STRATEGIC HOTEL CAPITAL INC
Form 10-K
March 07, 2005
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2004

OR

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

For the Transition period from to

Commission File No. 001-32223

STRATEGIC HOTEL CAPITAL, INC.

(Exact name of registrant as specified in its charter)

Maryland **(State of Incorporation)**	**33-1082757** **(I.R.S. Employer Identification No.)**
77 West Wacker Drive, Suite 4600, Chicago, Illinois **(Address of Principal executive offices)**	**60601** **(Zip Code)**

Registrant s telephone number, including area code: (312) 658-5000

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

Title of each class	Name of exchange on which registered
Common Stock ($0.01 par value)	**New York Stock Exchange, Inc.**

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

None

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ¨ No x.

The aggregate market value of the voting stock of the registrant held by nonaffiliates of the registrant was approximately $258,705,300 as of June 30, 2004.

The number of shares of Common Stock ($0.01 par value) of the registrant outstanding as of March 4, 2005 was 30,035,701.

(1) The registrant became subject to the Securities Exchange Act of 1934 on June 23, 2004.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Report on Form 10-K incorporates by reference certain information from the registrant s definitive Proxy Statement which will be furnished to stockholders in connection with the Annual Meeting of Stockholders of the registrant scheduled to be held on May 18, 2005.

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This report contains registered trademarks that are the exclusive property of their respective owners, which are companies other than us, including Embassy Suites®, Four Seasons®, Hilton®, Hyatt®, Inter.Continental®, Loews®, Marriott® and Ritz-Carlton®. None of the owners of these trademarks, their affiliates or any of their respective officers, directors, agents or employees has or will have any liability or responsibility for any financial statements, projections or other financial information or other information contained in this report.

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DISCLOSURE REGARDING FORWARD LOOKING STATEMENTS

Some of the statements contained in this report constitute forward-looking statements. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by terms such as may , will , should , expects , plans , anticipates , believe estimates , predicts , potential or the negative of these terms or other comparable terminology.

The forward-looking statements contained in this report reflect our current views about future events and are subject to risks, uncertainties, assumptions and changes in circumstances that may cause our actual results to differ significantly from those expressed in any forward-looking statement. The factors that could cause actual results to differ materially from expected results include changes in economic, business, competitive market and regulatory conditions. Important risks and factors that could cause our actual results to differ materially from any forward-looking statements include, but are not limited to:

- The factors discussed in this report set forth under the sections titled Business Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations ;
- Downturns in economic and market conditions, particularly levels of spending in the travel and leisure industries in the markets where we invest;
- Hostilities, including future terrorist attacks, or apprehension of hostilities that affect travel within or to the United States, Mexico, Czech Republic, Germany, France or other countries where we invest;
- Increases in interest rates and operating costs;
- Difficulties in identifying properties to acquire and completing acquisitions;
- Our ability to dispose of existing properties in a manner consistent with our investment strategy;
- Risks related to natural disasters;
- General volatility of the capital markets and the market price of our common shares;
- Our failure to maintain our status as a REIT;
- Changes in real estate and zoning laws or regulations;
- Increases in real property tax rates; and

Changes in the competitive environment in our industry and the markets where we invest.

We do not intend, and disclaim any duty or obligation, to update or revise any industry information or forward-looking statements set forth in this report to reflect new information, future events or otherwise.

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PART I

ITEM 1. BUSINESS.

Overview

We were incorporated in January 2004 to own and asset manage upper upscale and luxury hotels in North America and Europe. We went public in an initial public offering in June 2004. Our founder and accounting predecessor, Strategic Hotel Capital, L.L.C., or SHC LLC, was founded in 1997 by Laurence Geller, our President and Chief Executive Officer, WHSHC, L.L.C. and W9/WHSHC, L.L.C.I, which we collectively call Whitehall (an affiliate of Goldman Sachs & Co.), and others. We own our properties through our investment in SHC Funding, our operating partnership.

We:

- own the fee interest in 11 hotels, comprising approximately 4,961 rooms, located in Arizona, California, Florida, Illinois and Louisiana and in Mexico;
- lease three hotels from unaffiliated lessors: a ground lease for a hotel in Lincolnshire, Illinois and operating leases for hotels in Paris, France and Hamburg, Germany, comprising an aggregate of approximately 859 rooms;
- own a 35% interest in a joint venture, with an unaffiliated party, that owns a hotel in Prague, Czech Republic comprising approximately 372 rooms, and we asset manage such hotel on behalf of the joint venture;
- own a 31% interest in and act as asset manager for a joint venture, which joint venture is with two unaffiliated parties, that is developing the Four Seasons Residence Club Punta Mita, a luxury vacation home product that will be sold in fractional ownership interests on property adjacent to our Four Seasons Punta Mita Resort hotel in Mexico; and
- asset manage seven hotels for SHC LLC under an asset management agreement.

We do not operate any of our hotels directly; instead we employ internationally known hotel management companies to operate them for us under management contracts or operating leases. Our existing hotels are operated under the widely recognized upper upscale and luxury brands of Embassy Suites®, Four Seasons®, Hilton®, Hyatt®, Inter.Continental®, Loews®, Marriott® and Ritz-Carlton®.

As used in this report, references to we , our , us , SHCI and the REIT are to Strategic Hotel Capital, Inc. and, except as the context otherwise requires, its consolidated subsidiaries, including Strategic Hotel Funding, L.L.C. and its consolidated subsidiaries. References to Whitehall are to Whitehall Street Real Estate Limited Partnership VII, Whitehall Street Real Estate Limited Partnership IX and their affiliates. Whitehall is affiliated with The Goldman Sachs Group, Inc., which is the parent company of Goldman, Sachs & Co. References to Prudential are to Prudential Financial, Inc. and its affiliates, including Strategic Value Investors, LLC, The Prudential Insurance Company of America, Prudential Investment Management, Inc., PIC Realty Corporation and Prudential Assets, LLC, and to entities owning our securities over which Prudential

Financial, Inc. or its affiliates have investment management discretion, including (SHC/Olayan) Redemption Vehicle, LLC and SVI (SHC/Houston) Redemption Vehicle, LLC.

We seek to maximize asset values and operating results through asset management. We also seek to acquire additional properties that meet our disciplined investment criteria. Based on our past experience, we believe that full-service properties such as ours in the upper-upscale and luxury segments of the hotel industry may benefit to a greater extent than properties in other segments during periods of economic recovery. Given our history of asset management, strategic acquisitions and selective dispositions, we believe that we are well-positioned to take advantage of current favorable market conditions.

Business Strategy

Our goal is to build upon our existing portfolio of hotel properties to become a preeminent owner of upper upscale and luxury branded hotels primarily in the United States with select international hotels. Our future

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growth will be driven through the execution of a two-fold business strategy, which focuses on maximizing asset values and operating results through asset management and by research-driven capital deployment through acquisitions.

Earnings Growth Through Expert Asset Management

We believe that we can enhance our earnings growth through expert asset management which will ultimately generate higher overall investment returns. We have developed a comprehensive asset management system that we believe maximizes cash flow growth and property value. In addition, we believe that our asset management style has helped us to maximize economic benefits in an industry that has suffered reduced performance, and to position our properties for the current recovery. Our value-added asset management system has the following general components:

Working in partnership with our brands, we build an asset management approach to enhancing the cash flow and upside of our properties:

Our senior management team has long-standing relationships with executives of most major hospitality companies. With over 40 years of experience in the hospitality industry, Laurence Geller, our President and Chief Executive Officer, has developed strong relationships with hotel operators throughout the hotel industry as a senior executive, operator and consultant. In addition, we generally believe we have asset managers with broader experience in hotel operations than our competitors, in large part as a result of our belief that the efficiency of our team requires in-depth knowledge of all of the components of each property.

We believe that we can more effectively influence the operating performance of our hotels if we have multi-property relationships with a select group of hotel management companies, which we call our preferred operators. We select our preferred operators based on our opinion as to whether an operator has strong brand recognition, superior marketing capabilities, management depth and a history of efficient operations. Because our preferred operators provide the services, technology, human resources training and infrastructure to conduct day-to-day hotel operations, we can focus our energies on monitoring their performance, identifying areas of improvement and providing our operators with useful feedback that they can utilize to maximize operating results and enhance the value of our hotels.

We have a proven track record of improving hotel operating performance through the application of value-added programs involving consumer and market research, competitive benchmarking, technology upgrades and systems development and upgrades. In addition, we have long-standing relationships with specialists with whom we consult or recommend to the managers of our hotels as needed in order to provide them more focused support and expertise in areas such as consumer research, purchasing, retailing, merchandising, food and beverage services, physical plant and equipment maintenance, labor systems and parking. Our asset management group is supported by:

- consumer-based marketing research to assess overall trends in consumer preferences and attitudes on issues such as price, brand, services, amenities and facility needs that have led to strategies that alter customer mix, and improve pricing and overall total revenues; and

- well-developed techniques for measuring and analyzing departmental and overall hotel profitability and operating trends that have led to implementation of efficiency measures which result in cost savings.

We have also improved operating performance at a number of our hotels through measures including:

appealing real estate taxes, generating annualized tax savings;

assisting our hotel operators in conducting energy reviews and audits, generating fuel and electric savings;

assisting our operators in a review of staffing levels and productivity standards, generating labor savings; and

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assisting our operators in a review of their food purchasing practices and vendor pricing, generating reductions in food costs.

Our hotels are operated under a number of different brands in different locations, which exposes us to diverse management approaches and provides us with an opportunity to identify, develop and apply what we believe to be the best practices in the industry. Our asset management group uses this knowledge to help our preferred operators implement revenue enhancement opportunities, improve operating performance through cost-saving actions and generate incremental profitability above a hotel s baseline results.

***We provide rigorous oversight of the properties and management companies to ensure the alignment of interests and compliance with management contracts*:**

We closely monitor the management companies to which we have delegated the management of our hotels to ensure that they adhere to the terms of their contracts with us. Our asset management group systematically monitors operating decisions, which are made independently by hotel operators but impact the profitability of our hotel properties. In addition, our asset management group works with each of our preferred operators at their corporate level to seek to maximize the value of our properties through the operation of their internal programs and to ensure that cost allocations to each of our properties are appropriate.

As a result of the depth of our involvement in our hotel properties, we attain more favorable terms upon renewal of management contracts. For example, where possible, we negotiate management contracts that align the interests of hotel operators with those of the hotel owner by increasing the emphasis on incentive management fees, which we believe focuses the obligation of each hotel s management to operate for the benefit of the hotel rather than for the benefit of the brand the hotel carries. In certain cases, these initiatives have included a cap on the allocation of certain chain level expenses to our hotels and, in other cases, have included persuading hotel management companies to adopt money saving labor management and food and beverage purchasing systems.

***Our asset management team is integral to the capital planning at each hotel including both routine maintenance expenditures and innovative hotel investments to enhance revenues*:**

We work with our managers to ensure that each of our hotel properties is maintained in good repair and condition in conformity with applicable laws and regulations and consistent with the brand s standards, other hotels and the provisions of the management agreements. The expense of routine repairs, maintenance and ordinary course capital expenditures performed by our management companies are deducted from a furniture, fixtures and equipment reserve, which is generally funded on a monthly basis by a portion of a hotel s gross revenue. With respect to extraordinary capital expenditures or expenditures outside the ordinary course of operating a hotel, we typically retain approval rights, spending limits or other restrictions that limit the ability of our management companies to perform significant programs of capital improvements, renovation or refurbishing that we believe are unnecessary, undesirable or would result in an unacceptable return on investment.

Our team s creative approach often results in capital investment plans for conversion of unused or underutilized space to new revenue-generating facilities. Examples have included changing the usage of existing hotel space and the identification of expansion areas to create additional meeting rooms, guest rooms and retail outlets.

Asset Growth Through Acquisitions

Key elements. Our acquisition strategy incorporates three key elements:

focusing on the acquisition of upper upscale and luxury hotels in attractive markets with barriers to entry where we believe there are opportunities for us to add value by employing our asset management skills and systems;

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- targeting either hotels with existing management contracts or hotels where there is an opportunity to put in place a management contract with one of our preferred operators that would enhance asset value; and

- building single- and multi-brand relationships with our preferred operators, which are leading hotel management companies that have strong brand recognition, superior marketing capabilities, management depth and a history of efficient operations.

Acquire upper upscale and luxury hotels. We target upper upscale and luxury hotels in select urban and resort markets, including major business centers and leisure destinations, with strong growth characteristics and high barriers to entry. Typically our target hotels would be larger than 150 rooms and have growth or expansion opportunities. We believe that the upper upscale and luxury hotel sector is an extremely attractive sector for long-term investment, especially considering the supply constraints characteristic of that sector. These supply constraints include the importance of location, lack of available land, high development costs, long development and entitlement lead times and brand trade area restrictions that prevent the addition of a certain brand or brands in close proximity. Moreover, the management-intensive nature of upper upscale and luxury hotels provides our experienced management team with the opportunity to enhance value and maximize operating results at these hotels by monitoring performance and suggesting practical strategies for creating greater revenue flow to the bottom line.

Target hotels with management contracts or where we can put value-enhancing management contracts in place. We believe that a significant percentage of upper upscale and luxury hotels in North America have management contracts with remaining durations in excess of five years. Many other acquirers of hotel properties are in the hotel management business or are affiliated with specific management companies and, therefore, pursue hotels only if they can assume management. As a result, we believe that competition to acquire properties with existing management contracts can be less intense, providing us with attractive investment opportunities to achieve higher initial investment returns than we might attain from similar-quality hotels without management contracts. Our management team, based on its experience and knowledge of hotel operating practices, is well positioned to advise hotel operators on practices to improve operating performance and extract additional value from these hotels encumbered by management contracts.

Leverage our relationships with preferred operators. Because we provide professional, financially strong ownership and the opportunity for our preferred operators to continue managing the hotels after our acquisition of the property, they are more likely to seek to involve us in acquisition and disposition opportunities. Given these circumstances, we believe we are viewed by certain preferred operators as an attractive buyer whether a preferred operator is (1) considering a sale of one or more of its owned hotels or (2) attempting to expand its brand by acquiring management contracts in respect of hotels that are not subject to management contracts.

Continuous research and disciplined investment decisions. As a result of our ongoing research, the selection of target markets and individual property targets is updated continuously to foster a proactive acquisition process.

We believe our acquisition process permits us to make disciplined investment decisions quickly and efficiently, offering sellers the benefit of an expedited closing and certainty of execution.

Selected international opportunities. We have the skills and experience to acquire and asset manage hotels both domestically and internationally, which have permitted us to diversify our portfolio geographically. We currently own hotels in Mexico City and Punta Mita, Mexico, leasehold interests in hotels in Paris, France and Hamburg, Germany and a joint venture interest in a hotel in Prague, Czech Republic, which we asset manage for the joint venture. We believe that the international scope of our knowledge and skills places us in a unique position among lodging REITs and will permit us to take advantage of select international hotel opportunities. Our international acquisition activity will be consistent with our domestic acquisition strategy, namely targeting upper upscale and luxury hotels that have management contracts with preferred operators or hotels where we can enter into value enhancing management contracts with our preferred operators.

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Growth through joint ventures. While joint venture financing of new acquisitions is not a primary growth strategy, the company has a successful history of entering into joint venture arrangements and will consider opportunities in the future when:

- they are with strategic partners whose financial objectives are compatible with ours;
- they provide compelling economics that may include current asset management fee income, or upside participation; and/or
- they provide access to strategically important hotel acquisitions.

Advantages of this investment strategy include allowing us to expand our portfolio, increase fee-based income, enhance the return on our real estate through fee and incentive income and foster closer relationships with our preferred operators. We can also gain additional diversification of our capital and higher return on investment by investing in a larger number of properties, although through a smaller investment in each property.

Growth through strategic asset management. We will seek to asset manage properties when such an involvement leads to access to profitable hotel investment opportunities. Our goal is not to enter the traditional asset management business and compete with pure fee for service asset managers on price, but rather to take advantage of special opportunities, like the joint venture opportunities as previously described, or strategic alliances that will allow us to earn fees to supplement the returns from our owned properties with limited or no accompanying financial commitment. Similar to our joint venture properties, through these management relationships we expect to gain familiarity with the assets we oversee which may position us favorably to acquire ownership of these properties if they are offered for sale.

Recycle capital for future investments through opportunistic dispositions. We will take advantage of opportunities to sell a property, thereby freeing capital for future investment, when we believe that a disposition would be in our best interests. For example, we are likely to sell properties in circumstances where:

- we believe that our asset management team has maximized the property s value;
- the proceeds of the disposition are unusually attractive;
- the market in which the property is located is declining or static; or
- competition in the market requires substantial capital investment which will not generate returns that meet our criteria.

Competition

The hotel industry is highly competitive and our hotel investments are subject to competition from other hotels for guests. Competition is based on a number of factors, most notably convenience of location, brand affiliation, price, range of services and guest amenities or accommodations

offered and quality of customer service. Competition is often specific to the individual markets in which our properties are located and includes competition from existing and new hotels operated under brands in the upper-upscale and luxury segments as described under Description of Real Estate and Individual Property Data . Increased competition could have a material adverse effect on occupancy, average daily rate and room revenue per available room of our hotels or may require us to make capital improvements that we otherwise would not have to make, which may result in decreases in our profitability.

We believe that our properties enjoy competitive advantages associated with their operations under the Embassy Suites®, Four Seasons®, Hilton®, Hyatt®, Inter.Continental®, Loews®, Marriott® and Ritz-Carlton® hotel brand systems. The national marketing programs and reservation systems of these brands combined with the strong management systems and expertise they provide should enable our properties to continue to perform favorably in terms of both occupancy and room rates. Each of the managers of our hotels maintains national

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reservation systems with reservation agents that have the current status of the rooms available and rates from the properties. In addition, repeat guest business is enhanced by guest rewards programs offered by some of our brands including Hilton®, Hyatt®, Inter.Continental® and Marriott®.

Because our hotels operate in the luxury and upper upscale segment of the market, we face increased competition from providers of less expensive accommodations, such as limited service hotels or independent owner-managed hotels, during periods of economic downturn when leisure and business travelers become more sensitive to room rates. As a result, there is pressure to lower average daily rates during such periods to compete for these guests.

We believe that competition for the acquisition of hotels is highly fragmented. We face competition from institutional pension funds, private equity investors, other REITs and numerous local, regional and national owners in each of our markets. Some of these entities may have substantially greater financial resources and may be able to accept more risk than we can prudently manage. Competition may generally reduce the number of suitable investment opportunities offered to us and increase the bargaining power of property owners seeking to sell.

Offices

We sub-lease our headquarters located at 77 West Wacker Drive, Suite 4600, Chicago, Illinois 60601 from SHC LLC at a fair market value determined at the commencement date of the sublease, which is currently less than the amount paid by SHC LLC under its lease. We believe that our current facilities are adequate for our present and future operations.

Employees

At December 31, 2004, we had 30 full-time and three part-time corporate employees. We believe that our relations with our employees are good. None of our corporate employees are unionized.

Promoters

We were founded by SHC LLC. In addition, Mr. Geller, who was chairman and chief executive officer of SHC LLC, and Whitehall and Prudential, which are the principal investors in SHC LLC, may also be considered our promoters because they indirectly participated in founding and organizing our business.

Environmental

Environmental consultants retained by our lenders conducted Phase I environmental site assessments in 2004 on many of our properties. These Phase I assessments often relied on older environmental assessments prepared in connection with a prior financing. The lenders did not conduct

Phase I assessments on our European properties, although older environmental assessments or building engineering surveys exist for these properties. Phase I assessments are designed to evaluate the potential for environmental contamination on properties based generally upon site inspections, facility personnel interviews, historical information and certain publicly-available databases, but Phase I assessments will not necessarily reveal the existence or extent of all environmental conditions, liabilities or compliance concerns at the properties.

