

STRATEGIC HOTELS & RESORTS, INC  
Form 10-K  
February 29, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2007

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 HOTELS & RESORTS, INC.**

(Exact name of registrant as specified in its charter)

Maryland

33-1082757

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(State of Incorporation)  
**200 West Madison Street, Suite 1700, Chicago, Illinois**  
(Address of Principal executive offices)

(I.R.S. Employer Identification No.)  
**60606-3415**  
(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
8.50% Series A Cumulative Preferred Stock (\$0.01 par value)	New York Stock Exchange
8.25% Series B Cumulative Preferred Stock (\$0.01 par value)	New York Stock Exchange
8.25% Series C Cumulative Preferred Stock (\$0.01 par value)	New York Stock Exchange

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

**None**

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer  Accelerated filer  Non-accelerated filer .

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

The aggregate market value of the common stock of the registrant held by nonaffiliates of the registrant was approximately \$1.7 billion as of June 30, 2007.

The number of shares of Common Stock (\$0.01 par value) of the registrant outstanding as of February 27, 2008 was 74,406,705

## 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 22, 2008.



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<b>WHERE TO FIND MORE INFORMATION:</b>	

We maintain a website at <http://www.strategichotels.com>. Through our website, we make available, free of charge, our annual proxy statement, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission (SEC). The SEC maintains a website that contains these reports at <http://www.sec.gov>.

This report contains registered trademarks that are the exclusive property of their respective owners, which are companies other than us, including Embassy Suites®, Fairmont®, Four Seasons®, Hilton®, Hyatt®, InterContinental®, Loews®, Marriott®, Ritz-Carlton®, and Westin®. 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, other financial information or other information contained in this report.

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**DISCLOSURE REGARDING FORWARD LOOKING STATEMENTS**

On one or more occasions, we may make statements regarding our assumptions, projections, expectations, targets, intentions or beliefs about future events. All statements other than statements of historical facts included or incorporated by reference in this 10-K are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act).

Words or phrases such as anticipates, believes, estimates, expects, intends, may, plans, potential, predicts, projects, should, continue, will likely result or other comparable expressions or the negative of these terms identify forward-looking statements. Forward-looking statements reflect our current views about future events and are subject to risks, uncertainties, assumptions and changes in circumstances that may cause actual results or outcomes to differ materially from those expressed in any forward-looking statement. We caution that while we make such statements in good faith and we believe such statements are based on reasonable assumptions, including without limitation, management's examination of historical operating trends, data contained in records and other data available from third parties, we cannot assure you that our projections will be achieved.

Our actual results may differ significantly from any results expressed or implied by these forward-looking statements. Some, but not all, of the factors that might cause such a difference include, but are not limited to:

the factors discussed in this report set forth in Item 1A under the section titled Risk Factors ;

availability of capital;

our failure to maintain effective internal control over financial reporting and disclosure controls and procedures;

risks related to natural disasters;

increases in interest rates and operating costs;

difficulties in identifying properties to acquire and completing acquisitions;

our ability to obtain or refinance debt;

the failure of closing conditions or contingencies in our agreements to be satisfied;

rising insurance premiums;

delays and cost-overruns in construction and development;

marketing challenges associated with entering new lines of business or pursuing new business strategies;

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our ability to dispose of existing properties in a manner consistent with our investment strategy;

downturns in economic and market conditions, particularly levels of spending in the travel and leisure industries in the markets where we invest;

general volatility of the capital markets and the market price of our common shares;

our failure to maintain our status as a REIT;

increases in real property tax rates;

changes in the competitive environment in our industry and the markets where we invest;

changes in real estate and zoning laws or regulations;

legislative or regulatory changes, including changes to laws governing the taxation of REITS;

changes in generally accepted accounting principles, policies and guidelines; and

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hostilities, including future terrorist attacks, or the apprehension of hostilities, in each case that affect travel within or to the United States, Mexico, Czech Republic, Germany, France, England or other countries where we invest.

Any forward-looking statement speaks only as of the date on which such statement is made. New factors emerge from time to time and it is not possible for management to predict all such factors. 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 annual report on Form 10-K to reflect new information, future events or otherwise, except as required by law. Readers are urged to carefully review and consider the various disclosures made in this annual report on Form 10-K and in our other documents filed with the SEC that attempt to advise interested parties of the risks and other factors that may affect our business, prospects and results of operations and financial condition.

