assets and liabilities, which establishes a framework for measuring fair value and expands disclosures about fair value measurements by establishing a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The review of any potential goodwill impairment requires estimates of fair value for our properties and other assets that have goodwill arising from unallocated acquisition costs. These estimates of fair value are prepared using Level 3 measurements.

Table of Contents

- **Acquisition related assets and liabilities.** Accounting for the acquisition of a hotel property or other entity as a purchase transaction requires an allocation of the purchase price to the assets acquired and the liabilities assumed in the transaction at their respective estimated fair values. The most difficult estimations of individual fair values are those involving long-lived assets, such as property, equipment, intangible assets and capital lease obligations that are assumed as part of the acquisition of a leasehold interest. During the first six months of 2013 and the full-year 2012, we used all available information to make these fair value determinations, and engaged independent valuation specialists to assist in the fair value determinations of the long-lived assets acquired in our purchases of Hilton New Orleans St. Charles, the Hyatt Chicago Magnificent Mile and the Hilton Garden Inn Chicago Downtown/ Magnificent Mile. Due to the inherent subjectivity in determining the estimated fair value of long-lived assets, we believe that the recording of acquired assets and liabilities is a critical accounting policy.
- **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 investments are depreciated using the straightline method over estimated useful lives primarily ranging from five to 35 years for buildings and improvements and three to 12 years for furniture, fixtures and equipment. While we believe our 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.

New Accounting Standards and Accounting Changes

In December 2011, the FASB issued Accounting Standards Update No. 2011-10, *Property, Plant and Equipment: Derecognition of in Substance Real Estate a Scope Clarification* (ASU No. 2011-10). Under the amendments in ASU No. 2011-10, when a parent (reporting entity) ceases to have a controlling financial interest in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt, the reporting entity should apply the guidance in Subtopic 360-20 to determine whether it should derecognize the in substance real estate. Generally, a reporting entity would not satisfy the requirements to derecognize the in substance real estate before the legal transfer of the real estate to the lender and the extinguishment of the related nonrecourse indebtedness. That is, even if the reporting entity ceases to have a controlling financial interest under Subtopic 810-10, the reporting entity would continue to include the real estate, debt, and the results of the subsidiary's operations in its consolidated financial statements until legal title to the real estate is transferred to legally satisfy the debt. The adoption of ASU No. 2011-10 in the first quarter of 2013 did not have any effect on our financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

To the extent we incur debt with variable interest rates, our future income, cash flows and fair values relevant to financial instruments are dependent upon prevalent market interest rates. Market risk refers to the risk of loss from adverse changes in market prices and interest rates. We have no derivative financial instruments held for trading purposes. We use derivative financial instruments to manage, or hedge, interest rate risks.

As of June 30, 2013, 68.1% of our debt obligations are fixed in nature, which largely mitigates the effect of changes in interest rates on our cash interest payments. If market rates of interest on our variable rate debt increase or decrease by 100 basis points, interest expense would increase or decrease, respectively, our future cash flows by approximately \$4.4 million based on the variable rates at June 30, 2013. This increase or decrease in interest expense would increase or decrease, respectively, our future earnings by \$3.8 million, after adjusting for the non-controlling interest in the Hilton San Diego Bayfront based on the variable rates at June 30, 2013. However, increases and decreases in LIBOR rates are sometimes correlated with increases and decreases in lodging operations, which may mean that any increases in our interest expense due to

higher variable rates may coincide with increases in our revenue due to higher lodging demand.

Item 4. Controls and Procedures

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

Table of Contents

Changes in Internal Control over Financial Reporting. During our fiscal quarter to which this Quarterly Report on Form 10-Q relates, there has not occurred any change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

None.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

Table of Contents

Item 6. Exhibits

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

| Exhibit Number | Description |
|-----------------------|--|
| 3.1 | Articles of Amendment and Restatement of Sunstone Hotel Investors, Inc. (incorporated by reference to Exhibit 3.1 to the registration statement on Form S-11 (File No. 333-117141), filed by the Company). |
| 3.2 | Amended and Restated Bylaws of Sunstone Hotel Investors, Inc. (incorporated by reference to Exhibit 3.1 to Form 10-Q, filed by the Company on August 5, 2008). |
| 3.3 | First Amendment to the Amended and Restated Bylaws of Sunstone Hotel Investors, Inc., effective as of March 19, 2012 (incorporated by reference to Exhibit 3.1 to Form 8-K, filed by the Company on March 22, 2012). |
| 3.4 | Form of Articles Supplementary for Series C preferred stock (incorporated by reference to Exhibit 3 to Form 8-K filed by the Company on July 13, 2005). |
| 3.5 | Form of Articles Supplementary for Series D preferred stock (incorporated by reference to Exhibit 3.3 to the registration statement on Form 8-A filed by the Company on April 6, 2011). |
| 3.6 | Articles Supplementary Prohibiting the Company From Electing to be Subject to Section 3-803 of the Maryland General Corporation Law Absent Shareholder Approval (incorporated by reference to Exhibit 3.1 to Form 8-K, filed by the Company on April 29, 2013). |
| 10.1 | Loan Agreement, dated January 27, 2013 between RP/HH Park Plaza, Limited Partnership (as borrower) and Bank of America, N.A. (as lender). |
| 10.2 | Assumption Agreement, dated July 2, 2013, by U.S. BANK NATIONAL ASSOCIATION, as Trustee for Morgan Stanley Bank of America Merrill Lynch Trust 2013-C8, Commercial Mortgage Pass-Through Certificates, Series 2013-C8 (<i>Noteholder</i>), RP/HH PARK PLAZA, LIMITED PARTNERSHIP, a Delaware limited partnership (<i>Borrower</i>), ROCKPOINT REAL ESTATE FUND III, L.P., a Delaware limited partnership (<i>Original Guarantor</i>), BOSTON 1927 OWNER, LLC, a Delaware limited liability company (<i>Assumptor</i>) and SUNSTONE HOTEL PARTNERSHIP, LLC, a Delaware limited liability company (<i>New Guarantor</i>) and is acknowledged and agreed to by BOSTON 1927 LESSEE, INC., a Delaware corporation (<i>Operating Lessee</i>) solely to acknowledge and agree to certain representations, warranties and covenants. |
| 31.1 | Certification of Principal Executive Officer Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Principal Financial Officer Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Principal Executive Officer and Principal Financial Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document * |
| 101.SCH | XBRL Taxonomy Extension Schema Document * |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document * |

Edgar Filing: Sunstone Hotel Investors, Inc. - Form 10-Q

| | |
|---------|--|
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document * |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document * |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document * |

* Attached as Exhibit 101 to this Quarterly Report on Form 10-Q are the following materials, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets at June 30, 2013 and December 31, 2012; (ii) the Consolidated Statements of Operations and Comprehensive Income (Loss) for the three and six months ended June 30, 2013 and 2012; (iii) the Consolidated Statement of Equity for the six months ended June 30, 2013; (iv) the Consolidated Statements of Cash Flows for the six months ended June 30, 2013 and 2012; and (v) Notes to Consolidated Financial Statements that have been detail tagged. The financial information contained in the XBRL-related documents is unaudited or unreviewed.

Table of Contents

SIGNATURES

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

Sunstone Hotel Investors, Inc.

Date: August 7, 2013

By:

/s/ Bryan A. Giglia
Bryan A. Giglia
**(Chief Financial Officer and Duly Authorized
Officer)**