Although the Phase I assessments and other environmental reports we have reviewed disclose certain conditions on our properties and the use of hazardous substances in operation and maintenance activities that could pose a risk of environmental contamination or liability, we are not aware of any environmental liability (including asbestos related liability) that we believe would have a material adverse effect on our business, financial position, results of operations or cash flows. The Hilton Burbank Airport and Convention Center is

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located within a Federal Superfund site. The area was designated as a Superfund site because groundwater underneath the area is contaminated. We have not been named, and do not expect to be named, as a party responsible for the clean-up of the groundwater contamination. There can be no assurance regarding potential future developments concerning this site, however. We have detected the presence of mold at a few of our properties. See Risk Factors Environmental and other governmental laws and regulations could increase our compliance costs and liabilities and adversely affect our financial condition and results of operations and The presence of any environmental conditions at our properties could result in remediation and other costs and liabilities and adversely affect our financial condition and results of operations .

Insurance

Our management believes that our properties are adequately covered by insurance, subject to the risks described under Risk Factors and the following. We are responsible for arranging the insurance for most of our hotels, although in certain cases, hotel management companies assume responsibility for arranging insurance under the relevant operating agreement. Our properties are covered by blanket insurance policies which cover multiple properties. In the event that these blanket policies are drawn on to cover losses on other properties, the amount of insurance coverage available under such policies would thereby be reduced and could be insufficient to cover the remaining properties insurable risks.

Due to the catastrophic flooding that occurred in the Czech Republic in August 2002, many buildings in Prague, including the Hotel Inter.Continental Prague, experienced significant damage. The Hotel Inter.Continental Prague sustained approximately 17 million ($20.9 million) of property damage and business interruption losses due to the eleven week closure required to complete the repairs.

Since then, flood insurance for buildings in Prague has become more expensive and coverage has diminished. Our flood insurance contains a deductible that requires that the joint venture, in which we own a 35% interest, cover the losses related to any claims for less than 1.0 million ($1.4 million). In addition, any claims over 20 million ($27.1 million) are also self insured. To help offset this exposure, the lender, Aareal Bank, has required that a minimum balance of 2.0 million ($2.7 million) be maintained in the furniture, fixtures and equipment reserve at all times until more acceptable flood insurance has been obtained. Accordingly, if the hotel were to sustain damages in an amount similar to that which was experienced in 2002, we may not have sufficient coverage to provide full reimbursement for losses. Our share of the joint venture s exposure is 35%.

Hotel Management Agreements

Our hotels are managed and operated by third parties pursuant to management or lease agreements with our lessee subsidiaries or, in the case of the Paris Marriott Champs Elysees, an independent third party that subleases the property from us. See Taxable REIT Subsidiary below. The agreements generally provide for the payment of base management fees of between 1.25% to 4% of gross revenues, as defined in the applicable agreement. In addition, an incentive fee may be paid if certain criteria are met. The remaining terms (not including renewal options) of these management agreements range from one to 25 years. Our management agreements with our operators typically have the terms described below.

Operational services. The managers have exclusive authority to supervise, direct and control the day-to-day operation and management of the hotels, including establishing all room rates, processing reservations, procuring inventories, supplies and services, and preparing public relations, publicity and marketing plans for the hotels. The manager receives compensation in the form of a base management fee and an incentive management fee, typically calculated as percentages of gross revenues and operating profits, respectively. In some cases, the incentive management fee is paid only after the owner has received a certain level of income.

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Executive supervision and management services. The managers supervise all managerial and other employees for the hotels, review the operation and maintenance of the hotels, prepare reports, budgets and projections and provide other administrative and accounting support services to the hotel. In some cases, we maintain authority to approve the appointment of the hotel s general manager.

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

Working capital and fixed asset supplies. Our management agreements typically require us to maintain working capital for each hotel and to fund the cost of fixed asset supplies such as linen and other similar items. We are also responsible for providing funds to meet the cash needs for the hotel operations of the hotels if at any time the funds available from hotel operations are insufficient to meet the financial requirements of the hotels.

Furniture, fixtures and equipment replacements. The management agreements generally provide that once each year the manager will prepare a list of furniture, fixtures and equipment to be acquired and certain routine repairs to be performed in the next year and an estimate of the funds that are necessary therefor, subject to our review or approval. Under the agreement, we are required to provide to the manager all necessary furniture, fixtures and equipment for the operation of the hotels (including funding any required furniture, fixtures and equipment replacements). For purposes of funding the furniture, fixtures and equipment replacements, a specified percentage of the gross revenues of the hotel is deposited by the manager in an escrow account (typically 3.0% to 5.5%).

Building alterations, improvements and renewals. The management agreements generally require the manager to prepare an annual estimate of the expenditures necessary for major repairs, alterations, improvements, renewals and replacements to the structural, mechanical, electrical, heating, ventilating, air conditioning, plumbing and vertical transportation elements of each hotel. In addition to the foregoing, the management agreements generally provide that the manager may propose such changes, alterations and improvements to the hotel as are required by reason of laws or regulations or, in the manager s reasonable judgment, to keep the hotel in a safe, competitive and efficient operating condition.

Sale of the hotel. Most of the management agreements limit our ability to sell, lease or otherwise transfer the hotels unless the transferee is not a competitor of the manager, and unless the transferee assumes the related management agreements and meets specified other conditions.

Service marks. During the term of the management agreements, the service mark, symbols and logos currently used by the manager may be used in the operation of the hotel. Any right to use the service marks, logo and symbols and related trademarks at a hotel will terminate with respect to that hotel upon termination of the management agreement with respect to such hotel.

We lease one of our hotels, the Marriott Hamburg, pursuant to a lease agreement whereby rent is paid by the lessee to us for an amount equal to a fixed base rent plus a specified percentage of profits in excess of the base rent. Otherwise, the terms of the lease are similar to the terms of the management contracts described above.

Lease Agreements

We are the tenant under leases with third-party landlords for the Marriott Lincolnshire, the Paris Marriott Champs Elysees and the Hamburg Marriott. The terms of these leases (including renewal options) range from 46 to 55 years. These lease agreements require us to make annual rental payments comprised of a minimum rental amount (subject to indexation) plus additional rent comprised of a percentage of hotel operating

profit, less minimum rent, or the greater of a minimum rental amount and a percentage of certain revenues.

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Taxable REIT Subsidiary

On January 1, 2001, the provisions of the REIT Modernization Act became effective. These provisions allow REITs, subject to certain limitations, to own, directly or indirectly, up to 100% of the stock of a taxable REIT subsidiary, or TRS, that can engage in businesses previously prohibited to a REIT. In particular, these provisions permit hotel REITs to own a TRS that leases hotels from the REIT, rather than requiring the lessee to be a separate, unaffiliated party. However, hotels leased to a TRS still must be managed by an unaffiliated third party. The TRS provisions are complex and impose several conditions on the use of TRSs, generally to assure that TRSs are subject to an appropriate level of corporate taxation. Further, no more than 20% of a REIT s assets may consist of securities of TRSs, and no more than 25% of a REIT s assets may consist of non-qualifying assets, including securities of TRSs and other taxable subsidiaries. In addition, the TRS legislation provides that a REIT may generally not own more than 10% of the voting power or value of a corporation that is not treated as a TRS.

We have formed SHC DTRS, Inc. as a wholly-owned TRS. Each of our 10 domestic hotels that are subject to management agreements are leased by our relevant property-owning subsidiary to limited liability company subsidiaries of SHC DTRS, Inc. As described below, these leases provide for a base rent plus a percentage rent. These leases must contain economic terms which are similar to a lease between unrelated parties. Otherwise, we may have to pay a 100% penalty tax. We have a similar arrangement with respect to our foreign hotels in Mexico. In Prague, there is an existing lease agreement between the property-owning entity and a tenant that has prepaid the rent, which is being amortized on a straight-line basis over a period of fifteen years. The management agreements between the relevant property-owning subsidiary and the relevant hotel management company have been amended or assigned so that the hotel management company has agreed to manage the properties directly with the relevant limited liability company subsidiary of one of our TRSs. In addition, in order to comply with French law and the REIT qualification rules, a subsidiary of SanMon Services, LLC, which is controlled by a third party, subleases the Paris Marriott Champs Elysees from us in lieu of a sublease with a TRS. The owner of SanMon Services, LLC bears the economic risks and benefits of this arrangement.

Our TRS Leases

Each lease for the hotels, other than with respect to the Inter.Continental Prague, has a non-cancelable term of five years, subject to earlier termination upon the occurrence of certain contingencies such as damage or destruction that renders the hotel unsuitable for the lessee s use and occupancy, condemnation, or our sale or disposition of the hotel.

During the term of each lease, other than with respect to the Inter.Continental Prague, our TRS lessees are obligated to pay a fixed annual base rent and a percentage rent. In Prague, the tenant has prepaid the rent as noted above. Percentage rent is calculated by multiplying fixed percentages by gross room revenues and other revenues for each of the hotels with certain adjustments. Percentage rent is paid quarterly, except with respect to the Paris Marriott Champs Elysees which is paid monthly. Base rent accrues and is paid monthly. The base rent and percentage rents are adjusted annually for changes in the consumer price index.

Other than fixed charges, including real estate and personal property taxes, capital expenditures and a reserve for capital expenditures, which are obligations of the lessor, the leases require our TRS lessees to pay rent, property insurance, all costs and expenses and all utility and other charges incurred in the operation of the hotels. The leases also provide for rent reductions and abatements in the event of damage to, or destruction or a partial taking of, a hotel.

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Risk Factors

The following factors could affect our future financial performance:

Risks Related to Our Business

If the recent economic slowdown reoccurs, our results will be adversely affected by declines in average daily room rates or occupancy.

The performance of the lodging industry has traditionally been closely linked with the general economy. In an economic downturn, upper upscale and luxury hotels may be more susceptible to a decrease in revenues, as compared to hotels in other categories that have lower room rates. In periods of weak demand, profitability is negatively affected by the relatively high fixed costs of operating upper upscale and luxury hotels, when compared to other classes of hotels. If the recent economic slowdown reoccurs, this could result in further declines in average daily room rates or occupancy and thereby have a material adverse effect on our results of operations.

The threat of terrorism has adversely affected the hotel industry generally and these adverse effects may continue or, particularly if there are further terrorist events, worsen.

The threat of terrorism has caused a significant decrease in hotel occupancy and average daily rates due to disruptions in business and leisure travel patterns and concerns about travel safety. Hotels in major metropolitan areas and near airports have been adversely affected due to concerns about air travel safety and a significant overall decrease in the amount of air travel, particularly transient business travel, which includes the corporate and premium business segments that generally pay the highest average room rates. Future terrorist acts, terrorism alerts or outbreaks of hostilities could have a negative effect on travel and on our business.

Rising operating expenses and costs of capital improvements could reduce our cash flow, EBITDA and funds available for future distributions.

Our properties are subject to operating risks common to the lodging industry in general. If a property s occupancy or room rates drop to the point where its revenues are insufficient to cover its operating expenses, then we could be required to spend additional funds for that property s operating expenses. In the future, our properties will be subject to increases in real estate and other tax rates, utility costs, operating expenses, insurance costs, repairs and maintenance and administrative expenses, which could reduce our cash flow, EBITDA and funds available for future distributions.

Our hotel properties have an ongoing need for renovations and other capital improvements, including replacements, from time to time, of furniture, fixtures and equipment. Some of these capital improvements are mandated by health, safety or other regulations. These capital improvements may give rise to (i) a possible shortage of available cash to fund capital improvements, (ii) the possibility that financing for these capital improvements may not be available to us on affordable terms and (iii) uncertainties as to market demand or a loss of market demand after capital improvements have begun. The costs of these capital improvements could adversely affect our financial condition and amounts available

for distribution to our stockholders.

Our business and operating results depend in large part upon the performance of third-party hotel management companies that manage our hotels.

Our hotels are managed by third-party hotel management companies pursuant to management agreements or an operating lease in the case of the Marriott Hamburg. Therefore, our business and operating results depend in large part upon our hotel management companies performance under the management agreements.

Under the terms of these management agreements, the third-party hotel managers control the daily operations of our hotels. For a summary discussion of the material terms of these management agreements, see

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Hotel Management Agreements . We do not have the authority to require any hotel to be operated in a particular manner or to govern any particular aspect of the daily operations of any hotel (for instance, setting room rates). Thus, even if we believe our hotels are being operated inefficiently or in a manner that does not result in satisfactory occupancy rates, RevPAR and average daily rates, we may not be able to force the management company to change its method of operation of our hotels. Additionally, in the event that we need to replace any of our management companies, we may be required by the terms of the management agreement to pay substantial termination fees and may experience disruptions at the affected hotels. The effectiveness of the hotel management companies in managing our hotels will, therefore, significantly affect the revenues, expenses and value of our hotels.

Additionally, our hotel management companies and their affiliates own, operate or franchise properties other than our properties, including properties that directly compete with our properties. Therefore, a hotel management company may have different interests than our own with respect to short-term or long-term goals and objectives, including interests relating to the brands under which such hotel management companies operate. Such differences may be significant depending upon many factors, including the remaining term of the management agreement, trade area restrictions with respect to competition by the hotel management company or its affiliates or differing policies, procedures or practices. Any of these factors may adversely impact the operation and profitability of a hotel, which could harm our financial condition and results of operations.

All revenues generated at our hotels, including credit card receivables, are deposited by the payors into accounts maintained and controlled by the relevant hotel management company, which pays operating and other expenses for the relevant hotel (including real and personal property taxes), pays itself management fees in accordance with the terms of the applicable management agreement and makes deposits into any reserve funds required by the applicable management agreement. In the event of a bankruptcy or insolvency involving a hotel management company, there is a risk that the payment of operating and other expenses for the relevant hotel and payment of revenues to us may be delayed or otherwise impaired. The bankruptcy or insolvency of a hotel management company may significantly impair its ability to provide services required under the management agreement.

We have substantial debt, a portion of which is variable rate debt, and we may incur additional indebtedness, which may negatively affect our business and financial results.

Our debt may negatively affect our business and financial results, including:

- requiring us to use a substantial portion of our funds from operations to make required payments on principal and interest, which will reduce the amount available for distributions to stockholders, funds available for operations and capital expenditures, future business opportunities and other purposes;
- making us more vulnerable to economic and industry downturns and reducing our flexibility in responding to changing business and economic conditions;
- limiting our ability to borrow more money for operations, capital or to finance acquisitions in the future; and
- requiring us to dispose of properties in order to make required payments of interest and principal.

As of December 31, 2004, we had approximately $543.1 million of outstanding indebtedness. Approximately $240.0 million of this debt bears interest at a variable rate, and we had at that date the ability to borrow approximately $66.0 million of additional variable rate debt under our

revolving credit facility. We have also swapped $96.0 million of the variable rate debt to a fixed rate, resulting in approximately 56% of debt having fixed rates. Increases in interest rates on our existing variable rate indebtedness would increase our interest expense, which could harm our cash flow and our ability to pay distributions.

Since we anticipate that our internally generated cash will be adequate to repay only a portion of our indebtedness prior to maturity, we expect that we will be required to repay debt through re-financings and/or

equity offerings. The amount of our existing indebtedness may adversely affect our ability to repay debt through re-financings. If we are unable to refinance our indebtedness on acceptable terms, or at all, we might be forced to dispose of one or more of our properties on disadvantageous terms, which might result in losses to us and which might adversely affect cash available for distributions. If prevailing interest rates or other factors at the time of refinancing result in higher interest rates on refinancing, our interest expense would increase, which would adversely affect our operating results.

We also intend to incur additional debt in connection with future acquisitions of real estate. We may, in some instances, borrow under our revolving credit facility or borrow new funds to acquire properties. In addition, we may incur mortgage debt by obtaining loans secured by a portfolio of some or all of the real estate properties we acquire. If necessary or advisable, we may also borrow funds to satisfy the requirement that we distribute to stockholders at least 90% of our annual REIT taxable income or to ensure otherwise that we maintain our qualification as a REIT for Federal income tax purposes.

Our working capital and liquidity reserves may not be adequate to cover all of our cash needs and we may have to obtain financing from either affiliated or unaffiliated sources. Sufficient financing may not be available or, if available, may not be available on reasonable terms. Additional borrowings for working capital purposes will increase our interest expense, and therefore may harm our financial condition and results of operations.

Our organizational documents do not limit the amount of indebtedness that we may incur. If we become highly leveraged, then the resulting increase in debt service would reduce cash available for distribution and could adversely affect our ability to make payments on our outstanding indebtedness and harm our financial condition.

Our financial covenants may restrict our operating or acquisition activities.

Our revolving credit facility contains customary restrictions, requirements and other limitations on our ability to incur indebtedness, including customary financial covenants. Our ability to borrow under our revolving credit facility is subject to compliance with these financial and other covenants. We may use borrowings under our revolving credit facility to finance acquisitions and redevelopment activities and for working capital. If we are unable to borrow under our revolving credit facility or to refinance existing indebtedness, we may be prevented from making acquisitions or funding our working capital needs and our financial condition and results of operations would be adversely affected.

Our asset management agreement with SHC LLC may be terminated resulting in a loss of revenue and a material adverse effect on our results of operations and financial condition.

Our asset management agreement with SHC LLC is terminable by SHC LLC at any time after June 29, 2006 upon 90 days notice. Additionally, the annual fee of $5.0 million payable under the asset management agreement is automatically reduced after June 29, 2005 to the extent that SHC LLC sells any of its hotels covered by the asset management agreement. If the asset management agreement is terminated or the fees reduced, we will experience a loss of revenue, which could have a material adverse effect on our results of operations and financial condition.

The geographic concentration of our hotels in California makes us more susceptible to economic downturn in that state.

Five of our hotels are located in California, the greatest concentration of our portfolio properties in any state. California has been historically at greater risk to certain acts of nature, such as floods and earthquakes, than other states, and has also been subject to a more pronounced economic downturn than other regions. It is also possible that a change in California laws applicable to hotels and the lodging industry may have a greater impact on us than a change in comparable laws in another jurisdiction where we have hotels. Accordingly, our business, financial condition and results of operations may be particularly susceptible to a downturn or changes in the California or other local economies where we operate.

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We face competition for the acquisition of real estate properties.

We compete with institutional pension funds, private equity investors, other REITs, owner-operators of hotels and others who are engaged in real estate investment activities for the acquisition of hotels. These competitors may drive up the price we must pay for real property, other assets or other companies we seek to acquire or may succeed in acquiring those properties, assets or companies themselves. In addition, our potential acquisition targets may find our competitors to be more attractive suitors because they may have greater resources, may be willing to pay more, or may have a more compatible operating philosophy. In addition, the number of entities competing for suitable investment properties may increase in the future. This would result in increased demand for these assets and therefore increased prices paid for them. If we pay higher prices for properties, our profitability may be reduced. Also, future acquisitions of real property, other assets or other companies may not yield the returns we expect and, if financed using our equity, may result in stockholder dilution. We also may not be successful in identifying or consummating acquisitions and joint ventures on satisfactory terms. In addition, our profitability may suffer because of acquisition-related costs or amortization costs for acquired goodwill and other intangible assets.

We may experience conflicts of interest with significant stockholders and those stockholders may also exercise significant influence over our affairs.

Our two largest stockholders, Whitehall and Prudential, in aggregate beneficially own approximately 18.4% and 14.2%, respectively, of the outstanding shares of our common stock and each have the right to appoint up to two observers (depending on share ownership levels) to attend our board meetings without a right to vote. In addition, Whitehall and Prudential are the largest beneficial owners of SHC LLC, which owns the seven properties that we continue to asset manage under an asset management agreement between our domestic taxable REIT subsidiary and SHC LLC. As a result, we may experience conflicts of interest in connection with: (i) competition with SHC LLC, Whitehall or Prudential over the acquisition of hotel properties; (ii) the disposition of properties that we currently own, if prospective purchasers compete with SHC LLC; (iii) the disposition of properties owned by SHC LLC which will result in a lower or no management fee payable to us; or (iv) our acquisition of hotels from SHC LLC.