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**PART I**

**ITEM 1. BUSINESS.**

**Overview**

Strategic Hotels & Resorts, Inc. (SHR) was incorporated in Maryland in January 2004 to own and asset manage upper upscale and luxury hotels that are subject to long-term management contracts. The terms upper upscale and luxury are classifications of hotels by brand that are defined by Smith Travel Research, an independent provider of lodging industry statistical data. We went public in an initial public offering in June 2004. Our accounting predecessor, Strategic Hotel Capital, L.L.C. (SHC LLC) was founded in 1997 by Laurence Geller, our President and Chief Executive Officer, Goldman, Sachs & Co.'s Whitehall Fund and others. We own our properties through our investment in Strategic Hotel Funding, L.L.C., our operating partnership, which we refer to herein as SH Funding, and its subsidiaries.

We operate as a self-administered and self-managed real estate investment trust (REIT) managed by our board of directors and executive officers and conduct our operations through our direct and indirect subsidiaries including SH Funding. We are the managing member of SH Funding and hold approximately 99% of its membership units as of February 28, 2008.

As of February 28, 2008, we:

wholly own or lease 17 hotels, own a 51% interest in affiliates that own two hotels where we asset manage such hotels and own a 45% interest in and act as asset manager for a joint venture that owns one hotel;

own land held for development, including the La Solana project adjacent to our Four Seasons Punta Mita Resort, which includes a 20.5-acre site for the development of hotel suites and a 27.0-acre site for the development of for-sale villas, a separate 60.0-acre oceanfront land parcel near the Four Seasons Punta Mita Resort and a 10.0-acre parcel adjacent to the Fairmont Scottsdale Princess; and

own a 31% interest in and act as asset manager for a joint venture with two unaffiliated parties that is developing the Four Seasons Residence Club Punta Mita, a luxury vacation home product that is being sold in fractional ownership interests on property adjacent to our Four Seasons Punta Mita Resort hotel in Mexico.

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 Fairmont®, Four Seasons®, Hyatt®, InterContinental®, Loews®, Marriott®, Ritz-Carlton® and Westin®. The Hotel del Coronado is operated by a specialty management company, KSL Resorts.

We seek to maximize asset values and operating results through asset management. Although we have no imperative to grow, we will opportunistically seek to acquire additional properties that meet our disciplined investment criteria.

As used in this report, references to we, our, us, and SHR are to Strategic Hotels & Resorts, Inc. and, except as the context otherwise requires, its consolidated subsidiaries.

**Business Strategy**

We are a preeminent owner of upper upscale and luxury branded hotels located primarily in the United States with select international hotels. We believe our future growth will be driven by the execution of our life cycle-based investment strategy. This strategy involves the acquisition of hotels with strong underlying real estate values, adding value through the application of management's superior asset management skills, identifying redevelopment opportunities to enhance cash flow and value, and disposing of hotels upon completion of our value enhancement and cash flow generating strategies.





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### Acquisition Strategy

As a result of our ongoing research, the selection of target markets and individual property targets is updated continuously to foster a proactive acquisition strategy. We believe this acquisition strategy permits us to make disciplined investment decisions quickly and efficiently. Members of our management team have the skills and experience to acquire and asset manage hotels both domestically and internationally, which places us in a unique position among lodging REITs. Our acquisition strategy incorporates the following elements, each of which is supported by continuous research and disciplined investment evaluation processes:

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.

Target hotels with management contracts with operators which we believe will be receptive to our asset management and redevelopment initiatives, or hotels with respect to which we can enter into value-enhancing management contracts.

Acquire properties that present redevelopment opportunities in which we can invest capital to create additional cash flow potential with relatively high returns.

Selected international opportunities. Members of our management team have the skills and experience to acquire and asset manage international hotels, which have permitted us to diversify our portfolio and take advantage of select international hotel investment opportunities.

Develop hotel condominiums, fractional ownership interests and other residential properties at certain of our properties where we believe these types of developments may create value. The goals of this residential conversion strategy include improving the return on an existing asset, liquidating an asset at a premium that would permit reinvestment into additional hospitality assets, and/or providing a mixed use opportunity that would be complementary to, and therefore increasing the revenue potential of, an investment.

Enter into joint ventures, allowing us to experience growth through the expansion of our portfolio, increase fee-based income, enhance the return on our real estate through fee and incentive income and foster closer relationships with the hotel management companies that operate our hotels. Entering into joint ventures also allows us to 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.