Whitehall and Prudential s shares of common stock constitute a significant portion of the votes needed to approve matters required to be submitted to our stockholders for approval, including decisions relating to the election of our board of directors, and the determination of our day-to-day corporate and management policies. In particular, Whitehall and Prudential have agreed to vote all their shares of capital stock in favor of Mr. Geller s election to our board of directors, as long as they own any shares of our capital stock and we nominate Mr. Geller as a director. Also, Whitehall and Prudential will together be able to exercise significant influence over the outcome of any proposed merger or consolidation of our company under Maryland law. Whitehall and Prudential s ownership interest in our company may discourage third parties from seeking to acquire control of our company which may adversely affect the market price of our common stock.

We are prohibited from selling one of our properties in taxable transactions before specified dates in the future.

Unless the transaction will qualify as a tax deferred exchange, the terms of certain agreements prohibit us from selling the Loews Santa Monica Beach Hotel before the earlier of March 4, 2013 or the date three named individuals are deceased. Also, we agreed to maintain $60 million of indebtedness on the Loews Santa Monica Beach Hotel until such date. These limitations may prevent us from selling this property on a timely basis or at all.

Our management has a limited history operating a REIT and limited experience managing a public company.

We have a brief operating history. Until recently, our management team has historically operated our business as a privately-owned corporation, has limited experience operating a REIT and limited experience managing a publicly-owned company. We continue to develop control systems and procedures adequate to

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support a public REIT company and this transition could place a significant strain on our management systems, infrastructure, overhead and other resources.

Risks Related to the Lodging and Real Estate Industries

A number of factors, many of which are common to the lodging industry and beyond our control, could affect our business, including those described elsewhere in this section as well as the following:

- increased competition from new supply or existing hotel properties in our markets, which adversely affects occupancy and revenues at our hotels;
- dependence on business, commercial and leisure travelers and tourism;
- dependence on group and meeting/conference business;
- increases in energy costs, airline strikes or other factors that may affect travel patterns and reduce the number of business and commercial travelers and tourists; and
- risks generally associated with the ownership of hotel properties and real estate, as we discuss in more detail below.

These factors could have an adverse effect on our financial condition, results of operations and ability to make distributions to our stockholders.

The illiquidity of real estate investments and the lack of alternative uses of hotel properties could significantly limit our ability to respond to adverse changes in the performance of our properties and harm our financial condition.

Because real estate investments are relatively illiquid, our ability to promptly sell one or more of our properties in response to changing economic, financial and investment conditions is limited. We cannot predict whether we will be able to sell any property for the price or on the terms set by us, or whether any price or other terms offered by a prospective purchaser would be acceptable to us. We also cannot predict the length of time needed to find a willing purchaser and to close the sale of a property.

In addition, hotel properties may not readily be converted to alternative uses if they were to become unprofitable due to competition, age of improvements, decreased demand or other factors. The conversion of a hotel to alternative uses would also generally require substantial capital expenditures.

We may be required to expend funds to correct defects or to make improvements before a property can be sold. We may not have funds available to correct those defects or to make those improvements and as a result our ability to sell the property would be limited. These factors

and any others that would impede our ability to respond to adverse changes in the performance of our properties could significantly harm our financial condition and results of operations.

We derive revenues from outside the United States, which subjects us to different legal, monetary and political risks, as well as currency exchange risks, and may cause unpredictability in a source of our cash flows.

Our business plan assumes that a portion of our investments will continue to be in hotel properties located outside the United States. International investments and operations generally are subject to various political and other risks that are different from and in addition to those for U.S. investments and operations, including:

- enactment of laws prohibiting or restricting the foreign ownership of property;
- laws restricting us from removing profits earned from activities within the country to the United States, including the payment of distributions, i.e., nationalization of assets located within a country;
- changes in laws, regulations and policies, including land use, zoning and environmental laws as well as real estate and other tax rates;

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- exchange rate fluctuations;
- change in the availability, cost and terms of mortgage funds resulting from varying national economic policies or changes in interest rates;
- high administrative costs; and
- terrorism, war or civil unrest.

Unfavorable legal, regulatory, economic or political changes such as those described above could adversely affect our financial condition and results of operations.

Seasonal variations in revenue at our hotels can be expected to cause quarterly fluctuations in our revenues.

Revenues for hotels in tourist areas generally are substantially greater during tourist season than other times of the year. To the extent that cash flows from operations are insufficient during any quarter, due to seasonal fluctuations in revenues, we may have to enter into short-term borrowings to make distributions to our stockholders.

The increasing use of Internet travel intermediaries by consumers may adversely affect our profitability as a result of increased commissions or lower room rates.

Some of our hotel rooms are booked through Internet travel intermediaries such as Travelocity.com, Expedia.com, Orbitz.com, Hotels.com and Priceline.com. As these Internet bookings increase, these intermediaries may be able to obtain higher commissions, reduced room rates or other significant contract concessions from our management companies. If the amount of sales made through Internet intermediaries increases significantly and our hotel operators fail to appropriately price room inventory in a manner that maximizes yields, room revenues may flatten or decrease and our profitability may be adversely affected.

Uninsured and underinsured losses could adversely affect our financial condition, results of operations and our ability to make distributions to our stockholders.

Various types of catastrophic losses, such as losses due to wars, terrorist acts, earthquakes, floods, hurricanes, pollution or environmental matters, generally are either uninsurable or not economically insurable, or may be subject to insurance coverage limitations, such as large deductibles or co-payments. Five of our hotels are located in California, which has been historically at greater risk to certain acts of nature (such as floods and earthquakes) than other states. Our Four Seasons in Mexico City is also in an area exposed to greater risk of earthquakes. Our Hyatt Regency New Orleans and Four Seasons Punta Mita Resort are located in areas that are prone to hurricanes and/or floods. Also, we were forced to close the Inter.Continental Prague for approximately eleven weeks during the latter half of 2002 due to flooding.

In the event of a catastrophic loss, our insurance coverage may not be sufficient to cover the full current market value or replacement cost of our lost investment. Should an uninsured loss or a loss in excess of insured limits occur, we could lose all or a portion of the capital we have invested in a property, as well as the anticipated future revenue from the property. In that event, we might nevertheless remain obligated for any mortgage debt or other financial obligations related to the property. In the event of a significant loss, our deductible may be high and we may be required to pay for all such repairs and, as a consequence, it could materially adversely affect our financial condition. Inflation, changes in building codes and ordinances, environmental considerations and other factors might also keep us from using insurance proceeds to replace or renovate a hotel after it has been damaged or destroyed. Under those circumstances, the insurance proceeds we receive might be inadequate to restore our economic position on the damaged or destroyed property.

Since September 11, 2001, it has generally become more difficult and expensive to obtain property and casualty insurance, including coverage for terrorism. When our current insurance policies expire, we may encounter difficulty in obtaining or renewing property or casualty insurance on our properties at the same levels

of coverage and under similar terms. Such insurance may be more limited and for some catastrophic risks (e.g., earthquake, flood and terrorism) may not be generally available at current levels. Also, since the flooding in Prague described above, flood insurance has become more expensive and coverage has diminished at the property. Even if we are able to renew our policies or to obtain new policies at levels and with limitations consistent with our current policies, we cannot be sure that we will be able to obtain such insurance at premium rates that are commercially reasonable. If we were unable to obtain adequate insurance on our properties for certain risks, it could cause us to be in default under specific covenants on certain of our indebtedness or other contractual commitments we have which require us to maintain adequate insurance on our properties to protect against the risk of loss. If this were to occur, or if we were unable to obtain adequate insurance and our properties experienced damages which would otherwise have been covered by insurance, it could materially adversely affect our financial condition and the operations of our properties.

Environmental and other governmental laws and regulations could increase our compliance costs and liabilities and adversely affect our financial condition and results of operations.

Our hotel properties are subject to various Federal, state and local environmental laws. Under these laws, courts and government agencies have the authority to require us, as owner of a contaminated property, to clean up the property, even if we did not know of or were not responsible for the contamination. These laws also apply to persons who owned a property at the time it became contaminated. In addition to the costs of clean-up, environmental contamination can affect the value of a property and, therefore, an owner s ability to borrow funds using the property as collateral or to sell the property. These laws can also impose liability on parties that arrange for the disposal of wastes at an offsite property that becomes contaminated.

In addition, some of these environmental laws can restrict the use of a property and place conditions on various activities. An example would be laws that require a business using hazardous substances on a property (such as swimming pool and lawn care chemicals) to manage them carefully and to notify local officials that the chemicals are being used. Failure to comply with these laws could result in fines and penalties or expose us to third-party liability.

From time to time, the United States Environmental Protection Agency, or EPA, designates certain sites affected by hazardous substances as Superfund sites. Superfund sites can cover large areas, affecting many different parcels of land. The EPA may choose to pursue parties regardless of their actual contribution to the contamination. The Hilton Burbank Airport and Convention Center is located within a Federal Superfund site. The area was designated as a Superfund site because groundwater underneath the area is contaminated. We have not been named, and do not expect to be named, as a party responsible for the clean-up of the groundwater contamination. There can be no assurance regarding potential future developments concerning this site, however.

The presence of any environmental conditions at our properties could result in remediation and other costs and liabilities and adversely affect our financial condition and results of operations.

We have reviewed environmental reports prepared by consultants retained by our lenders at various times, which disclose certain conditions on our properties and the use of hazardous substances in operation and maintenance activities that could pose a risk of environmental contamination or liability. At some facilities these include on-site dry cleaning operations, petroleum storage in underground storage tanks, past tank removals and the known or suspected presence of asbestos and mold.

We have detected the presence of mold at a few of our hotels. In the case of one of our hotels where the presence of mold might not be confined to limited areas, we have engaged a consultant to study the extent of the moisture infiltration and resultant mold. While we have not yet

determined the extent of the moisture infiltration and resultant mold at that hotel, the costs to remediate the situation and any litigation that may arise from the presence of mold could be significant. Many of the costs may be excluded from coverage under our property and general liability policies, in which event we would be required to use our own funds to resolve the issue. Further,

if the moisture infiltration and resulting mold is pervasive, we may not be able to rent rooms at that hotel, which could result in a loss of revenue. We can make no assurance that liabilities resulting from moisture infiltration and the presence of or exposure to mold will not have a future material adverse effect on our business, financial condition, results of operations and ability to make distributions to our stockholders.

Furthermore, various court decisions have established that third parties may recover damages for injury caused by property contamination or exposure to hazardous substances such as asbestos, lead paint or black mold. In recent years, concern about indoor exposure to mold has been increasing as such exposure has been alleged to have a variety of adverse effects on health. As a result, there has been an increasing number of lawsuits against owners and managers of real property relating to the presence of mold. Damages related to the presence of mold are generally excluded from our insurance coverage. Should an uninsured loss arise against us, we would be required to use our own funds to resolve the issue, which could have a adverse impact on our results of operations and ability to make distributions to stockholders.

The costs to clean up a contaminated property, to defend against a claim, or to comply with environmental laws could be material and could adversely affect the funds available for distribution to our stockholders. Future laws or regulations may impose material environmental liabilities on us, the current environmental condition of our hotel properties may be affected by the condition of the properties in the vicinity of our hotel properties (such as the presence of leaking underground storage tanks) or by third parties unrelated to us and currently unknown environmental liabilities related to our hotel properties may be identified.

Under the Americans with Disabilities Act of 1990, or the ADA, all public accommodations must meet various Federal requirements related to access and use by disabled persons. Compliance with the ADA s requirements could require removal of access barriers, and non-compliance could result in the U.S. government imposing fines or in private litigants winning damages. If we are required to make substantial modifications to our hotels, whether to comply with the ADA or other changes in governmental rules and regulations, our financial condition, results of operations and ability to make distributions to our stockholders could be adversely affected.

We face competition in the acquisition of properties and properties that we acquire may not perform as anticipated.

We expect to acquire additional hotel properties from time to time. The acquisition of properties involves risks, including the risk that the acquired property will not perform as anticipated and the risk that that any actual costs for rehabilitating, repositioning, renovating and improving identified in the pre-acquisition process will exceed estimates. There is, and it is expected that there will continue to be, significant competition for acquisitions that meet our investment criteria as well as risks associated with obtaining financing for acquisition activities.

Risks Related to Our Organization and Structure

Provisions of our organizational documents may limit the ability of a third party to acquire control of our company and may depress our stock price.

In order for us to maintain our status as a REIT, no more than 50% of the value of outstanding shares of our stock may be owned, actually or constructively, by five or fewer individuals at any time during the last half of each taxable year. To make sure that we will not fail to qualify as a REIT under this test, subject to some exceptions, our charter prohibits any stockholder from owning actually or constructively more than 9.8% of the value of outstanding shares of our stock or more than 9.8% of the value or number of shares, whichever is more restrictive, of the outstanding shares of our common stock. Any attempt to own or transfer shares of our capital stock in excess of the ownership limit without the

consent of our board of directors will be void, and could result in the shares being automatically transferred to a charitable trust. This ownership limitation may prevent an acquisition of control of our company by a third party without our board of directors grant of an exemption from the ownership limitation, even if our stockholders believe the change of control is in their interest.

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Our charter authorizes our board of directors to cause us to issue up to 150,000,000 shares of common stock and up to 150,000,000 shares of preferred stock, to amend our charter without stockholder approval to increase or decrease the aggregate number of shares of stock or the number of shares of any class or series of our stock that we have authority to issue, to classify or reclassify any unissued shares of common stock or preferred stock and to set the preferences, rights and other terms of the classified or reclassified shares. Issuances of additional shares of stock may have the effect of delaying or preventing a change in control of our company, including transactions at a premium over the market price of our stock, even if stockholders believe that a change of control is in their interest.

Our charter permits the removal of a director only upon the affirmative vote of two-thirds of the votes entitled to be cast generally in the election of directors and provides that vacancies may only be filled by a majority of the remaining directors. Our bylaws require advance notice of a stockholder s intention to nominate directors or present business for consideration by stockholders at an annual meeting of our stockholders. These provisions may delay, defer, or prevent a transaction or change in control that involves a premium price for our common stock or that for other reasons may be desired by our stockholders.

Provisions of Maryland law may limit the ability of a third party to acquire control of our company.

Certain provisions of the Maryland General Corporation Law, or the MGCL, may have the effect of inhibiting a third party from making a proposal to acquire us or of impeding a change of control under circumstances that otherwise could provide the holders of shares of our common stock with the opportunity to realize a premium over the then prevailing market price of such shares, including:

- business combination provisions that, subject to limitations, prohibit certain business combinations between us and an interested stockholder (defined generally as any person who beneficially owns 10% or more of the voting power of our shares or an affiliate thereof) for five years after the most recent date on which the stockholder becomes an interested stockholder, and thereafter imposes special super majority stockholder voting requirements on these combinations;

- control share provisions that provide that control shares of our company (defined as shares which, when aggregated with other shares controlled by the stockholder, entitle the stockholder to exercise one of three increasing ranges of voting power in electing directors) acquired in a control share acquisition (defined as the direct or indirect acquisition of ownership or control of control shares) have no voting rights except to the extent approved by our stockholders by the affirmative vote of at least two-thirds of all the votes entitled to be cast on the matter, excluding all interested shares; and

- unsolicited takeover provisions of Maryland law permit our board of directors, without stockholder approval, to implement a classified board as well as impose other restrictions on the ability of a third party to acquire control.

We have opted out of the control share provisions of the MGCL pursuant to a provision in our bylaws. However, we may, by amendment to our bylaws, become subject to the control share provisions of the MGCL in the future except with respect to Prudential and Whitehall who will not be subject to the operation of the control share provisions without their prior written consent.

We rely on our President and Chief Executive Officer, Mr. Laurence Geller, the loss of whom could have a material adverse effect on our business.

Our continued success will depend to a significant extent on the efforts and abilities of our President and Chief Executive Officer, Mr. Laurence Geller. Mr. Geller is an experienced hotel industry senior executive, operator and consultant with over 40 years experience working with many major multinational hotel companies and executives. Mr. Geller is actively engaged in our management and determines our strategic direction, especially with regard to operational, financing, acquisition and disposition activity. Mr. Geller s departure could have a material adverse effect on our operations, financial condition and operating results.

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You have limited control as a stockholder regarding any changes we make to our policies.

Our board of directors determines our major policies, including our investment objectives, financing, growth and distributions. Our board may amend or revise these and other policies without a vote of our stockholders. This means that our stockholders will have limited control over changes in our policies.

Tax Risks

If we fail to maintain our status as a REIT, our distributions will not be deductible by us, and our income will be subject to Federal taxation, reducing our earnings available for distribution.

We currently qualify as a REIT under the Internal Revenue Code. The requirements for this qualification, however, are complex. If we fail to meet these requirements in the future, our distributions will not be deductible by us and we will have to pay a corporate Federal level tax on our income. This would substantially reduce our cash available to pay distributions and your yield on your investment in our stock. In addition, such a tax liability might cause us to borrow funds, liquidate some of our investments or take other steps which could negatively affect our results of operations. Moreover, if our REIT status is terminated because of our failure to meet a technical REIT requirement or if we voluntarily revoke our election, we would generally be disqualified from electing treatment as a REIT for the four taxable years following the year in which REIT status is lost.

Even if we maintain our status as a REIT, we may become subject to Federal, state, local or foreign taxes on our income or property reducing our earnings available for distribution.

Even if we maintain our status as a REIT, we may become subject to Federal income taxes and related state taxes. For example, if we have net income from a prohibited transaction , that income will be subject to a 100% tax. A prohibited transaction is, in general, the sale or other disposition of inventory or property, other than foreclosure property, held primarily for sale to customers in the ordinary course of business. We may not be able to make sufficient distributions to avoid excise taxes applicable to REITs. We may also decide to retain income we earn from the sale or other disposition of our property and pay Federal income tax directly on that income. In that event, our stockholders would be treated as if they earned that income and paid the tax on it directly. However, stockholders that are tax-exempt, such as charities or qualified pension plans, would have no benefit from their deemed payment of that tax liability. We cannot assure you that we will be able to continue to satisfy the REIT requirements, or that it will be in our best interests to continue to do so.

We may also be subject to state and local taxes on our income or property, either directly or at the level of our operating partnerships or at the level of the other companies through which we indirectly own our assets.

Foreign countries impose taxes on our hotels and our operations within their jurisdictions. We may not fully benefit from a foreign tax credit against our U.S. income tax liability for the foreign taxes we pay. As a result, our foreign taxes will reduce our income and available cash flow from our foreign hotels, which, in turn, could reduce our ability to make distributions to our stockholders.

If the leases of our hotels to our taxable REIT subsidiaries are not respected as true leases for Federal income tax purposes, we would fail to maintain our status as a REIT.

To continue to qualify as a REIT, we must satisfy two gross income tests, under which specified percentages of our gross income must be passive income, such as rent. The rent paid pursuant to the leases of our hotels to our taxable REIT subsidiaries will only qualify for purposes of the gross income tests if the leases are respected as true leases for Federal income tax purposes and are not treated as service contracts, joint ventures or some other type of arrangement. If the leases are not respected as true leases for Federal income tax purposes, we would fail to qualify as a REIT.

Our taxable REIT subsidiary is subject to special rules that may result in increased taxes.

Several Internal Revenue Code provisions ensure that a taxable REIT subsidiary is subject to an appropriate level of Federal income taxation. For example, a taxable REIT subsidiary is limited in its ability to deduct

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interest payments made to an affiliated REIT. In addition, the REIT has to pay a 100% penalty tax on some payments that it receives if the economic arrangements between the REIT and the taxable REIT subsidiary are not comparable to similar arrangements between unrelated parties. The IRS may successfully assert that the economic arrangements of any of our inter-company transactions, including the hotel leases, are not comparable to similar arrangements between unrelated parties.

We may be required to pay a penalty tax upon the sale of a hotel.

The Federal income tax provisions applicable to REITs provide that any gain realized by a REIT on the sale of property held as inventory or other property held primarily for sale to customers in the ordinary course of business is treated as income from a prohibited transaction that is subject to a 100% penalty tax. Under current law, unless a sale of real property qualifies for a safe harbor, the question of whether the sale of a hotel (or other property) constitutes the sale of property held primarily for sale to customers is generally a question of the facts and circumstances regarding a particular transaction. We may make sales that do not satisfy the requirements of the safe harbors or the IRS may successfully assert that one or more of our sales are prohibited transactions, and therefore we may be required to pay a penalty tax.

ITEM 2. PROPERTIES.

Overview. Set forth below is a summary of certain information related to our owned hotel properties as of December 31, 2004. For further information regarding our hotel properties, see Individual Property Data below.

Hotel	Location	Number of Rooms	Property Interest	Date Acquired
Hyatt Regency New Orleans(*)	New Orleans, LA	1,184	Fee simple	9/1997
Hyatt Regency Phoenix(*)	Phoenix, AZ	712	Fee simple	1/1998
Hilton Burbank Airport and Convention Center(*)	Burbank, CA	488	Fee simple	1/1998
Marriott Rancho Las Palmas Resort(*)	Rancho Mirage, CA	444	Fee simple	1/1998
Hyatt Regency La Jolla at Aventine(*)	La Jolla, CA	419	Fee simple	7/1999
Marriott Chicago Schaumburg(*)	Schaumburg, IL	398	Fee simple	5/1998
Marriott Lincolnshire Resort(1)(*)	Lincolnshire, IL	390	Ground lease	9/1997
Inter.Continental Prague(2)(*)	Prague, Czech Republic	372	Fee simple	8/1998
Loews Santa Monica Beach Hotel(3)(*)	Santa Monica, CA	342	Fee simple	3/1998
Embassy Suites Lake Buena Vista Resort(*)	Orlando, FL	333	Fee simple	9/1997
Marriott Hamburg(4)	Hamburg, Germany	277	Leasehold	6/2000
Ritz-Carlton Half Moon Bay(*)	Half Moon Bay, CA	261	Fee simple	8/2004
Four Seasons Mexico City(*)	Mexico City, Mexico	240	Fee simple	12/1997
Paris Marriott Champs Elysees(4)	Paris, France	192	Leasehold	2/1998
Four Seasons Punta Mita Resort(*)	Punta Mita, Mexico	140	Fee simple	2/2001
Total Number of Rooms		6,192		

(1) We have a ground lease interest in this property.
(2) We have a 35% joint venture interest in this property.
(3) We are restricted by agreement from selling this property other than in a transaction that will qualify as a tax deferred exchange and must maintain a specific minimum level of indebtedness encumbering this property until a future date.
(4)

These properties were originally acquired on the dates indicated in the table, but were subsequently sold to a third party and leased back by us in transactions that are more fully described below under Management s Discussion and Analysis of Financial Condition and Results of Operations Recent Trends and Events Sales of Hotels .

(*) These properties are subject to mortgages as more fully described below under Mortgage and Other Indebtedness Outstanding .

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Property Performance. The following table presents statistical data and certain performance information for our hotel properties for 2004 and 2003. For additional information regarding business segment data such as revenues and long-lived assets, see note 17 to our consolidated financial statements included herein.

	Year Ended December 31, 2004			Year Ended December 31, 2003		
Hotel	**Average Daily Rate**	**Average Occupancy%**	**RevPAR**	**Average Daily Rate**	**Average Occupancy%**	**RevPAR**
Hyatt Regency New Orleans	$ 141.14	62.3%	$ 87.92	$ 142.75	65.0%	$ 92.79
Hyatt Regency Phoenix	$ 134.37	64.7%	$ 86.97	$ 136.33	59.7%	$ 81.34
Hilton Burbank Airport and Convention Center	$ 114.56	61.9%	$ 70.92	$ 112.47	61.1%	$ 68.70
Marriott Rancho Las Palmas Resort	$ 142.28	67.3%	$ 95.74	$ 143.66	68.0%	$ 97.70
Hyatt Regency La Jolla at Aventine	$ 152.57	74.2%	$ 113.14	$ 155.73	69.0%	$ 107.47
Marriott Chicago Schaumburg	$ 107.56	65.5%	$ 70.45	$ 104.05	64.1%	$ 66.72
Marriott Lincolnshire Resort	$ 112.49	68.7%	$ 77.23	$ 112.95	65.6%	$ 74.08
Inter.Continental Prague	$ 195.21	80.4%	$ 156.87	$ 181.39	73.5%	$ 133.36
Loews Santa Monica Beach Hotel	$ 244.00	79.7%	$ 194.53	$ 236.58	70.3%	$ 166.22
Embassy Suites Lake Buena Vista Resort	$ 121.56	82.6%	$ 100.46	$ 114.92	77.1%	$ 88.61
Marriott Hamburg	$ 149.05	79.8%	$ 118.93	$ 133.00	78.7%	$ 104.63
Ritz-Carlton Half Moon Bay	$ 319.11	67.9%	$ 216.84	N/A	N/A	N/A
Four Seasons Mexico City	$ 217.62	63.3%	$ 137.69	$ 216.92	63.2%	$ 137.05
Paris Marriott Champs Elysees	$ 406.54	82.2%	$ 334.19	$ 384.07	82.0%	$ 315.12
Four Seasons Punta Mita Resort	$ 540.10	75.2%	$ 406.39	$ 528.85	68.0%	$ 359.83
Total	$ 170.75	69.5%	$ 118.61	$ 163.99	67.2%	$ 110.25

Individual Property Data

The following descriptions of our individual properties include additional financial and tax disclosure for our two largest properties as measured by gross revenue or book asset value.

Hyatt Regency New Orleans

The Property. We own a fee simple interest in the Hyatt Regency New Orleans. The hotel opened in 1976 and is comprised of 1,184 guest rooms, including 570 king rooms, 566 double/double rooms and 48 suites. Capital expenditures for 2004 were approximately $2.3 million and are expected to be approximately $9.1 million for 2005. We expect to fund such capital expenditures with existing and anticipated reserve funds. The hotel is situated on the northwestern periphery of the New Orleans central business district. The Louisiana Superdome and the New Orleans Sports Arena are situated in the immediate vicinity of the Hyatt Regency New Orleans. The hotel is also connected to the New Orleans Mall which is a 600,000 square-foot retail mall. Nearby attractions include the Ernest N. Morial Convention Center, the French Quarter and the Riverfront, which are located within two miles of the property.

Location and Access. The Hyatt Regency New Orleans benefits from convenient access. By virtue of the building s height and clear signage on top of the structure, the Hyatt Regency New Orleans hotel is highly visible from either direction on Poydras Street. The Hyatt Regency New Orleans is located approximately 12 miles from New Orleans International Airport.

Competition. Competitor hotels include the Radisson Hotel New Orleans, Hilton New Orleans Riverside, Sheraton Hotel New Orleans, Marriott New Orleans, Fairmont New Orleans and Inter.Continental New Orleans.

Selected Financial and Operating Information. The following table shows selected financial and operating information regarding the Hyatt Regency New Orleans hotel following its acquisition by us in September 1997.

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For purposes of comparison, we have provided financial information for this property as if the hotel was operated under a management agreement (not leased) for all periods presented.

	2004	2003	2002	2001	2000
	(in thousands, except selected operating information)				
Selected Pro Forma Financial Information:					
Total revenue	$ 59,101	$ 63,143	$ 64,558	67,745	68,388
Operating expenses	34,696	36,245	35,868	36,827	37,633
Gross operating profit	24,405	26,898	28,690	30,918	30,755
Other expenses	$ 7,441	$ 6,749	$ 7,036	$ 6,567	$ 6,931
Selected Operating Information:					
Rooms	1,184	1,184	1,184	1,184	1,184
Average Occupancy	62.3%	65.0%	63.2%	67.2%	66.3%
ADR	$ 141.14	$ 142.75	$ 147.02	$ 150.75	$ 152.95
RevPAR	$ 87.92	$ 92.79	$ 92.98	$ 101.30	$ 101.33

The adjusted tax basis for the building for the year ended December 31, 2004 was $34.2 million, which is depreciated on a straight-line basis over an estimated life of 39 years.

Ritz-Carlton Half Moon Bay

The Property. We own a fee simple interest in the Ritz-Carlton Half Moon Bay. The hotel opened in 2001 with its first full year of operations in 2002. The hotel is comprised of 261 guest rooms, the majority of which offer ocean or coastal views, including 159 king rooms, 80 double/double rooms and 22 suites. Capital expenditures in 2004 for our period of ownership were approximately $274,000. Capital expenditures for 2005 are expected to be approximately $3.7 million and include the new fire and wine master plan, the Conservatory Restaurant seating addition as well as design fees for the expansion of the Conservatory kitchen. We expect to fund such capital expenditures with existing reserve funds, cash provided by operations and borrowings under our revolving credit facility. The hotel is situated on a bluff overlooking the Pacific Ocean. The resort is located between two recognized golf courses (The Ocean Course and the Old Course) that are under separate ownership. Half Moon Bay is located in Western San Mateo County and is less than an hour from downtown San Francisco.

Competition. Competitor hotels include the Shutters on the Beach, Wyndham Luxury Carmel Valley, Fairmont Sonoma Mission Inn and Spa, Hotel Del Coronado, Ritz-Carlton Laguna Niguel (which we separately asset manage for SHC LLC), Hyatt Regency Monterey, Xanterra Parks & Resorts, Silverado Resort, Four Seasons Resort Aviara and Four Seasons Resort Santa Barbara.

Selected Financial and Operating Information. The following table shows selected financial and operating information regarding the Ritz Carlton Half Moon Bay hotel following its acquisition by us in August 2004 (in thousands, except selected operating information):

	2004
Selected Financial Information:	
Total revenue	$ 18,202

Operating expenses	13,942
Gross operating profit	4,260
Other expenses	$ 1,436
Selected Operating Information:	
Rooms	261
Average Occupancy	67.9%
ADR	$ 319.11
RevPAR	$ 216.84

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The adjusted tax basis for the building for the year ended December 31, 2004 was $75.0 million, which is depreciated on a straight-line basis over an estimated life of 39 years.

Hyatt Regency Phoenix

We hold a fee simple interest in the Hyatt Regency Phoenix hotel. The Hyatt Regency Phoenix was completed in 1976 and is comprised of 712 guest rooms, including 286 king rooms, 205 queen/queen rooms, 152 double/double rooms, 36 studio suites, 25 two bedroom suites, five hospitality suites and three one bedroom suites. The hotel guest rooms were refurbished in 1999. The Hyatt Regency Phoenix is located in downtown Phoenix, Arizona. Nearby attractions include the Phoenix Downtown Civic Plaza Convention Center, local, national and multinational businesses in the downtown area, along with several entertainment and sports venues including BankOne Ballpark, America West Arena and the Dodge Theatre.

Hilton Burbank Airport and Convention Center

We hold a fee simple interest in the Hilton Burbank Airport and Convention Center. The first phase of the Hilton Burbank hotel was completed in 1981 and the second phase was completed in 1991. The hotel is comprised of 488 guest rooms, including 224 standard doubles, 185 standard kings (including 14 parlors in the West Tower), two presidential suites, 35 one bedroom king suites and 42 one bedroom double suites. Guest rooms are located in one nine-story tower and one eight-story tower that are adjacent to the 42,000 square-foot convention center. Between 1998 and 2002, the hotel underwent a refurbishment of all rooms plus the corridors. In addition, all of the bathrooms in the West Tower were completely renovated soon after acquisition. The hotel is located at the southeast quadrant of Hollywood Way and Thornton Avenue, directly east of the Bob Hope Airport (formerly known as the Burbank-Glendale-Pasadena Airport). The hotel has 1205 surface parking spaces and given its proximity to the Bob Hope Airport, generates overnight parking revenues from airport patrons. Nearby attractions include the movie and television studios of Warner Brothers, NBC, Walt Disney and Universal, which are located within seven miles of the property.

Marriott Rancho Las Palmas Resort

We hold a fee simple interest in the Marriott Rancho Las Palmas Resort hotel, which is located in Rancho Mirage, California. The Marriott Rancho Las Palmas Resort opened in 1979 and is comprised of 444 guest rooms, including 219 double/double rooms, 209 king rooms and 16 suites. The Marriott Rancho Las Palmas Resort has a spa, a golf course, a man-made lake and three swimming pools. The Spa Las Palmas opened in 1999 and features 26 treatment rooms, a dedicated outdoor wading pool, a full-service salon, a gift shop and locker room facilities. The 27-hole championship golf course consists of three nine-hole courses. The Fiesta Ballroom is divisible into eight sections and can accommodate 1,200 people for receptions and 800 for banquets. The Starlight Terrace is located outside on the roof of the Fiesta Ballroom and can be utilized weather-permitting. Between 1998 and 2002, the resort made approximately $44 million in capital improvements which included a complete renovation of rooms, the addition of the Spa Las Palmas and outdoor wading pool, a Tortuga/water feature pool and expansion of meeting space. The Marriott Rancho Las Palmas Resort is located in the Coachella Valley area, which has a reputation as one of the premier resort destinations in the United States. The area around the Marriott Rancho Las Palmas Resort has more than 100 golf courses and 600 tennis courts.

Hyatt Regency La Jolla at Aventine

We own a fee simple interest in the Hyatt Regency La Jolla at Aventine. The hotel, which was completed in 1989, has 419 guest rooms, including 11 suites, 233 king rooms and 175 double/double rooms. Guest rooms are located in a 16-story building. The hotel is part of a larger, mixed-use development known as the Aventine that was constructed in 1989 and includes a six-story office building with an adjacent 11-story office tower, a three-story health club building, the 16-story Hyatt Regency La Jolla hotel, a restaurant complex housing four individual restaurants, two parking garages, an outdoor swimming pool and two lighted tennis courts. Our

ownership within the Aventine development includes the hotel facilities (including the free standing Pavillion meeting space), the hotel motor court/entrance, the swimming pool and the 30,000 square-foot health club.

Marriott Chicago Schaumburg

We own a fee simple interest in the Marriott Chicago Schaumburg hotel. The Marriott Chicago Schaumburg was completed in 1983 and is comprised of 398 guest rooms, including two sleeper suites, two hospitality suites, 204 king rooms, 179 double/double rooms and 11 handicapped accessible rooms. Guest rooms are located in a 12-story building and a four-story building. The property underwent a full-scale room renovation in 1995. The Marriott Chicago Schaumburg is situated approximately 12 miles northwest of Chicago s O Hare International Airport and approximately 30 miles northwest of downtown Chicago.

Marriott Lincolnshire Resort

We hold a ground lease interest in the Marriott Lincolnshire Resort hotel. The current term of the ground lease will expire on January 1, 2021 and we have the option to extend for three additional 10-year periods. Our leasehold interests are further described under Lease Agreements . The Marriott Lincolnshire Resort was completed in 1975 and is comprised of 390 guest rooms, including seven suites, 165 king rooms and 218 double/double rooms. The Marriott Lincolnshire Resort also has many amenities including the 18-Hole George Fazio PGA Golf Course and an 882-seat theatre. The hotel is located in Lincolnshire, Illinois, a northern suburb of Chicago.

Hotel Inter.Continental Prague

We have a 35% ownership interest in a joint venture which holds a fee simple interest in the Hotel Inter.Continental Prague. The hotel opened in 1974 and is comprised of 372 guest rooms, including 89 suites. In addition, the property includes a 27-unit extended stay apartment building and two additional apartment buildings for long-term residential lets. The hotel underwent a $45 million renovation in 1995. The hotel is located in Prague s historic Old Town with views of the Vltava River.

On June 26, 2003, the joint venture owning the Inter.Continental Prague entered into an agreement to refinance its long-term bank debt. As a result of this refinancing, the loan and all accrued interest payable to Westdeutsche Landesbank Girozentrale was fully repaid using 70.0 million ($78.7 million) of proceeds funded on July 14, 2003 obtained from a 75.0 million ($84.3 million) loan negotiated with Aareal Bank. An additional 5.0 million ($6.2 million) was funded on January 15, 2004 upon satisfaction of certain conditions, which included the registration of a first ranking mortgage. The loan bears floating interest at the three-month EURIBOR rate plus 1.5% and matures July 15, 2006. At the joint venture s option, the maturity date may be extended to July 15, 2008. Interest and principal are payable quarterly with a final payment of 62.7 million ($77.1 million) due on July 15, 2008 (assuming the joint venture utilizes the extension options under the loan). There was 72.1 million ($97.9 million) outstanding under this arrangement at December 31, 2004.

Loews Santa Monica Beach Hotel

We hold a fee simple interest in the Loews Santa Monica Beach Hotel. The Loews Santa Monica Beach Hotel opened in 1989 and is comprised of 342 guest rooms, including 19 suites, 150 king rooms and 173 double/double rooms. Guest rooms are located in an eight-story building. The hotel is located approximately 150 feet east of the Santa Monica Beach. The Third Street Promenade and the Santa Monica Pier are within walking distance of the Loews Santa Monica Beach Hotel.

Embassy Suites Lake Buena Vista Resort

We hold a fee simple interest in the Embassy Suites Lake Buena Vista Resort, which opened in 1991. The Embassy Suites Lake Buena Vista Resort is an all-suite hotel comprised of 333 guest rooms, including 209

double suites, 123 king suites and one two-bedroom suite. Most guest rooms are located in a six-story building and were renovated in 1999. Since then, renovations have been ongoing. An additional 53 guest suites were added to the hotel in 2000. The hotel is less than a mile north of Downtown Disney s northern entrance. The Embassy Suites Lake Buena Vista Resort is also within ten miles of the Magic Kingdom, MGM-Studios, Epcot Center, Animal Kingdom, SeaWorld, Universal Studios, Islands of Adventure and the Orange County Convention Center.

Hamburg Marriott

We lease the Hamburg Marriott from Deutsche Immobilien Fonds Aktiengesellschaft under a lease agreement with an initial term expiring in 2030 and renewal options extending through 2050. Our leasehold interests are further described under Lease Agreements . The hotel opened in 1988 and comprises 277 guest rooms, including nine suites. The Hamburg Marriott hotel is located in the heart of the city center, in an area which has been rejuvenated over the last ten years and now accommodates the up-market retail and central business district of the city.

Four Seasons Mexico City

We hold a fee simple interest in the Four Seasons Mexico City hotel. The hotel, which opened in 1994, has 240 rooms, including 40 suites, 176 king rooms and 24 twin rooms. The hotel is constructed in the Mexican colonial style with an extensively landscaped central courtyard. The hotel is located on the Paseo de la Reforma, which is the location of a number of important Mexican and international corporate offices as well as other service businesses including major law and accounting firms, and is proximate to the Polanco business district and to the historical and governmental districts. The hotel is situated at the top of the Reforma between the exclusive shopping and entertainment district known as Zona Rosa and Chapultepec Park.

Paris Marriott Champs Elysees

We lease the Paris Marriott Champs Elysees from Deutsche Immobilien Fonds Aktiengesellschaft under a lease agreement with an initial term expiring on December 31, 2029 and renewal options extending through 2059. Our leasehold interests are further described under Lease Agreements . The hotel opened in 1997 and comprises 192 guest rooms, including 18 suites. Approximately $1.2 million was spent on capital improvements in 2001 and 2002. All of the guest rooms were completely renovated in 2002. The Paris Marriott Champs Elysees is the only hotel located on the famous Avenue des Champs Elysees. The hotel is located near the Arc de Triomphe, the Eiffel Tower, the Louvre and the La Defense business district. The hotel also adjoins approximately 6,000 square feet of high-end retailers.