### Asset Management Strategy

We believe that we can enhance our cash flow and earnings growth through expert asset management, which will ultimately generate increased operating margins and higher investment returns. Our value-added asset management strategy has the following general components:

Working in partnership with the hotel management companies that operate our hotels, we build an asset management approach to enhance the cash flow and value of our properties. We have multi-property relationships with a select group of hotel management companies that in our opinion have strong brand recognition, superior marketing capabilities, management depth and an ability to work with our team to create efficient operations. We improve hotel operating performance through the application of value-added programs involving consumer and market research, competitive benchmarking, technology upgrades and systems development and upgrades.

We provide rigorous oversight of the properties and the hotel management companies that operate them to ensure the alignment of the hotel management companies and our interests and to monitor the hotel management companies and our compliance with the

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management contracts relating to our properties. Typically, this oversight provides sustained increases in operating margins and enhances property values. Our growth strategies are incentives for hotel management companies to seek additional revenue opportunities and, in turn, provide us with opportunities to revisit our contractual relationships with hotel management companies in order to reduce costs and increase flexibility.

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### Redevelopment Strategy

Our asset management team is integral to the planning of capital expenditures at each of our hotels, including both routine maintenance expenditures and more extensive capital improvements. Such capital expenditures are undertaken to improve the quality of our properties and ultimately enhance revenues.

Underpinning our redevelopment strategy is a consumer research driven, creative and forward looking master plan for each hotel in our portfolio designed to provide near-term earnings growth potential beyond mere cyclical growth. Many of our hotel master plans include capital expenditures designed to increase food and beverage and other non-rooms revenue to drive growth in total revenue per available room, or Total RevPAR, and bottom line metrics.

Typically, the application of our redevelopment strategy leads to increased, risk-adjusted returns and can result in meaningful improvements in cash flow and hotel value.

### Disposition Strategy

We recycle capital for future investments through opportunistic dispositions. We are likely to dispose of all or part of our investment in a property in circumstances where we believe our asset management strategy 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.

Proceeds from dispositions would generally be intended to be reinvested in redevelopment activities in our existing portfolio or the acquisition of additional hotel properties where the application of our life cycle-based investment strategy can begin again.

## **Competition**

The hotel industry is highly competitive and the hotels in which we invest 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, 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. Increased competition could have a material adverse effect on the occupancy rate, average daily room 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.

Because our hotels operate in the upper upscale and luxury 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 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 their properties to us.

## **Employees**

As of February 28, 2007, we had 62 full-time and 4 part-time corporate employees. We believe that our relations with our employees are good. None of our corporate employees are unionized.



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### **Environmental**

Environmental consultants retained by us or our lenders conducted Phase I environmental site assessments in 2006 on many of our properties. These Phase I assessments often relied on older environmental assessments prepared in connection with a prior financing or acquisition. 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 that have been conducted with respect to certain of our properties 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 that we believe would have a material adverse effect on our business, financial position, results of operations or cash flows. See Item 1A. 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 Item 1A. Risk Factors 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 Item 1A. Risk Factors, including, among others, the factors described under Uninsured and underinsured losses could adversely affect our financial condition and results of operations, which may affect our ability to make distributions to our stockholders, and the following. We are responsible for arranging the insurance for most of our hotels, although in certain cases, the hotel management companies that operate our hotels assume responsibility for arranging insurance under the relevant management 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 certain 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.

In August 2005, Hurricane Katrina caused substantial damage to our Hyatt Regency New Orleans property. The hurricane damage also caused significant interruption to the hotel's business and the hotel effectively ceased operations. On August 1, 2007, we entered into a complete and final settlement with our insurer for the property with respect to property damage and business interruption insurance claims relating thereto. On December 28, 2007, we sold the Hyatt Regency New Orleans property.

### **REIT Structure**

The provisions of the REIT Modernization Act of 1999, as amended (the RMA), allow REITs, subject to certain limitations, to own, directly or indirectly, up to 100% of the stock of a taxable REIT subsidiary (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. 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 RMA 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.