Four Seasons Punta Mita Resort

We hold a fee simple interest in the Four Seasons Punta Mita Resort hotel. The resort, which opened in 1999, has 114 guest rooms and 26 suites for a total of 140 units. All units are situated in one- to three-story Mexican style, tile-roofed casitas. The Four Seasons Punta Mita Resort is located in Punta Mita, Nayarit, Mexico, which is 25 miles northwest of Puerto Vallarta, which is one of Mexico s most popular tourist destinations located on the Pacific coast.

ITEM 3. LEGAL PROCEEDINGS.

We are not involved in any material litigation nor, to our knowledge, is any material litigation threatened against us, other than routine litigation arising in the ordinary course of business or that which is expected to be covered by insurance.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Our common stock is listed and traded on the New York Stock Exchange. As of March 3, 2005, the number of holders of record of our common stock was 16.

The following table sets forth the high and low sale prices for and the frequency and amount of cash dividends declared on our common stock for the period June 23, 2004 through December 31, 2004.

	Per Share of Common Stock		
	Market Price		
2004	High	Low	Dividend
Second Quarter	$ 14.70	$ 14.00	$
Third Quarter	15.75	13.00	0.22
Fourth Quarter	16.56	13.10	0.22
Year	$ 16.56	$ 13.00	$ 0.44

We did not repurchase any of our equity securities during the fourth quarter of 2004.

ITEM 6. SELECTED FINANCIAL DATA.

The following sets forth our selected consolidated financial and operating information on a historical basis. The selected historical financial data as of December 31, 2004 and 2003 and for each of the three years in the period ended December 31, 2004 has been derived from our audited financial statements. The following information should be read together with Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and notes thereto, which is included in Item 8 Financial Statements and Supplementary Data.

The historical financial data presented herein prior to the date of our initial public offering (the Offering) is the historical financial data of our predecessor, SHC LLC, and reflects the historical results of operations and financial position of SHC LLC, including the seven properties that were distributed by SHC Funding to SHC LLC in the Formation and Structuring Transactions.

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Historical

for the Years Ended December 31,

	2004(1)(2)	2003(1)	2002(1)	2001(1)	2000(1)
			(In thousands, except statistical data)		
Statistical Data:					
Number of hotels excluding joint venture hotels	14	20	25	25	26
Number of rooms excluding joint venture hotels	5,820	9,567	10,621	10,619	11,263
Average occupancy rate	70.5%	69.2%	69.4%	67.6%	75.8%
Operating Data:					
Revenue:					
Rooms	$ 270,820	$ 317,978	$ 329,322	$ 345,568	$ 432,256
Food and beverage	144,593	164,358	167,691	174,284	209,032
Other hotel operating revenue	51,064	55,580	58,738	67,228	76,304
Lease revenue	24,233	27,638	35,134	45,286	51,460
Total Revenues	490,710	565,554	590,885	632,366	769,052
Operating Costs and Expenses:					
Rooms	67,761	82,245	81,950	83,983	100,246
Food and beverage	110,768	127,751	128,167	132,254	152,579
Other departmental expenses	135,323	148,595	147,506	153,625	172,453
Management fees	17,145	19,295	19,481	20,920	25,868
Other property level expenses	30,344	36,903	34,977	34,047	35,740
Lease expense	6,446				
Depreciation and amortization	61,463	82,661	104,302	118,690	135,275
Impairment losses on goodwill and hotel properties	12,675		5,435	53,185	3,500
Corporate expenses	28,845	21,912	15,854	18,428	28,798
Total Operating Costs and Expenses	470,770	519,362	537,672	615,132	654,459
Operating Income	19,940	46,192	53,213	38,765	114,593
Interest Expense	(64,578)	(107,391)	(101,075)	(128,875)	(146,908)
Minority Interests	4,831	(2,895)	(10,264)	(10,812)	(11,693)
Loss from Continuing Operations	(62,329)	(82,241)	(57,537)	(110,351)	(39,853)
Income from Discontinued Operations	75,662	26,047	7,234	1,668	8,340
Net Income (Loss)	$ 13,333	$ (56,194)	$ (50,303)	$ (116,659)	$ (31,513)
FFO Fully Converted(3)	$ (260)	$ 32,025	$ 117,151	$ 42,847	$ 173,929
EBITDA(3)	$ 143,630	$ 152,030	$ 186,838	$ 161,849	$ 284,899
Balance Sheet Data:					
Property and equipment, net, including goodwill, intangible assets and assets held for sale	$ 798,618	$ 1,748,864	$ 1,922,681	$ 2,001,785	$ 2,233,281
Cash and cash equivalents(4)	67,050	193,134	254,807	250,779	114,486
Total assets	990,350	2,079,521	2,269,657	2,352,572	2,472,947
Convertible debt, mortgages and other debt	543,140	1,696,167	1,818,580	1,865,260	1,588,009
Total liabilities	732,744	1,832,845	1,934,264	1,970,817	1,734,220

Minority interests	61,053	107,608	217,778	213,025	277,265
Owners equity	196,553	139,068	117,615	168,730	461,462

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(1) We sold five hotel properties during the year ended December 31, 2003 and one hotel property during the first quarter of 2004 as described under Management s Discussion and Analysis of Financial Condition and Results of Operations Recent Trends and Events Sales of Hotels . The statistical data for each year presented above includes the sold hotels prior to the date of sale. The operations of the sold hotels are included as discontinued operations in the operating data above for all years presented.

(2) The historical information for the year ended December 31, 2004 does not reflect the operations of the distributed properties subsequent to the date of the Offering.

(3) We present two non-GAAP financial measures herein for us that we believe are useful to investors as key measures of our operating performance: Funds from Operations, or FFO; and Earnings Before Interest Expense, Taxes, Depreciation and Amortization, or EBITDA. Reconciliation of these measures to net income (loss), the most directly comparable GAAP measure, is set forth in the following tables.

We compute FFO in accordance with standards established by the National Association of Real Estate Investment Trusts, or NAREIT, which adopted a definition of FFO in order to promote an industry-wide standard measure of REIT operating performance that would not have certain drawbacks associated with net income under GAAP. NAREIT defines FFO as net income (or loss) (computed in accordance with GAAP) excluding gains (or losses) from sales of property plus real estate-related depreciation and amortization, and after adjustments for our portion of these items related to unconsolidated partnerships and joint ventures. We also present Fully Converted FFO, which is FFO plus convertible debt interest expense and minority interest expense on convertible minority interests. We believe that the presentation of FFO and Fully Converted FFO provides useful information to investors regarding our results of operations because they are measures of our ability to fund capital expenditures and expand our business. In addition, FFO is widely used in the real estate industry to measure operating performance without regard to items such as depreciation and amortization.

EBITDA represents net income (loss) excluding: (i) interest expense, (ii) income tax expense, including deferred income tax benefits and expenses applicable to our foreign subsidiaries and income taxes applicable to sale of assets; and (iii) depreciation and amortization. EBITDA also excludes interest expense, income tax expense and depreciation and amortization of our equity method investments. EBITDA for 2004 and 2003 is presented on a full participation basis, which means we have assumed conversion of all minority interests into our common stock. We believe this treatment of minority interest provides more useful information for management and our investors and appropriately considers our current capital structure. We believe EBITDA is useful to an investor in evaluating our operating performance because it provides investors with an indication of our ability to incur and service debt, to satisfy general operating expenses, to make capital expenditures and to fund other cash needs or reinvest cash into our business. We also believe it helps investors meaningfully evaluate and compare the results of our operations from period to period by removing the impact of our asset base (primarily depreciation and amortization) from our operating results. Our management also uses EBITDA as a measure in determining the value of acquisitions and dispositions.

We caution investors that amounts presented in accordance with our definitions of FFO, Fully Converted FFO, and EBITDA may not be comparable to similar measures disclosed by other companies, since not all companies calculate these non-GAAP measures in the same manner. FFO, Fully Converted FFO, and EBITDA should not be considered as an alternative measure of our net income (loss) or operating performance. FFO, Fully Converted FFO, and EBITDA may include funds that may not be available for our discretionary use due to functional requirements to conserve funds for capital expenditures and property acquisitions and other commitments and uncertainties. Although we believe that FFO, Fully Converted FFO, and EBITDA can enhance your understanding of our financial condition and results of operations, these non-GAAP financial measures, when viewed individually, are not necessarily a better indicator of any trend as compared to comparable GAAP measures such as net income (loss). In addition, you should be aware that adverse economic and market conditions might negatively impact our cash flow. Below, we include a quantitative reconciliation of FFO, Fully Converted FFO, and EBITDA to the most directly

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comparable GAAP financial performance measure, which is net income (loss), and provide an explanatory description by footnote of the items excluded from FFO, Fully Converted FFO, and EBITDA.

(4) Includes restricted cash and cash equivalents.

The following tables show the reconciliation between net income (loss) and FFO and net income (loss) and EBITDA for the periods indicated:

Reconciliation of Net Income (Loss) to Funds From Operations (FFO)

Historical for the Years Ended December 31,

	2004(1)(2)	2003(1)	2002	2001	2000
			(In thousands)		
Net income (loss)	$ 13,333	$ (56,194)	$ (50,303)	$ (116,659)	$ (31,513)
Depreciation and amortization continuing operations	61,463	82,661	104,302	118,690	135,275
Depreciation and amortization discontinued operations		5,513	13,383	11,901	18,449
Gain on sale of assets continuing operations				(21,531)	(1,702)
Gain on sale of assets discontinued operations	(75,982)	(21,072)			
Realized portion of deferred gain on sale leasebacks	(2,180)				
Deferred tax expense on realized portion of deferred gain on sale leasebacks	657				
Minority interest adjustments	(5,573)	(466)	(819)	(1,019)	(1,036)
Adjustments from unconsolidated affiliates	3,174	3,320	2,989	3,021	3,211
FFO(3)	(5,108)	13,762	69,552	(5,597)	122,684
Convertible debt interest expense	4,105	14,902	36,516	36,613	38,516
Convertible minority interests	743	3,361	11,083	11,831	12,729
FFO Fully Converted(3)	$ (260)	$ 32,025	$ 117,151	$ 42,847	$ 173,929

(1) We sold five hotel properties during the year ended December 31, 2003 and one hotel property during the first quarter of 2004 as described under Management s Discussion and Analysis of Financial Condition and Results of Operations Recent Trends and Events Sales of Hotels .

(2) The reconciliation for the year ended December 31, 2004 does not reflect the operations of the distributed properties subsequent to the date of the Offering.

(3) FFO has not been adjusted for the following amounts included in net income (loss) because these losses have either occurred during the prior two years or are reasonably likely to occur within two years (in thousands).

Impairment losses from continuing operations amounted to $12,675, $5,435 and $53,185 for the years ended December 31, 2004, 2002 and 2001 respectively.

Impairment losses from discontinued operations amounted to $7,803 for the year ended December 31, 2001.

Loss on extinguishment of debt from continuing operations amounted to $21,934, $13,761 and $13,868 for the years ended December 31, 2004, 2003 and 2001, respectively.

Loss on extinguishment of debt from discontinued operations amounted to $1,086 for the year ended December 31, 2003.

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Reconciliation of Net Income (Loss) to EBITDA

Historical for the Years Ended December 31,

	2004(1)(2)	2003(1)	2002	2001	2000
			(In thousands)		
Net income (loss)	$ 13,333	$ (56,194)	$ (50,303)	$ (116,659)	$ (31,513)
Depreciation and amortization continuing operations	61,463	82,661	104,302	118,690	135,275
Depreciation and amortization discontinued operations		5,513	13,383	11,901	18,449
Interest expense continuing operations	64,578	107,391	101,075	128,875	146,908
Interest expense discontinued operations	577	6,352	10,856	12,666	8,091
Income taxes	5,265	247	3,493	3,185	4,153
Mexican asset tax refund	(2,427)				
Minority interests	(4,831)	2,895	(1,382)	(1,503)	(2,002)
Adjustments from unconsolidated affiliates	5,672	3,165	5,414	4,694	5,538
EBITDA(3)	$ 143,630	$ 152,030	$ 186,838	$ 161,849	$ 284,899

(1) We sold five hotel properties during the year ended December 31, 2003 and one hotel property during the first quarter of 2004 as described under Management s Discussion and Analysis of Financial Condition and Results of Operations Recent Trends and Events Sales of Hotels .

(2) The reconciliation for the year ended December 31, 2004 does not reflect the operations of the distributed properties subsequent to the date of the Offering.

(3) EBITDA has not been adjusted for the following amounts included in net income (loss) because these losses have either occurred during the prior two years or are reasonably likely to occur within two years (in thousands).

Impairment losses from continuing operations amounted to $12,675, $5,435 and $53,185 for the years ended December 31, 2004, 2002 and 2001 respectively.

Impairment losses from discontinued operations amounted to $7,803 for the year ended December 31, 2001.

Loss on extinguishment of debt from continuing operations amounted to $21,934, $13,761 and $13,868 for the years ended December 31, 2004, 2003 and 2001, respectively.

Loss on extinguishment of debt from discontinued operations amounted to $1,086 for the year ended December 31, 2003.

Gain on sale of assets from discontinued operations amounted to $75,982 and $21,072 for the years ended December 31, 2004 and 2003, respectively. Gain on sale of assets from continuing operations amounted to $21,531 and $1,702 for the years ended December 31, 2001 and 2000, respectively.

Realized portion of deferred gain on sale leasebacks amounted to $2,180 for the year ended December 31, 2004.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion and analysis is based primarily on the consolidated financial statements of Strategic Hotel Capital, Inc. for the years presented and should be read together with the notes thereto contained in this Form 10-K. Terms employed herein as defined terms, but without definition, have the meanings set forth in the notes to the financial statements (see Item 8. Financial Statements and Supplementary Data).

Overview

Strategic Hotel Capital, Inc., or SHCI, was incorporated in January 2004 to own and asset manage upper upscale and luxury hotels in North America and Europe. Strategic Hotel Capital, L.L.C., or SHC LLC, was founded in 1997 by Laurence Geller, our President and Chief Executive Officer, WHSHC, L.L.C. and W9/WHSHC, L.L.C. I, which we collectively call Whitehall (an affiliate of Goldman, Sachs & Co.), and others. We intend to make an election to qualify, beginning with our 2004 tax year, as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended. On June 29, 2004, we completed our initial public offering (the Offering) of common stock. Prior to the Offering, 21 hotel interests were owned by SHC LLC. Concurrent with and as part of the transactions relating to the Offering, a reverse spin-off distribution to shareholders separated SHC LLC into two companies, a new, privately-held SHC LLC, with interests in seven hotels, and Strategic Hotel Capital, Inc., a public entity with interests in 14 hotels. See Item 8. Financial Statements and Supplementary Data Note 1. General for the hotel interests owned by us and SHC LLC.

We operate as a self-administered and self-managed REIT, which means that we are managed by our board of directors and executive officers. A REIT is a legal entity that holds real estate interests and, through payments of dividends to stockholders, is permitted to reduce or avoid federal income taxes at the corporate level. For us to continue to qualify as a REIT, we cannot operate hotels; instead we employ internationally known hotel management companies to operate our hotels for us under management contracts. We conduct our operations through our direct and indirect subsidiaries including our operating partnership, Strategic Hotel Funding, L.L.C. (SHC Funding), which holds substantially all of our assets. We are the sole managing member of our operating partnership and hold approximately 76.30% of its membership units. We manage all business aspects of our operating partnership, including the sale and purchase of hotels, the investment in these hotels and the financing of our operating partnership and its assets.

The historical financial data prior to June 29, 2004 presented in this report is the historical financial data for our predecessor, SHC LLC, and reflects the historical results of operations and financial position of SHC LLC, including the seven properties that were not contributed to SHC Funding as part of the transactions relating to the Offering. As a result, our historical results of operations and financial position are not indicative of our results of operations and financial position after the Offering. Throughout this Management s Discussion and Analysis of Financial Condition and Results of Operations section, or MD&A, references to we , our and us are references to SHC LLC and its consolidated subsidiaries before the Offering and SHCI, SHC Funding and their subsidiaries after the Offering.

When presenting the dollar equivalent amount for any amounts expressed in a foreign currency, the dollar equivalent amount has been computed based on the exchange rate on the date of the transaction or the exchange rate prevailing on December 31, 2004, as applicable, unless otherwise noted.

Factors Affecting Our Results of Operations

Acquisition and Sale of Interests in Hotel Properties. We sold five hotel properties during 2003. In addition, in February 2004, we sold one hotel property, the Hyatt Regency Capitol Hill in Washington, D.C. The results of operations for the hotel properties we sold during 2003, and the Hyatt Regency Capitol Hill, which we held for sale as of December 31, 2003, have been classified as discontinued operations in the statements of operations for the years ended December 31, 2004, 2003 and 2002. Based on the continued cash flow SHCI

generates from its asset management agreement with SHC LLC, the operations of seven hotel properties distributed to SHC LLC are not reflected as discontinued operations in the accompanying statements of operations.

In addition, we acquired our joint venture partner s 65% interest in the lease of the Hamburg Marriott on March 1, 2004. On August 24, 2004, we purchased the Ritz-Carlton Half Moon Bay, located south of San Francisco, California, for approximately $123.0 million.

We present certain information about our hotel operating results and statistics on a comparable hotel basis. We define our Comparable REIT Assets as those (a) that are owned or leased by us, and their operations are included in our consolidated operating results, and (b) for which we reported operating results throughout the reporting periods being compared. Accordingly, our comparable hotels for purposes of the comparison of 2004 and 2003 do not include the Hamburg Marriott which we accounted for under the equity method until we acquired the remaining 65% joint venture interest in March 2004, the Ritz-Carlton Half Moon Bay which we purchased in August 2004, the Prague Inter.Continental which we account for under the equity method, the five hotel properties sold in the year ended December 31, 2003 and the one hotel sold in the year ended December 31, 2004. The Comparable REIT Assets exclude the seven hotels owned by our accounting predecessor SHC LLC prior to the Offering, which we refer to as the Distributed Properties, because these properties were excluded from our results of operations after June 29, 2004. We present these Comparable REIT Asset results because we believe that doing so provides management and the reader with useful information for evaluating the period-to-period performance of our hotels and facilitates comparisons with other hotel REITs and hotel owners, in particular, these measures assist management and the reader in distinguishing whether increases or decreases in revenues and/or expenses are due to operations of the Comparable REIT Assets or from the remainder of the portfolio. For the years ended December 31, 2003 and 2002 analysis, the results of the total portfolio for both periods presented include the same properties and therefore, we have not included a Comparable REIT Asset portfolio analysis.

Revenues. Substantially all of our revenue is derived from the operation of our hotels. Specifically, our revenue consists of:

Rooms revenue. Occupancy and average daily rate are the major drivers of rooms revenue. For the years ended December 31, 2004, 2003 and 2002 we recorded $270.8 million, $318.0 million and $329.3 million, respectively, in rooms revenue, which represented 55.2%, 56.2% and 55.7% of our total revenue for those periods. For the years ended December 31, 2004 and 2003, we recorded $185.4 million and $169.8 million for the Comparable REIT Assets, respectively, in rooms revenue, which represented 54.1% and 52.9% of our total revenue from the Comparable REIT Assets for those periods.