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### **Ownership of Hotels**

Where we have an ownership interest in a hotel, the entity through which we hold such ownership interest (a Strategic Ownership Entity) will generally lease the hotel to one of our TRSs and the TRS will enter into a management agreement with an independent third party for such party to operate the hotel. A lease between a Strategic Ownership Entity and one of our TRSs (an Affiliate Lease) provides for the TRS to pay to the Strategic Ownership Entity a base rent plus a percentage rent (as more fully described below). An Affiliate Lease must contain economic terms which are similar to a lease between unrelated parties or, pursuant to the RMA, the Strategic Ownership Entity may have to pay a 100% penalty tax on some of the payments it receives from our TRS under such Affiliate Lease.

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

During the term of each Affiliate Lease, other than the lease with respect to the InterContinental Prague, our TRS is obligated to pay a fixed annual base rent and a percentage rent to the applicable Strategic Ownership Entity. With respect to the InterContinental Prague, there is an existing lease agreement between the applicable Strategic Ownership Entity and a tenant that has prepaid the rent which is being amortized on a straight-line basis over 15 years. Percentage rent is calculated by multiplying fixed percentages by gross room revenues and other revenues, subject to certain adjustments. Percentage rent is paid quarterly, except with respect to the Paris Marriott Champs Elysees where percentage rent is paid monthly. Base rent accrues and is paid monthly. Base rents and percentage rents are adjusted annually for changes in the consumer price index or similar indices.

Fixed charges, including real estate and personal property taxes, capital expenditures and a reserve for capital expenditures are obligations of the lessor under our Affiliate Lease. Our TRSs are required to pay rent, all costs and expenses and all utility and other charges incurred in the operation of the hotels we own. The party responsible for maintaining insurance on a property is dependent on the specific lease.

### **Third Party Lease Agreements**

We are the tenant under leases with third-party landlords for the Paris Marriott Champs Elysees and the Marriott Hamburg. We are also the tenant under ground leases with third-party landlords where we lease the land for the Marriott Lincolnshire, the Marriott London Grosvenor Square and a parcel of land that is part of the Fairmont Scottsdale Princess hotel property. The terms of these third party leases, including renewal options, range from 46 to 78 years. These third party lease agreements require us to make annual rental payments comprised of a minimum rental amount (subject to indexation) and may also include 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.

### **Hotel Management Agreements**

Most of our hotels are managed and operated by third parties pursuant to management agreements entered into between our TRSs and hotel management companies. These management agreements generally provide for the payment of base management fees between 1.25% to 4.00% of revenues, as defined in the applicable agreements. In addition, an incentive fee may be paid if certain criteria are met. Certain of the management agreements also provide for the payment by us of advisory fees or license fees. The remaining terms (not including renewal options) of these management agreements range from two to 50 years. A management agreement with one of our operators typically has the terms described below.

***Operational services.*** The manager has exclusive authority to supervise, direct and control the day-to-day operation and management of the hotel, including establishing all room rates, processing reservations, procuring inventories, supplies and services, and preparing public relations, publicity and marketing plans for the hotel. The manager receives compensation in the form of a base management

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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 we have received a certain level of income.

***Executive supervision and management services.*** The manager supervises all managerial and other employees for the hotel, reviews the operation and maintenance of the hotel, prepares reports, budgets and projections and provides 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.*** Our management agreements require the managers to furnish chain services that are generally made available to other hotels managed by such operators. 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.*** Our management agreements typically require us to maintain working capital for a 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 if at any time the funds available from hotel operations are insufficient to meet the financial requirements of the hotel.

***Furniture, fixtures and equipment replacements.*** Our 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 therefore, subject to our review and approval. In addition, we are required to provide to the manager all necessary furniture, fixtures and equipment for the operation of a hotel (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 5.0%).

***Building alterations, improvements and renewals.*** Our 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 a 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 our management agreements limit our ability to sell, lease or otherwise transfer a hotel unless the transferee is not a competitor of the manager, and unless the transferee assumes the related management agreement and meets specified other conditions.

***Service marks.*** During the term of our 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 hotel management company that operates the hotel, as 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 our management contracts described above.

## **Code of Business Conduct and Ethics and Corporate Governance Documents**

We have adopted a code of business conduct and ethics that applies to all of our employees, directors and officers, including our principal executive officer, principal financial officer and principal accounting officer.