Food and beverage revenue. Occupancy and local social catering are the major drivers of food and beverage revenue. For the years ended December 31, 2004, 2003 and 2002 we recorded $144.6 million, $164.4 million and $167.7 million, respectively, in food and beverage revenue, which represented 29.5%, 29.1% and 28.4% of our total revenue for those periods. For the years ended December 31, 2004 and 2003, we recorded $101.0 million and $93.7 million for the Comparable REIT Assets, respectively, in food and beverage revenue, which represented 29.4% and 29.2% of our total revenue from the Comparable REIT Assets for those periods.

Other hotel operating revenue, which consists of ancillary revenue such as telephone, parking, golf course, spa, entertainment and other guest services, is also driven by occupancy. For the years ended December 31, 2004, 2003 and 2002 we recorded $51.1 million, $55.6 million and $58.7 million, respectively, in other hotel operating revenue, which represented 10.4%, 9.8% and 9.9% of our total revenue for those periods. For the years ended December 31, 2004 and 2003, we recorded $39.3 million and $37.5 million for the Comparable REIT Assets, respectively, in other hotel operating revenue, which represented 11.5% and 11.7% of our total revenue from the Comparable REIT Assets for those periods.

Lease revenue historically consisted of rent paid by two domestic hotels (Hyatt Regency New Orleans and Hyatt Regency San Francisco) to us for an amount approximately equal to 80% of operating profit

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as defined in the lease agreements. Commencing with the March 1, 2004 acquisition of our joint venture partner s interest in the Hamburg Marriott, we also report lease revenue applicable to the Hamburg Marriott. Lease revenue for the Hamburg Marriott consists of a fixed annual rental paid in monthly installments plus a percentage of profits in excess of the base rent. Because lease revenues applicable to the two domestic hotels are calculated as a percentage of the hotel s operating profit and for the Hamburg Marriott consist of fixed rent and a percentage of profits in excess of the base rent, we do not directly account for either the revenues or expenses of the hotels we lease in our statement of operations. After the Offering transactions, including the conversion on June 29, 2004 of the Hyatt Regency New Orleans lease to a management agreement and the distribution of the Hyatt Regency San Francisco to SHC LLC, we only earn lease revenue from the Hamburg Marriott and the Paris Marriott Champs Elysées (Paris Marriott) (see Sales of Hotels).

For the years ended December 31, 2004, 2003 and 2002 we recorded $24.2 million, $27.6 million and $35.1 million, respectively, of lease revenue from these lease agreements, which represented 4.9%, 4.9% and 5.9% of our total revenue for those periods. For the years ended December 31, 2004 and 2003, we recorded $17.3 million and $20.2 million of lease revenue for the Comparable REIT Assets, respectively, from these lease agreements, which represented 5.0% and 6.3% of our total revenue from the Comparable REIT Assets for those periods.

Changes in our revenues are most easily explained by three performance indicators that are commonly used in the hotel real estate industry:

- average daily occupancy,
- average daily rate, or ADR, and
- net revenue per available room, or RevPAR, which is the product of ADR and average daily occupancy, but does not capture food and beverage revenues or other hotel operations revenue such as telephone, parking and other guest services.

Fluctuations in revenues, which tend to correlate with changes in the U.S. gross domestic product, are driven largely by general economic and local market conditions as well as general health and safety concerns, which in turn affect levels of business and leisure travel. Guest demographics also affect our revenues. For example, a greater percentage of transient guests, which includes corporate and premium business travelers who generally pay the highest average room rates, will generate higher revenues. In addition to economic conditions, supply is another important factor that can affect revenues. Room rates and occupancy tend to fall when supply increases unless the supply growth is offset by an equal or greater increase in demand. One reason why we target upper upscale and luxury hotels in select urban and resort markets, including major business centers and leisure destinations, is because they tend to be in locations that have greater supply constraints such as lack of available land, high development costs, long development and entitlement lead times and brand trade area restrictions that prevent the addition of a certain brand or brands in close proximity. Nevertheless, our hotels are not completely insulated from competitive pressures and our hotel operators will lower room rates to compete more aggressively for guests in periods when occupancy declines. Our ADR decreased 0.9% to $178.00 during the year ended December 31, 2004 from $179.62 during the year ended December 31, 2003. Our ADR decreased 3.1% to $179.62 during the year ended December 31, 2003 from $185.31 during the year ended December 31, 2002. With respect to the Comparable REIT Assets, ADR increased by 1.7% to $167.45 for the year ended December 31, 2004 from $164.58 for the year ended December 31, 2003.

Operating Costs and Expenses. Our operating costs and expenses consist of the costs to provide hotel services, including:

Rooms expense. Like rooms revenue, occupancy is a major driver of rooms expense, which has a significant correlation with rooms revenue. For the years ended December 31, 2004, 2003 and 2002 we recorded $67.8 million, $82.2 million and $82.0 million, respectively, in rooms expense, which represented 14.4%, 15.8% and 15.2% of our total operating costs and expenses for those periods. For the

years ended December 31, 2004 and 2003, we recorded $41.7 million and $36.9 million for the Comparable REIT Assets, respectively, in rooms expense, which represented 13.7% and 14.0% of our total operating costs and expenses from the Comparable REIT Assets for those periods.

Food and beverage expense. Like food and beverage revenue, occupancy and local social catering are the major drivers of food and beverage expense, which has a significant correlation with food and beverage revenue. For the years ended December 31, 2004, 2003 and 2002 we recorded $110.8 million, $127.8 million and $128.2 million, respectively, in food and beverage expense, which represented 23.5%, 24.6% and 23.8% of our total operating costs and expenses for those periods. For the years ended December 31, 2004 and 2003, we recorded $74.8 million and $69.4 million for the Comparable REIT Assets, respectively, in food and beverage expense, which represented 24.6% and 26.3% of our total operating costs and expenses from the Comparable REIT Assets for those periods.

Other departmental expenses consist of general and administrative, marketing, repairs and maintenance, utilities and expenses related to earning ancillary revenue. For the years ended December 31, 2004, 2003 and 2002 we recorded $135.3 million, $148.6 million and $147.5 million, respectively, in other departmental expenses, which represented 28.7%, 28.6% and 27.4% of our total operating costs and expenses for those periods. For the years ended December 31, 2004 and 2003, we recorded $98.3 million and $89.5 million for the Comparable REIT Assets, respectively, in other departmental expenses, which represented 32.3% and 33.9% of our total operating costs and expenses from the Comparable REIT Assets for those periods.

Management fees. We pay base and incentive management fees to our hotel operators. Base management fees are computed as a percentage of revenue and correlate to revenues. Incentive management fees are incurred when operating profits exceed levels prescribed in our management agreements. For the years ended December 31, 2004, 2003 and 2002 we recorded $17.1 million, $19.3 million and $19.5 million, respectively, in management fees, which represented 3.6%, 3.7% and 3.6% of our total operating costs and expenses for those periods. For the years ended December 31, 2004 and 2003, we recorded $13.7 million for the Comparable REIT Assets, in management fees, which represented 4.5% and 5.2% of our total operating costs and expenses from the Comparable REIT Assets for those periods.

Other property level expenses consist primarily of insurance costs and property taxes. For the years ended December 31, 2004, 2003 and 2002 we recorded $30.3 million, $36.9 million and $35.0 million, respectively, in other property level expenses, which represented 6.4%, 7.1% and 6.5% of our total operating costs and expenses for those periods. For the years ended December 31, 2004 and 2003, we recorded $19.7 million and $16.0 million for the Comparable REIT Assets in other property level expenses, which represented 6.5% and 6.0% of our total operating costs and expenses from the Comparable REIT Assets for those periods.

Lease expense. In connection with the Offering, we recorded a sale and leaseback of the Paris Marriott and Hamburg Marriott as of June 29, 2004 and now record lease expense on our statements of operations. For the year ended December 31, 2004, we recorded $6.4 million in lease expense, which represented 1.4% of our total operating costs and expenses for the period. For the year ended December 31, 2004, we recorded $4.5 million for the Comparable REIT Assets in lease expense, which represented 1.5% of our total operating costs and expenses from the Comparable REIT Assets for the period.

Depreciation and amortization expense. For the year ended December 31, 2004, 2003 and 2002 we recorded $61.5 million, $82.7 million and $104.3 million, respectively, in depreciation and amortization, which represented 13.1%, 15.9% and 19.4% of our total operating costs and expenses for those periods. For the years ended December 31, 2004 and 2003, we recorded $39.1 million and $38.8 million for the Comparable REIT Assets, respectively, in depreciation and amortization, which represented 12.8% and 14.7% of our total operating costs and expenses from the Comparable REIT Assets for those periods.

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Corporate expenses include our corporate level expenses such as payroll and related costs, unit appreciation rights and restricted stock units plan expense, professional fees, travel expenses and office rent. For the years ended December 31, 2004, 2003 and 2002 we recorded $28.8 million, $21.9 million and $15.9 million, respectively, in corporate expenses, which represented 6.1%, 4.2% and 2.9% of our total operating costs and expenses for those periods.

Subsequent to the Offering, we began earning asset management fees, including an initial base annual fee of $5.0 million, under an asset management agreement between our domestic taxable REIT subsidiary and SHC LLC with regard to the Distributed Properties.

Most categories of variable operating expenses, such as utilities and certain labor such as housekeeping, fluctuate with changes in occupancy. Increases in RevPAR attributable to increases in occupancy are accompanied by increases in most categories of variable operating costs and expenses while increases in RevPAR attributable to increases in ADR typically only result in increases in limited categories of operating costs and expenses, such as management fees charged by our operators which are based on hotel revenues. Thus, changes in ADR have a more significant impact on operating margins.

The operators of our hotels have been able to minimize the impact of reductions in RevPAR stemming from reductions in room occupancy by following our advice regarding strategies to reduce variable costs and expenses at our hotels. For example, in response to the decline in hotel operating revenues that began during 2001, we developed a corporate action plan that focused on improving operating efficiencies for our hotels that was well received by the managers of our hotels. Following the events of September 11, 2001, we worked with our operators to implement more aggressive streamlining strategies. Many of these strategies continue to be used by our hotel operators today. These strategies include reducing labor costs, streamlining staffing levels and postponing new hiring to replace vacant positions, reducing hours of operations at hotel restaurants, reducing food costs, reducing amenities and services where appropriate and refocusing marketing strategies. We believe that the adoption of our advice by the managers of our hotels contributed towards slowing the decrease in our operating margins during those periods and has resulted in some meaningful long-term efficiencies. We believe that our expertise and advice will continue to be given careful consideration by the operators of our hotels and as a consequence the efficiency of our hotels may continue to improve in future years.

Notwithstanding our efforts to reduce variable costs, there are limits to how much we can accomplish because we have significant fixed costs, such as depreciation and amortization, labor costs and employee benefits, insurance and other expenses associated with owning hotels that do not necessarily decrease when circumstances such as market factors cause a reduction in our hotel revenues. Our ability to influence our operators is also restricted by the terms of our management agreements. As a result, changes in RevPAR can result in a greater percentage change in our earnings and cash flows than the reduction of costs.

Recent Trends and Events

Recent Trends.

The lodging industry and our portfolio have experienced increased demand during the year ended December 31, 2004, when compared to the year ended December 31, 2003. For example, RevPAR at our hotels increased 1.6% to $125.52 during the year ended December 31, 2004 from $123.56 for the year ended December 31, 2003. With respect to the Comparable REIT Assets, RevPAR increased 4.8% to $114.17 for the year ended December 31, 2004 from $108.93 for the year ended December 31, 2003. Increases in RevPAR for the year ended December 31, 2004 compared to the same period of 2003 include the Loews Santa Monica Beach Hotel with a 17.0% increase, the Four Seasons Punta Mita with a 12.9% increase, the Embassy Suites Lake Buena Vista with a 13.4% increase, and the Hyatt Regency Phoenix with a 6.9% increase. These increases were partially offset by a 5.3% RevPAR decrease at the Hyatt Regency New Orleans.

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During the years ended December 31, 2003 and 2002, the overall decline in both business and leisure travel led to decreased occupancies which, together with a relative increase in supply, led to declines in room rates as hotels competed more aggressively for guests. These events had a significant adverse effect on our RevPAR and operating performance during those periods. For example, during the years ended December 31, 2003 and 2002 as compared to the prior year, our comparable RevPAR declined by 3.1% and 4.9%, respectively. This decline in RevPAR was driven primarily by a decline in ADR. In particular, between 2000 and 2003, RevPAR for the Marriott Schaumburg declined 34.0% and RevPAR for the Marriott Lincolnshire declined 24.6%. We believe these declines in RevPAR for our Chicago-area properties resulted primarily from increased price competition caused by new limited service hotels opening in both the local and regional markets combined with the decrease in demand from the recent economic slowdown.

It is not possible to predict accurately if and when travel patterns and lodging industry fundamentals will be restored to pre-September 11, 2001 levels. While there have been recent improvements and industry analysts are optimistic about future prospects for growth, the uncertainty associated with the continuing war on terrorism and the possibility of future actions may continue to hamper business and leisure travel patterns. In addition, outbreaks of communicable diseases could have a material adverse effect on our revenues and results of operations due to decreased travel and food and beverage consumption at our hotels. We believe that the following factors may continue to have a negative effect on our revenues during 2005:

- changes in economic conditions that would slow or reverse the increase in demand presently being experienced by the lodging industry;
- downward pricing pressures resulting from intense competition for a reduced amount of business and new competition from internet wholesalers and distributors;
- the continuing effects of the September 11, 2001 attacks; and
- the war on terrorism, terrorism alerts, high oil prices, airline strikes and other factors that may have an adverse impact on travel and lodging demand.

Recent Events. In addition to the recent trends described above, we expect that the following events will cause our future results of operations to differ from our historical performance:

InterContinental Hotels. On February 28, 2005, we signed an agreement to acquire an 85% controlling interest in the InterContinental hotels in Chicago and Miami with a combined room count of 1,448 rooms for an agreed aggregate value of $303.5 million, or a $210,000 price per room. The acquisition, which is expected to close early in the second quarter of 2005, remains subject to customary closing conditions, including a satisfactory due diligence review, and no assurances can be given that the transaction ultimately will be completed.

The completely renovated 807-room InterContinental Chicago, located in the heart of the Magnificent Mile shopping district, is a historic luxury property. The hotel consists of two buildings, a 42-story historic tower and a 26-story main building, and features 44,000 square feet of function space, including six ballrooms and 30 meeting rooms.

The 641-room InterContinental Miami rises 34 stories above Biscayne Bay in the Central Business District of Miami. The luxury property is located on 3.6 acres of the Miami Centre, a prominent office and hotel complex in the core of Miami s downtown, and features 65,000 square feet of meeting space, a fitness center and other high-end amenities, including three restaurants.

The hotels will each be held in a partnership in which we will own a controlling 85% interest with InterContinental Hotels (IHG) holding the remaining 15%. Through the partnership agreement with IHG, we will be entitled to receive a non-cumulative preferred return of 8% on our total investment of $263.5 million (less our proportionate share of the partnership s debt service obligations, including in respect of approximately

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$202.0 million of CMBS financing that we currently expect to be put into place by the partnership at closing). Our $263.5 million investment includes our proportionate share of the cost of the properties and the CMBS financing expected to be put in place by the partnership at closing, anticipated closing costs and initial capital expenditures. We intend to fund the equity portion of our investment from the proceeds of this offering and borrowings under our revolving credit facility. After we receive our preferred return, IHG is entitled to receive a non-cumulative preferred return of 8% on its investment. Thereafter, we and IHG will share proportionately in partnership distributions in accordance with our respective percentage ownership interests.

Formation and Structuring Transactions. The following items associated with the consummation of the Offering will affect our future results of operations:

- We no longer own or receive revenues or record expenses and operating costs from the Distributed Properties. As a result, our historical results of operations, cash flows and financial position are not indicative of our results of operations, cash flows and financial position expected after the Offering.

- We recognize additional revenue when earned under an asset management agreement with SHC LLC for the Distributed Properties, which amounts to an initial base fee of $5.0 million per year, subject to reduction as properties are sold.

- As a result of the refinancing of existing debt obligations and the exclusion of the SHC LLC convertible debentures from our capital structure, interest expense will decline substantially.

- We restructured the lease related to the Paris Marriott to eliminate the finance obligation and now report it as an operating lease by changing the terms of the previously collateralized guarantee, meaning that the applicable assets and liabilities are eliminated to reflect the restructuring, lease expense replaces interest expense and principal amortization of the finance obligation and depreciation and amortization expense is also eliminated. In addition, as a result of a sublease arrangement whereby we lease our interest in the hotel to a third party, we record lease revenue in our consolidated statements of operations subsequent to June 29, 2004.

- We acquired our joint venture partner s interest in the Hamburg Marriott hotel on March 1, 2004, and restructured the lease related to that hotel to eliminate the finance obligation and as of June 29, 2004, we report it as an operating lease by changing the terms of the previously collateralized guarantee.

- The Hyatt New Orleans hotel was converted from an operating lease to a management agreement in connection with the Offering.

REIT Structure. For us to continue to qualify as a REIT, our income generally cannot be derived from operating hotels. Therefore, our operating partnership and its subsidiaries lease our hotel properties to our taxable REIT subsidiary lessees, which we call TRS lessees, or in the case of the Paris Marriott to an independent third party, who in turn contract with eligible independent contractors to manage our hotels. Our TRS lessees, except Prague, are consolidated into our financial statements for accounting purposes. However, since we control both our operating partnership and our TRS lessees, our principal source of funds on a consolidated basis is from the performance of our hotels. As in the past, our foreign operations continue to be taxed, but unlike our accounting predecessor, the earnings of our TRS lessees are subject to taxation like other regular C corporations, which reduces our operating results, funds from operations and the cash otherwise available for distribution to our stockholders.

Sales of Hotels. On February 20, 2003, we sold four hotels located in Coral Gables, Florida; Orlando, Florida; Santa Clara, California; and Crystal City, Virginia. On June 18, 2003, we sold an additional hotel located in Chicago, Illinois. During 2003, we realized net sales proceeds of approximately $154.6 million and an aggregate gain on these sales of approximately $21.1 million. On February 6, 2004, we sold the Hyatt Regency Capitol Hill in Washington, D.C. Net sales proceeds amounted to approximately $156.4 million and we recognized a gain on this sale of approximately $76.0 million. In each case, we sold these hotels because we believed that our asset management team had fully exploited

available opportunities to enhance revenues and improve the property s value. The long-lived assets applicable to the Hyatt Regency Capitol Hill were

reclassified to net assets held for sale as of December 31, 2003 and gain on sale has been classified as discontinued operations in the statement of operations for the year ended December 31, 2004. Therefore, the operating revenues and expenses of the properties we sold during 2003 and the first quarter of 2004 are not included in the operating results discussed below. See note 4 to our consolidated financial statements for a summary of the items that comprise Income from discontinued operations.

In July 2003, we sold the real estate (building and land) relating to the Paris Marriott to Deutsche Immobilien Fonds Aktiengesellschaft, or DIFA, for 163.0 million ($185.8 million) in cash. DIFA then leased this real estate to us with the right to continue to operate the hotel for an initial term expiring on December 31, 2029, with tenant renewal options extending through 2059. Under the terms of our lease, we make monthly minimum rent payments aggregating 10.5 million ($14.3 million based on the foreign exchange rate as of December 31, 2004) per year (increasing by an index-related formula) and pay additional rent based on the performance of the hotel. We arranged for a bank guarantee from Barclays Bank PLC (Barclays) of a portion of the minimum rent up to a capped amount of 14.6 million ($19.8 million based on the foreign exchange rate as of December 31, 2004). Amounts paid under the bank guarantee reduced the amount of the minimum rent guarantee euro for euro. There was no obligation to replenish the bank guarantee, although in the event of a failure to do so, DIFA would have been able to terminate the lease. In connection with obtaining the bank guarantee, we entered into a Guarantee Issuance Facility, or GIF, with Barclays. Under the GIF, an initial cash deposit was made with Barclays of 5.0 million ($5.7 million) and additional semi- annual cash deposits of 500,000 ($678,000 based on the foreign exchange rate as of December 31, 2004) were required until the cash collateral equals the guaranteed minimum rent of 14.6 million ($19.8 million based on the foreign exchange rate as of December 31, 2004) (or such lesser amount as may then be outstanding on the bank guarantee). In addition to the bank guarantee, SHC LLC has guaranteed performance (other than payment of rent and insured matters) by a guarantee to DIFA limited to 5.3 million ($7.1 million based on the foreign exchange rate as of December 31, 2004). We have agreed to indemnify SHC LLC for any losses arising from this guarantee. As a result of provisions in the lease agreement that provide for continuing involvement, we accounted for the sale and leaseback of the Paris Marriott as a finance obligation. We maintained the Paris Marriott on our consolidated balance sheet and continued to consolidate its results, including its depreciation. Based on the effective interest method, a portion of the monthly lease payments were reported as a reduction of the finance obligation with the remainder charged to interest expense.