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This code of business conduct and ethics is designed to comply with SEC regulations and New York Stock Exchange corporate governance rules related to codes of conduct and ethics and is posted on our corporate website at <http://www.strategichotels.com>. In addition, our corporate governance guidelines and charters for our audit, compensation and corporate governance and nominating committees are also posted on our corporate website. Copies of our code of business conduct and ethics, our corporate governance guidelines and our committee charters are also available free of charge upon request directed to Corporate Secretary, Strategic Hotels & Resorts, Inc., 200 West Madison Street, Suite 1700, Chicago, Illinois 60606.

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**ITEM 1A. RISK FACTORS.**

In addition to the information and factors discussed elsewhere in this annual report on Form 10-K, including our consolidated financial statements and the related notes, the factors disclosed below could cause our actual results to differ materially from those projected in any future-looking statements and could affect our future financial performance.

**Risks Related to Our Business**

*We rely to a significant extent 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 of 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 our operational, financing, acquisition and disposition activities. Mr. Geller's departure could have a material adverse effect on our operations, financial condition and operating results. Mr. Geller's employment agreement was amended and restated on September 7, 2006. Pursuant to that agreement, Mr. Geller will serve as our President and Chief Executive Officer through December 31, 2009, subject to earlier termination under certain circumstances described in the agreement.

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

As of February 28, 2008, six of the hotels we own were located in California, the greatest concentration of our portfolio of properties in any state. California has been historically at greater risk to certain acts of nature, such as fire, floods and earthquakes, than other states, and has also been subject to a more pronounced economic downturn than other states. 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 economy.

*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.*

We have a substantial amount of outstanding indebtedness, a portion of which bears interest at a variable rate, and we may borrow additional variable rate debt under our revolving credit facility. 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.

Our significant 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 amounts available for distributions to our stockholders and funds available for operations, 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.

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



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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 to our stockholders. 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 U.S. federal income tax purposes.

Turbulence in credit markets that began in 2007 has led to decreased availability of many forms of financing. If current market conditions continue to experience volatility and general tightening of credit, we may be unable to execute our business plans. Alternatively, the debt we do arrange may carry a higher rate of interest or shares we issue in any equity offering may require a higher rate of dividends. As a result, certain growth initiatives could prove more costly or not economically feasible. A failure to increase our capacity under our revolving credit facility or to add new or replacement debt facilities could have a material adverse effect on our business, financial condition and results of operations.

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 our debt service obligations would reduce cash available for distributions to our stockholders and could adversely affect our ability to make payments on our outstanding indebtedness and harm our financial condition.

***An economic slowdown would adversely affect our results by causing 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. An economic slowdown could result in further declines in average daily room rates or occupancy, and thereby have a material adverse effect on our results of operations.

***If we fail to maintain effective internal control over financial reporting and disclosure controls and procedures in the future, we may not be able to accurately report our financial results, which could have an adverse effect on our business.***

If our internal control over financial reporting and disclosure controls and procedures are not effective, we will not be able to provide reliable financial information. Subsequent to the filing of our annual report on Form 10-K for the year ended December 31, 2005, we determined that our consolidated statements of cash flows for the years ended December 31, 2005 and 2004 included in that annual report on Form 10-K and for the quarter ended March 31, 2005 included in our quarterly report on Form 10-Q for that quarter should be restated because the statements incorrectly classified certain items as cash flows from operating activities that should have been reported as cash flows from investing activities. Accordingly, we restated our consolidated statements of cash

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flows for the years ended December 31, 2005 and 2004 and our consolidated statement of cash flows for the quarter ended March 31, 2005 in our annual report on Form 10-K/A for the year ended December 31, 2005 and our quarterly report on Form 10-Q for the quarterly period ended March 31, 2006, respectively. In connection with these restatements, we determined that our internal control over financial reporting during the years ended December 31, 2004 and 2005 was not effective due to the existence of a material weakness in our internal control over financial reporting relating to the proper classification of cash flows pertaining to certain escrow deposits, purchased notes receivable and investments in our hotels. Although we have implemented additional procedures that we believe enable us to properly prepare and review our consolidated statement of cash flows, we cannot be certain that these measures will ensure that we will maintain adequate controls over our financial reporting process in the future. If we discover additional deficiencies, we will make efforts to remediate these deficiencies; however, there is no assurance what we will be successful either in identifying deficiencies or in their remediation. Any failure to maintain effective controls in the future could adversely affect our business or cause us to fail to meet our reporting obligations. Such non-compliance could also result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements. In addition, perceptions of our business among customers, suppliers, rating agencies, lenders, investors, securities analysts and others could be adversely affected.