As described above, following the Offering, we recorded the Paris Marriott as an operating lease and now record lease expense instead of mortgage interest and depreciation expense because we eliminated what is considered a collateralized guarantee under GAAP by canceling the GIF. After retiring mortgage debt of 99.1 million ($113.0 million) due upon sale of the Paris Marriott, terminating the related interest rate swap, paying transaction costs and reserving cash for the French income taxes due on the above-described sale, we repatriated the net proceeds from this transaction to the United States. As a result of a sublease arrangement whereby we lease our interest in the hotel to a third party, we record lease revenue in our consolidated statements of operations subsequent to June 29, 2004. SHCI recorded a deferred gain of $103.6 million in connection with this transaction. As part of the cancellation of the GIF, we funded a security deposit with DIFA representing approximately 16 months of the minimum rent. This amount at December 31, 2004 is $16.7 million and is included in Other assets on the accompanying consolidated balance sheet.

In February 2004, the joint venture that owned the Hamburg Marriott (Bohus) sold its interest in the hotel to DIFA for 50.0 million ($62.8 million) in cash. Upon the sale of the hotel, Bohus retired mortgage debt of 27.8 million ($34.9 million). Bohus paid a subsidiary of SHCI s predecessor 4.6 million ($5.6 million) for a guarantee fee, finders fee and as a sales commission, all of which were recorded as a reduction of our investment in Bohus. After these payments and providing certain reserves for capital expenditures and income taxes, Bohus distributed the net sales proceeds to us and our joint venture partner. DIFA leased the hotel back to Bohus. The lease s initial term runs through June 14, 2030 and is subject to extension. Under the terms of the lease, Bohus will make monthly minimum rent payments aggregating 3.3 million ($4.5 million based on the foreign

exchange rate as of December 31, 2004) per year (increasing by an index formula) and pay additional rent based upon the performance of the hotel. Bohus has guaranteed a portion of the minimum rent. A bank guarantee issued in favor of Bohus and DIFA by Barclays secured this guarantee. In connection with entering into the bank guarantee, Bohus entered into a GIF with Barclays. Under this GIF, Bohus made an initial cash deposit with Barclays of 2.5 million ($3.1 million) and was to make additional semi-annual cash deposits of 500,000 ($678,000 based on the foreign exchange rate as of December 31, 2004) until the cash collateral equaled the lesser of 5.0 million ($6.3 million) or the outstanding amount of the guarantee. SHC LLC has guaranteed Bohus s performance by a corporate guarantee to DIFA limited to 1.7 million ($2.1 million). We have agreed to indemnify SHC LLC for any losses arising from this guarantee. As a result of provisions in the lease agreement that provide for continuing involvement by Bohus, Bohus accounted for the sale and leaseback of the Hamburg Marriott as a finance obligation. Bohus maintained the Hamburg Marriott on its balance sheet and continued its depreciation. Based on the effective interest method, a portion of the monthly lease payments were reported as a reduction of the finance obligation with the remainder charged to interest expense.

Subsequent to Bohus sale of the Hamburg Marriott, on March 1, 2004, a subsidiary of SHCI s predecessor paid 130,000 ($162,000) to acquire the remaining 65% of Bohus it did not previously own. Additional consideration of 86,000 is required upon final settlement of working capital amounts. This transaction has been accounted for as a purchase and our basis in the assets and liabilities of Bohus have been adjusted to fair value to the extent of the 65% of Bohus SHCI s predecessor did not previously own. As described above, following the Offering, we restructured the terms of our lease to eliminate the previously collateralized guarantee by canceling the GIF, which constituted continuing involvement under GAAP. We now account for this transaction as an operating lease. We record lease expense instead of interest and depreciation expense and have removed the assets and the related financing obligation from our balance sheet. In addition, since we lease this hotel to the operator, we record lease revenue in our consolidated statement of operations. We recorded a deferred gain of $5.6 million in connection with this transaction. As part of the cancellation of the GIF, we funded a security deposit with DIFA representing approximately 18 months of the minimum rent. This amount at December 31, 2004 is $6.8 million and is included in Other assets on the accompanying consolidated balance sheet.

Acquisitions. On August 24, 2004, we purchased the Ritz-Carlton Half Moon Bay, located south of San Francisco, California, for approximately $123.0 million.

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Operating Results

Comparison of Year Ended December 31, 2004 to Year Ended December 31, 2003

The following table presents our total portfolio and Comparable REIT Assets operating results for the years ended December 31, 2004 and 2003, including the amount and percentage change in these results between the two periods. Our total portfolio represents the results of operations included in the consolidated statements of operations.

	Total Portfolio				Comparable REIT Assets			
	2004	2003	Change($)	Change(%)	2004	2003	Change($)	Change(%)
	(Dollars in thousands, except operating data)							
Revenues:								
Rooms	$ 270,820	$ 317,978	$ (47,158)	(14.8)%	$ 185,393	$ 169,780	$ 15,613	9.2%
Food and beverage	144,593	164,358	(19,765)	(12.0)%	100,950	93,659	7,291	7.8%
Other hotel operating revenue	51,064	55,580	(4,516)	(8.1)%	39,323	37,459	1,864	5.0%
	466,477	537,916	(71,439)	(13.3)%	325,666	300,898	24,768	8.2%
Lease revenue	24,233	27,638	(3,405)	(12.3)%	17,289	20,150	(2,861)	(14.2)%
Total revenues	490,710	565,554	(74,844)	(13.2)%	342,955	321,048	21,907	6.8%
Operating Costs and Expenses:								
Hotel operating expenses	361,341	414,789	(53,448)	(12.9)%	248,205	225,431	22,774	10.1%
Lease expense	6,446		6,446		4,492		4,492	
Depreciation and amortization	61,463	82,661	(21,198)	(25.6)%	39,084	38,801	283	0.7%
Impairment loss on goodwill and hotel property	12,675		12,675		12,675		12,675	
Corporate expenses	28,845	21,912	6,933	31.6%				
Total operating costs and expenses	470,770	519,362	(48,592)	(9.4)%	304,456	264,232	40,224	15.2%
Operating income	19,940	46,192	(26,252)	(56.8)%	$ 38,499	$ 56,816	$ (18,317)	(32.2)%
Interest expense, net	(63,308)	(104,748)	41,440	(39.6)%				
Loss on early extinguishment of debt	(21,934)	(13,761)	(8,173)	59.4%				
Other income (expenses), net	3,132	(7,581)	10,713	(141.3)%				
Loss before income taxes, minority interests and discontinued operations	(62,170)	(79,898)	17,728	(22.2)%				
Income tax (expense) benefit	(4,990)	552	(5,542)	(1,004.0)%				
Minority interests	4,831	(2,895)	7,726	(266.9)%				
Loss from continuing operations	(62,329)	(82,241)	19,912	(24.2)%				
Income from discontinued operations	75,662	26,047	49,615	190.5%				
Net Income (Loss)	$ 13,333	$ (56,194)	$ 69,527	(123.7)%				

Comparable REIT Asset Operating Income Reconciliation to Total Portfolio Operating Income								
Comparable REIT Asset operating income					$ 38,499	$ 56,816	$ (18,317)	(32.2)%
Corporate expenses					(28,845)	(21,912)	(6,933)	31.6%
Corporate depreciation and amortization					(191)	(289)	98	(33.9)%
Non-Comparable REIT Asset operating income					10,477	11,577	(1,100)	(9.5)%
Operating Income					$ 19,940	$ 46,192	$ (26,252)	(56.8)%
Operating Data(1):								
Number of hotels	14	19			12	12		
Number of rooms	5,820	8,733			5,282	5,282		
Comparable RevPAR	$ 125.52	$ 123.56	$ 1.96	1.6%	$ 114.17	$ 108.93	$ 5.24	4.8%

(1) Properties owned through joint ventures and sold properties are excluded from these numbers.

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In February 2003 we sold four hotels, in June 2003 we sold one hotel, and in February 2004 we sold one hotel. We did not acquire any hotels during 2003 but in August 2004 we acquired the Ritz-Carlton Half Moon Bay. The results of operations for the hotels we sold in 2003 and the Hyatt Regency Capitol Hill, which we held for sale as of December 31, 2003, are included in income from discontinued operations for the years ended December 31, 2004 and 2003. The comments below regarding revenues and operating expenses do not address the operating results of the hotels we sold during 2003 and 2004 that are included in income from discontinued operations. Based on the continued cash flow we generate from our asset management agreement with SHC LLC, the Distributed Properties are not reflected as discontinued operations in our operating results.

Operating Income. Operating income for the total portfolio decreased $26.3 million, or 56.8%, to $19.9 million for the year ended December 31, 2004, from $46.2 million for the year ended December 31, 2003. This decrease in operating income is due to the following events:

(a) a $7.0 million decrease attributable to an increase in corporate expenses;

(b) a $6.4 million decrease attributable to lease expense at the Hamburg Marriott and Paris Marriott, which were recorded as leases commencing June 29, 2004;

(c) a $13.7 million decrease attributable to the Comparable REIT Assets (excluding lease expense at the Paris Marriott);

(d) a $2.9 million decrease attributable to the Distributed Properties to SHC LLC that are reflected in the year ended December 31, 2003 amounts, but only from January 1, 2004 to June 29, 2004 for the year ended December 31, 2004;

(e) a $3.0 million increase (excluding lease expense at the Hamburg Marriott) attributable to the purchase of the remaining 65% of the Hamburg Marriott in February 2004. For the period from March 1, 2004 to December 31, 2004 this was recorded as lease revenue, which is reflected in operating income in the accompanying statements of operations, however for the period from January 1, 2004 to February 29, 2004 and for the year ended December 31, 2003, the Company s 35% interest in the hotel was recorded as earnings of joint venture and is reflected in other income (expenses), net in the accompanying statements of operations; and

(f) a $0.7 million increase attributable to the acquisition of Ritz-Carlton Half Moon Bay in August 2004.

On June 29, 2004, the Hyatt Regency New Orleans hotel was converted from an operating lease to a management contract. The results for the period from June 29, 2004 to December 31, 2004 are reflected in each line item of hotel operating revenues and expenses (excluding lease revenue) in the accompanying operating results. For the period from January 1, 2004 to June 29, 2004, and for the year ended December 31, 2003, the results are only reflected in lease revenue in the accompanying operating results. On June 29, 2004, our leasehold interest in the Paris Marriott was subleased to a third party operator. For the period from June 29, 2004 to December 31, 2004, the net results are reflected in lease revenue in the accompanying operating results. For the period from January 1, 2004 to June 29, 2004 and for the year ended December 31, 2003, the results are reflected in each line item of hotel operating revenues and expenses (excluding lease revenue) in the accompanying operating results. These events affect each line item comprising hotel operating revenues and expenses, but do not affect hotel operating income.

Due to the events mentioned above, we believe that an analysis of changes in each line item comprising total portfolio hotel operating income is not reflective of the operating results of the hotels. A more relevant approach is to analyze the changes of hotel operating income of the Comparable REIT Assets for the year ended December 31, 2004 and 2003, as described below.

Total Revenues. For the total portfolio, hotel operating revenues, including lease revenue, decreased $74.8 million or 13.2% to $490.7 million for the year ended December 31, 2004, from $565.6 million for the year ended December 31, 2003.

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For the Comparable REIT Assets, hotel operating revenues, including lease revenue, increased $21.9 million, or 6.8%, to $343.0 million for the year ended December 31, 2004, from $321.0 million for the year-ended December 31, 2003.

Rooms. For the total portfolio, room revenue decreased $47.2 million, or 14.8%, to $270.8 million for the year ended December 31, 2004, from $318.0 million for the year ended December 31, 2003. RevPAR from our total portfolio for the year ended December 31, 2004 increased by 1.6% from the year ended December 31, 2003. The components of RevPAR from our total portfolio for the years ended December 31, 2004 and 2003 are summarized as follows:

	Years Ended December 31,	
	2004	2003
Occupancy	70.5%	68.8%
Average daily rate	$ 178.00	$ 179.62
RevPAR	$ 125.52	$ 123.56

For the Comparable REIT Assets, room revenue increased $15.6 million, or 9.2%, to $185.4 million for the year ended December 31, 2004, from $169.8 million for the year ended December 31, 2003. The increase in room revenue is mainly due to increased occupancy for the period. ADR has also increased slightly for the year compared to the prior year, regaining ADR particularly in the last months of the year. While the industry is cautiously optimistic that additional ADR improvements are achievable, further ADR increases continue to be affected by several issues including local economic conditions, increased supply, a shorter booking cycle for group business, a more price-savvy consumer and the impact of electronic distribution channels. Corporate travel restrictions implemented in late 2001 and early 2002 continue to impact occupancy, however gains in rates have been negotiated and contracted.

RevPAR from our Comparable REIT Assets for the year ended December 31, 2004 increased by 4.8% from the year ended December 31, 2003. The components of RevPAR from our Comparable REIT Assets for the years ended December 31, 2004 and 2003 are summarized as follows:

	Years Ended December 31,	
	2004	2003
Occupancy	68.2%	66.2%
Average daily rate	$ 167.45	$ 164.58
RevPAR	$ 114.17	$ 108.93

The 4.8% increase in RevPAR for the Comparable REIT Assets resulted from a 2.0 percentage-point increase in occupancy and a 1.7% increase in the average daily rate. The increase in RevPAR seen in many of our major urban markets is a reflection of the gradually improving economic conditions in these markets this year and the severe impact the war in Iraq had on occupancy levels last year. Increases in RevPAR for the year include the Embassy Suites Lake Buena Vista with a 13.4% increase, the Loews Santa Monica Beach Hotel with a 17.0% increase, the Hyatt Regency Phoenix with a 6.9% increase and the Four Seasons Punta Mita with a 12.9% increase. These increases were partially offset by a 5.3% RevPAR decrease at the Hyatt Regency New Orleans.

Food and Beverage. For the total portfolio, food and beverage revenue decreased $19.8 million, or 12.0%, to $144.6 million for the year ended December 31, 2004, from $164.4 million for the year ended December 31, 2003.

For the Comparable REIT Assets, food and beverage revenue increased $7.3 million, or 7.8%, to $101.0 million for the year ended December 31, 2004, from $93.7 million for the year ended December 31, 2003. This increase is primarily driven by the increase in occupancy and aggressive marketing to the local social client, which has improved results for our local catering.

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Other Hotel Operating Revenue. For the total portfolio, other hotel operating revenue decreased $4.5 million, or 8.1% to $51.1 million for the year ended December 31, 2004, from $55.6 million for the year ended December 31, 2003.

For the Comparable REIT Assets, other hotel operating revenue increased $1.9 million, or 5.0% to $39.3 million for the year ended December 31, 2004, from $37.5 million for the year ended December 31, 2003. The increased occupancy led to increases in many of the other hotel operating revenue streams at the properties; however, these increases continued to be offset by the decline in telephone revenues, primarily caused by the increased use of cell phones. On a per occupied room basis, telephone revenues decreased 25.5% during 2004 compared to 2003.

Lease Revenue. For the total portfolio, lease revenue decreased $3.4 million, or 12.3% for the year ended December 31, 2004 as compared to the same period in 2003.

For the Comparable REIT Assets, lease revenue decreased $2.9 million, or 14.2% for the year ended December 31, 2004 as compared to the corresponding period of 2003. Lease revenue for the year ended December 31, 2004 includes lease revenue from the Paris Marriott, which began being recorded as a lease subsequent to June 29, 2004. Lease revenue for the year ended December 31, 2003 includes lease revenue from the Hyatt New Orleans hotel, which was converted to a management agreement in connection with the Offering.

Operating Costs and Expenses

Hotel Operating Expenses. The following table presents the components of our hotel operating expenses for the years ended December 31, 2004 and 2003, including the amount and percentage changes in these results between the two periods.

	Total Portfolio				Comparable REIT Assets			
	2004	2003	Change($)	Change(%)	2004	2003	Change($)	Change(%)
	(Dollars in thousands)							
Hotel operating expenses:								
Rooms	$ 67,761	$ 82,245	$ (14,484)	(17.6)%	$ 41,720	$ 36,936	$ 4,784	13.0%
Food and beverage	110,768	127,751	(16,983)	(13.3)%	74,833	69,430	5,403	7.8%
Other departmental expenses	135,323	148,595	(13,272)	(8.9)%	98,288	89,459	8,829	9.9%
Management fees	17,145	19,295	(2,150)	(11.1)%	13,679	13,651	28	0.2%
Other property level expenses	30,344	36,903	(6,559)	(17.8)%	19,685	15,955	3,730	23.4%
Total hotel operating expenses	$ 361,341	$ 414,789	$ (53,448)	(12.9)%	$ 248,205	$ 225,431	$ 22,774	10.1%

For the total portfolio, hotel operating expenses decreased $53.4 million, or 12.9% for the year ended December 31, 2004 as compared to the same period in 2003.

For the Comparable REIT Assets, hotel operating expenses increased $22.8 million, or 10.1% for the year ended December 31, 2004 as compared to the same period in 2003. This increase in hotel operating expenses is primarily related to the increase in salaries, wages and related benefits ($10.5 million), administration and general costs ($1.2 million), marketing costs ($1.3 million), travel commissions ($1.2 million), utilities ($1.6 million) and real estate taxes ($1.5 million).

Lease Expense. In connection with the Offering, we recorded a sale and leaseback of the Paris Marriott and Hamburg Marriott as of June 29, 2004 and now record lease expense on our statements of operations. In connection with these transactions, we also recorded a deferred gain.

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For the total portfolio, net lease expense of $6.4 million on the accompanying consolidated statement of operations for the year ended December 31, 2004 includes a realized portion of the deferred gain of $2.2 million. See note 3 Property and Equipment in the consolidated financial statements for more information.

For the Comparable REIT Assets, net lease expense of $4.5 million for year ended December 31, 2004 includes a realized portion of the deferred gain of $2.1 million related to the Paris Marriott and $0.1 million related to the Hamburg Marriott. See note 3 Property and Equipment in the consolidated financial statements for more information.

Depreciation and Amortization. For the total portfolio, depreciation and amortization decreased $21.2 million, or 25.6%, for the year ended December 31, 2004 as compared to the same period in 2003.

For the Comparable REIT Assets, depreciation and amortization increased $0.3 million, or 0.7%, for the year ended December 31, 2004 as compared to the same period in 2003.

Impairment Loss on Goodwill and Hotel Property. During the fourth quarter of the year ended December 31, 2004 we recorded an impairment loss of $12.7 million on the Schaumburg Marriott due to deteriorating performance and local market conditions.

Corporate Expenses increased by $6.9 million to $28.8 million for the year ended December 31, 2004 from $21.9 million for the same period in 2003. These expenses consist primarily of payroll and related costs, unit appreciation rights and restricted stock unit plan expense, professional fees, travel expenses and office rent. The increase of $6.9 million is primarily attributable to:

- a $2.4 million increase in severance expense;
- a $4.2 million increase in compensation expense related to restricted stock units issued;
- a $2.3 million increase in professional fees due to additional legal, consulting, tax and public relations fees related to operating as a public company;
- a $0.3 million increase in recruiting and relocation fees; and
- a $0.3 million increase in terminated acquisition costs; offset by
- a $1.2 million decrease in unit appreciation rights plan expense; and
- a $1.8 million decrease as a result of our settled litigation with Marriott.

Interest Expense, Net. The $41.4 million decrease in interest expense, net for the year ended December 31, 2004 as compared to the year ended 2003 was due to:

- a $31.3 million decrease attributable to lower average borrowings;
- a $7.5 million decrease due to lower average rates;
- a $2.2 million decrease in amortization of deferred financing costs; and
- a $2.0 million decrease applicable to incremental interest costs associated with the repayment of our 1999 and 2001 commercial mortgage-backed securities loans as well as certain mezzanine and mortgage debt; offset by
- a $0.2 million increase related to the mark-to-market of derivative instruments; and
- a $1.4 million increase in interest income.

The components of Interest expense, net for the year ended December 31, 2004 are summarized as follows:

- mortgage debt ($54.0 million);
- bank credit facility ($1.3 million);
- convertible debt ($4.0 million);
- amortization of deferred financing costs ($4.4 million);

- other debt ($0.5 million);
- mark-to-market of derivative instruments ($0.4 million) offset by
- interest income ($1.3 million).

Including convertible debt in 2003, the weighted average debt outstanding for the years ended December 31, 2004 and 2003 amounted to $1.1 billion and $1.6 billion, respectively, and the weighted average interest rates were 5.59% and 5.95%. At December 31, 2004, 44.2% of our total debt had variable interest rates and 55.8% had fixed interest rates.

Loss on Early Extinguishment of Debt. On June 29, 2004, we repaid the floating rate commercial mortgage-backed securities (CMBS 2003) using a portion of proceeds from the Offering and the 2004 mortgage loan financings as described in note 7 to the consolidated financial statements, and wrote off the unamortized deferred financing costs applicable to issuing this debt. This write-off, which amounted to $22.9 million, has been reported as Loss on early extinguishment of debt in the consolidated statement of operations for the year ended December 31, 2004.

On June 29, 2004, the U.S. dollar denominated mortgage debt secured by one domestic hotel (fixed rate loan) and our two Mexican hotels (variable rate loans) were repaid with proceeds of the financing described in note 7 to the consolidated financial statements, and we wrote off the unamortized deferred financing costs applicable to issuing these loans. This write-off, which amounted to $1.2 million, has been reported as Loss on early extinguishment of debt in the consolidated statement of operations for the year ended December 31, 2004.

On January 30, 2004, we repaid an outstanding note and accrued interest payable to the City of Burbank for $6.0 million by using cash reserves held by the CMBS 2003 loan trustee. The CMBS 2003 financing required us to fund cash reserves applicable to the loan and accrued interest payable to the City of Burbank. In connection with the payoff of the Burbank loan on January 30, 2004, the CMBS 2003 loan trustee returned the excess cash reserves in the amount of $3.7 million to us. We recognized a gain of $2.2 million on the retirement of this debt that has been reported as a reduction of Loss on early extinguishment of debt in the consolidated statement of operations for the year ended December 31, 2004.

On January 29, 2003, we cancelled our bank credit facility and retired the 1999 and 2001 commercial mortgage-backed securities loans as well as certain mezzanine and mortgage debt as described in note 7 to the consolidated financial statements. In connection with these transactions, we wrote off the unamortized deferred financing costs applicable to issuing this debt. This write-off, which amounted to $12.6 million, was reported as Loss on early extinguishment of debt ($11.5 million) and was included in Income from discontinued operations ($1.1 million), in our consolidated statement of operations for the year ended December 31, 2003.

In connection with the Paris Marriott sale described in note 3 to the consolidated financial statements, we retired the mortgage debt applicable to the Paris Marriott and wrote off unamortized deferred financing costs of $2.2 million. This write off is included in Loss on early extinguishment of debt in the consolidated statement of operations for the year ended December 31, 2003.

Other Income (Expenses), Net. Other income (expenses), net includes our pro rata share of earnings or losses of hotel joint ventures, asset management fees, Mexican asset tax, foreign exchange realized gains and losses, the change in value of our foreign currency forward exchange

contracts prior to their distribution, as well as other miscellaneous income and expenses. Other income (expenses), net amounted to $3.1 million of income for the year ended December 31, 2004 and $7.6 million of expense for the year ended December 31, 2003. The net change of $10.7 million is primarily attributable to the following factors:

We had two foreign currency forward exchange contracts with a combined notional amount of 1.62 billion Czech Koruna ($50.0 million) that were designated as hedges of our net investment in the Prague hotel joint venture. A portion of these contracts was deemed ineffective and, as such, does not qualify

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for hedge accounting. Accordingly, changes in the value of these forward exchange contracts are recorded in accumulated other comprehensive income (loss) (to the extent deemed effective) and to other income (expenses), net (to the extent deemed ineffective). When marking these contracts to market we recorded a charge to other income (expenses), net of $2.7 million and $6.5 million for the years ended December 31, 2004 and 2003, respectively. All of our forward currency contracts were distributed to SHC LLC on June 29, 2004 and as of December 31, 2004 we did not have any forward currency contracts.

During the years ended December 31, 2004 and 2003, we recorded $0.7 million of net income and $0.5 million of net loss, respectively, in our equity in earnings of joint ventures. The net change of $1.2 million is due to equity in loss of the Prague joint venture of $2.2 million primarily due to the settlement of a swap agreement in 2003 resulting in additional expense of $2.4 million and equity in earnings of the Hamburg joint venture of $1.0 million attributable to the purchase of the remaining 65% of the Hamburg Marriott in February 2004.

During the year ended December 31, 2004, we received a Mexican asset tax net refund of $2.4 million as a result of a retrospective recalculation of the asset tax.

We have an asset management agreement with SHC LLC that commenced on June 29, 2004, under which we manage the day-to-day business of SHC LLC for an annual fee of $5.0 million. During the year ended December 31, 2004, we recognized $2.5 million of income related to this agreement.

Income Tax Expenses. Prior to the Offering, we were not subject to U.S. federal and certain state income taxes, which were the responsibility of the members of our accounting predecessor. We were subject to certain state income and franchise taxes and foreign income taxes payable by our foreign subsidiaries. We were required to make tax distributions to our members and holders of certain convertible limited partnership interests. These tax distributions were equal to each member s or holder s allocable share of our taxable income times the highest U.S. federal and state income tax rate applicable to any member.

We intend to make an election to qualify, beginning in our 2004 tax year, as a REIT under Sections 856 through 860 of the Internal Revenue Code. As a REIT, we generally will not be subject to U.S. federal income tax if we meet the REIT requirements of the code. If we fail to qualify as a REIT in any taxable year, we will be subject to U.S. federal income tax (including any applicable alternative minimum tax) on our taxable income at regular corporate tax rates. Even if we qualify for taxation as a REIT, we may be subject to state and local income taxes and to U.S. federal income tax and excise tax on our undistributed income. In addition, taxable income from our taxable REIT subsidiaries is subject to U.S. federal, state and local income taxes. Also, the foreign countries where we have operations do not necessarily recognize REITs under their respective tax law. Accordingly, we recognize income taxes for these jurisdictions in accordance with GAAP, as necessary.

For the years ended December 31, 2004 and 2003, income tax (expense) benefit is summarized as follows:

	Years Ended December 31,	
	2004	2003
	(in thousands)	
Current expense	$ (2,244)	$ (31,686)
Deferred (expense) benefit	(2,746)	32,238
Income tax (expense) benefit	$ (4,990)	$ 552

Income taxes changed by $5.5 million for the year ended December 31, 2004 as compared to the same period in 2003. This change is primarily due to net tax benefits as a result of the July 2003 sale of the Paris Marriott, and deferred tax expense as a result of the Mexican asset tax refund received in 2004.

Minority Interests. Prior to the Offering, we acquired certain hotels through the formation of limited partnerships and a limited liability company that we control, but which have minority equity owners. Operating profits allocated to the minority owners of the limited partnership and limited liability company units are

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recorded as minority interests. Subsequent to the Offering, we record minority interest income or expense based on the percentage of SHC Funding we do not own. Minority interests changed by $7.7 million to $4.8 million of income for the year ended December 31, 2004 from $2.9 million of expense for the year ended December 31, 2003.

Income from Discontinued Operations. As described under Recent Trends and Events Sales of Hotels , we sold one hotel in the first quarter of 2004, four hotels during the first quarter of 2003 and one hotel in the second quarter of 2003 and, consistent with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , reclassified the results of operations for these six hotels as discontinued operations for the years ended December 31, 2004 and 2003. Income from discontinued operations amounted to $75.7 million and $26.0 million for the year ended December 31, 2004 and 2003, respectively. The net increase of $49.7 million is primarily attributable to the gain on sale for the hotel sold in the year ended December 31, 2004, where we recorded a gain of $76.0 million as compared to the gain on five hotels sold in the year ended December 31, 2003 of $21.1 million.

Comparison of Year Ended December 31, 2003 to Year Ended December 31, 2002

The following table presents our operating results for the years ended December 31, 2003 and 2002, including the amount and percentage changes in these results between the two periods.

	2003	2002	Change($)	Change(%)
	(Dollars in thousands, except operating data)			
Revenues:				
Rooms	$ 317,978	$ 329,322	$ (11,344)	(3.4)%
Food and beverage	164,358	167,691	(3,333)	(2.0)%
Other hotel operating revenue	55,580	58,738	(3,158)	(5.4)%
	537,916	555,751	(17,835)	(3.2)%
Lease revenue	27,638	35,134	(7,496)	(21.3)%
Total revenues	$ 565,554	$ 590,885	$ (25,331)	(4.3)%
Operating Costs and Expenses:				
Hotel operating expenses	414,789	412,081	2,708	0.7%
Depreciation and amortization	82,661	104,302	(21,641)	(20.7)%
Impairment losses on goodwill		5,435	(5,435)	
Corporate expenses	21,912	15,854	6,058	38.2%
Total operating costs and expenses	519,362	537,672	(18,310)	(3.4)%
Operating income	46,192	53,213	(7,021)	(13.2)%
Interest expense, net	(104,748)	(98,146)	(6,602)	6.7%
Loss on early extinguishment of debt	(13,761)		(13,761)	
Other (expenses) income, net	(7,581)	875	(8,456)	(966.4)%
Loss before income taxes, minority interests and discontinued operations	(79,898)	(44,058)	(35,840)	81.3%
Income tax benefit (expense)	552	(3,215)	3,767	(117.2)%
Minority interests	(2,895)	(10,264)	7,369	(71.8)%

Loss from continuing operations	(82,241)	(57,537)	(24,704)	42.9%
Income from discontinued operations	26,047	7,234	18,813	260.1%
Net Loss	$ (56,194)	$ (50,303)	$ (5,891)	11.7%
Operating Data(1):				
Number of hotels	19	19		
Number of rooms	8,733	8,733		
Comparable RevPAR	$ 123.56	$ 127.49	$ (3.93)	(3.1)%

(1) Properties owned through joint ventures and sold properties are excluded from these numbers.

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In February 2003, we sold four hotels and in June 2003, we sold one hotel. We did not acquire any hotels during 2003 and we did not acquire or sell any properties during 2002. Additionally, in February 2004, we sold one hotel. The results of operations for the hotels we sold in 2003 and the Hyatt Regency Capitol Hill, which we held for sale as of December 31, 2003 are included in income from discontinued operations for each of the years ended December 31, 2003 and 2002. The comments below regarding revenues and operating expenses pertain to our comparable portfolio and do not address the operating results of the hotels we sold during 2003 and 2004 that are included in income from discontinued operations.

Total Revenues. Hotel operating revenues, including lease revenue, decreased $25.3 million, or 4.3%, to $565.6 million for 2003 from $590.9 million for 2002.

Rooms. We, and the industry in general, continued to have difficulty maintaining room rates in 2003, and this accounted for the 3.4% decline in rooms revenue for 2003 compared to 2002. The ability to drive increases in rates at the properties has been affected by several issues including: economic conditions, increased supply, a shorter booking cycle for group business, a more price-savvy consumer and the impact of the electronic distribution channels available via the Internet. Corporate travel restrictions implemented in late 2001 and early 2002 have impacted the rate for high-end business travelers, which traditionally have been a consistent producer of business for the hospitality industry. Group business continued to be a challenge in the fourth quarter of 2003, as corporations remained focused on cutting costs and groups shopped around for room rates and other concessions they could negotiate.

RevPAR from our comparable hotels for 2003 decreased by 3.1% from RevPAR for 2002. RevPAR is the product of average occupancy expressed as a percent times the average daily room rate. The components of RevPAR from our comparable hotels for 2003 and 2002 are summarized as follows:

	Years Ended December 31,	
	2003	**2002**
Occupancy	68.8%	68.8%
Average daily rate	$ 179.62	$ 185.31
RevPAR	$ 123.56	$ 127.49

The 3.1% drop in RevPAR results from a 3.1% decrease in average daily rate. On a regional basis, our New York City hotels experienced a RevPAR decline (6.1%). Soft economic conditions and ongoing terrorism concerns had a significant impact on the New York City market. The Southern California and Northern California hotels fared somewhat better as they reported RevPAR decreases of 1.8% and 5.4%, respectively. RevPAR for the REIT assets decreased by 1.5% from $110.61 for 2002 to $108.93 for 2003. This decrease resulted from a 1.7% decrease in average daily rate offset by a 0.2 percentage-point increase in occupancy. Driven by increased occupancy rates, the two Mexico hotels experienced combined increases in RevPAR of 3.8%. The other REIT assets reported RevPAR decreases, with the largest decreases applicable to the California and Phoenix hotels while the Chicago and New Orleans hotels reported negligible declines.

Food and Beverage. The substantial downsize of the banquet programs and changes in group booking patterns impacted banquet revenues. This is the major contributor to the 2.0% decline in food and beverage revenue. Groups are generally spending less on food and beverage and on ancillary services, such as telephone and audiovisual. In many cases, this trend applies to the individual traveler as well.

Other Hotel Operating Revenue. As with food and beverage purchases, both the group and transient traveler spent less on entertainment, audio visual and telephone services during their hotel stays during 2003, which substantially contributed to the 5.4% decline in other hotel operating revenues. Telephone revenue has seen a significant drop with the ever-increasing use of the cell phone, declining from $12.8 million for 2002 to $11.0 million for 2003.

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Lease Revenue. Lease revenue, as described above, consists of rent paid to us for the Hyatt Regency New Orleans and the Hyatt Regency San Francisco in an amount approximately equal to 80% of hotel revenues less hotel operating expenses, or operating profit, for those hotels. Lease revenue declined 21.3% for 2003 as compared to 2002 in line with lower hotel revenues (primarily the Hyatt Regency San Francisco) which were not fully offset by a corresponding decline in operating expenses at these two hotels.

Operating Costs and Expenses

Hotel Operating Expenses. The following table presents the components of our hotel operating expenses for 2003 and 2002, including the amount and percentage changes in these results between the two periods.

	2003	2002	Change($)	Change(%)
	(Dollars in thousands)			
Hotel operating expenses:				
Rooms	$ 82,245	$ 81,950	$ 295	0.4%
Food and beverage	127,751	128,167	(416)	(0.3)
Other departmental expenses	148,595	147,506	1,089	0.7
Management fees	19,295	19,481	(186)	(1.0)
Other property level expenses	36,903	34,977	1,926	5.5
Total hotel operating expenses	$ 414,789	$ 412,081	$ 2,708	0.7%

Several factors, including increases in wages, employee benefits (especially workers compensation and health insurance) and utility costs, as well as increases applicable to property, casualty and terrorism insurance, led to the $2.7 million, or 0.7%, increase in hotel operating expenses for 2003 compared to 2002. Our property and casualty insurance policy year begins July 1, and effective July 1, 2002, these insurance premiums increased significantly, giving rise to a $2.6 million increase in insurance expense in 2003 as compared with 2002. In addition, our utility costs for 2003 were $1.1 million more than in 2002. These increases were partially offset by decreases in property taxes ($0.3 million), marketing costs ($0.5 million) and management fees ($1.0 million) during 2003 as compared to 2002.

Depreciation and Amortization. decreased by $21.6 million, or 20.7%, for 2003 compared to 2002. Some of our assets, including furniture, fixtures and equipment and building improvements, are depreciated over five years, and a portion of these assets became fully depreciated during 2002 and 2003.

Corporate Expenses increased by $6.1 million to $21.9 million for 2003 compared to 2002. These expenses consist primarily of payroll and related costs, unit appreciation rights plan expense, professional fees, travel expenses and office rent. The increase of $6.1 million is primarily attributable to unit appreciation rights plan expense ($1.1 million more in 2003 as compared to 2002) and legal fees ($5.0 million more in 2003 as compared to 2002). Our legal fees increased primarily as a result of our litigation with Marriott.

Interest Expense, Net. The $6.6 million increase in interest expense, net was due to:

- a $16.7 million increase attributable to higher blended spreads on CMBS and mezzanine debt;
- a $3.3 million increase due to the termination of an interest rate swap agreement; and
- a $0.3 million decrease in interest income.

Partly offsetting the increases in interest expense, net were:

- a $10.9 million decrease due to lower average borrowings;
- a $2.7 million decrease in amortization of deferred financing costs; and
- a $0.1 million decrease related to the mark-to-market of derivative instruments.

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The components of Interest expense, net for 2003 are summarized as follows:

- mortgage debt ($82.8 million);
- interest rate swap termination fee ($3.3 million);
- convertible debt ($14.6 million);
- amortization of financing costs ($6.6 million); offset by
- interest income ($2.6 million).

Including convertible debt, the weighted average debt outstanding for 2003 and 2002 amounted to $1.63 billion and $1.81 billion, respectively, and the weighted average interest rates, including the effect of an interest rate swap, were 5.95% and 5.03%. The weighted average interest rate for 2003 excludes the effect of the $3.3 million swap termination fee mentioned above. At December 31, 2003, 89.2% of our mortgage debt had variable interest rates and 10.8% had fixed interest rates.

Loss on Early Extinguishment of Debt. On January 29, 2003, we cancelled our bank credit facility and retired the 1999 and 2001 commercial mortgage-backed securities loans as well as certain mezzanine and mortgage debt. In connection with these transactions, we wrote off the unamortized deferred financing costs applicable to issuing this debt. This write-off, which amounted to $12.6 million, was reported as Loss on early extinguishment of debt ($11.5 million) and included in Income from discontinued operations ($1.1 million) in our consolidated statement of operations for 2003. In addition, in connection with the Paris Marriott transaction described under Recent Trends and Events Sales of Hotels above, we retired the mortgage debt applicable to the Paris Marriott and wrote off unamortized deferred financing costs of $2.2 million. This write-off is also included in Loss on early extinguishment of debt.

Other (Expenses) Income, Net. Other (expenses) income, net includes our pro rata share of earnings or losses of hotel joint ventures, asset management fees, Mexican asset tax, foreign exchange realized gains and losses, the change in value applicable to the ineffective portion of our foreign currency forward exchange contracts, as well as other miscellaneous income and expenses. Other (expenses) income, net amounted to $(7.6 million) for 2003 and $0.9 million for 2002. The net expense increase of $8.5 million is primarily attributable to the following two factors:

- In conjunction with refinancing its mortgage debt in July 2003, the Prague Hotel joint venture incurred $6.9 million in costs applicable to terminating an interest rate swap and wrote off unamortized deferred financing costs. Our 35% pro rata share of these joint-venture costs was charged to Other (expenses) income, net; and