### ***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, Earnings Before Interest Expense, Taxes, Depreciation and Amortization (EBITDA) and funds available for future distributions to our stockholders.

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 distributions 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, with respect to the Marriott Hamburg, the lease applicable to that property. Therefore, our business and operating results depend in large part upon the performance of these hotel management companies under these management agreements.

Under the terms of these management agreements, the third-party hotel managers control the daily operations of our hotels. 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, net revenue per available room (RevPAR) or average daily rates, we may not be able to force the hotel management companies in question to change their methods of operation of our hotels. Additionally, in the event that we need to replace any hotel management company, we may be required by the terms of the applicable management agreement to pay a substantial termination fee and may experience disruptions at any affected hotel. The effectiveness of the hotel management companies in managing our hotels will, therefore,

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significantly affect the revenues, expenses and value of our hotels. Occasionally, we have discovered accounting errors at some of our properties relating to the improper recording of income statement expenses, misstated inventories and other items apparently caused by poor accounting practices and oversight. In the event our third-party hotel management companies are not able to implement and maintain appropriate accounting controls with respect to our properties, our business, results of operations and financial condition could be adversely affected.

Additionally, the hotel management companies that operate our hotels 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 brand under which such hotel management company operates. Such differences may be significant depending upon many factors, including the remaining term of the applicable management agreement, trade area restrictions with respect to competitive practices 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.

### ***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 do certain things, including limitations on our incurrence of indebtedness and other customary financial and other 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, executing capital projects or funding our working capital needs and our financial condition and results of operations would be adversely affected.

### ***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 that focus on 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 real properties, other assets or other 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 real properties, other assets or other companies and therefore increase the prices required to be paid for them. If we pay higher prices for real properties, other assets or other companies, 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 intangible assets.

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***We are prohibited from selling our Loews Santa Monica Beach Hotel in a taxable transaction before a specified date 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 have agreed to maintain \$60.0 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.

***Investing through partnerships or joint ventures decreases our ability to manage risk.***

In addition to acquiring or developing hotels and resorts directly, we have from time to time invested, and expect to continue to invest, as a co-venturer. Joint venturers often have shared control over the operation of the joint venture assets. Therefore, joint venture investments may involve risks such as the possibility that the co-venturer in an investment might become bankrupt or not have the financial resources to meet its obligations, or have economic or business interests or goals that are inconsistent with our business interests or goals, or be in a position to take action contrary to our instructions or requests or contrary to our policies or objectives. Consequently, actions by a co-venturer might subject hotels and resorts owned by the joint venture to additional risk. Although we generally seek to maintain sufficient control of any joint venture, we may be unable to take action without the approval of our joint venture partners. Alternatively, our joint venture partners could take actions binding on the joint venture without our consent. Additionally, should a joint venture partner become bankrupt, we could become liable for our partner's share of joint venture liabilities.

***Our development activities are subject to timing, budgeting and other risks.***

We are in the process of developing and redeveloping several of our properties and expect to continue similar activities in the future. Furthermore, we are continuously investigating and pursuing acquisition and other corporate opportunities. These development and redevelopment activities and the pursuit of acquisition and other corporate opportunities expose us to certain risks, including those relating to:

construction delays or cost overruns that may increase project costs and, as a result, make the project uneconomical;

defects in design or construction that may result in additional costs to remedy or require all or a portion of a property to be closed during the period required to rectify any such situation;

the failure to complete construction of a property on schedule;

insufficient occupancy rates at a completed project impeding our ability to pay operating expenses or achieve targeted rates of return on investment;

the incurrence of acquisition and/or predevelopment costs in connection with projects that are delayed or not pursued to completion;

natural disasters such as earthquakes, hurricanes, floods or fires that could adversely impact a project;

receipt of zoning, occupancy, building, land-use or other required governmental permits and authorizations; and

governmental restrictions on the nature or size of a project or timing of completion.

In the case of an unsuccessful project, we may be required to write off capitalized costs associated with the project and such write-offs may be significant and adversely affect our financial condition and results of operations. We also may incur significant expenses in connection with acquisition or other corporate opportunities we pursue but do not consummate.



*Our entry into the hotel condominium, fractional ownership and residential markets exposes us to new risks.*

Potential plans to develop and market hotel condominiums, fractional ownership interests and other residential properties at certain of our properties exposes us to new risks associated with entering a new line of business, including developing the knowledge of and experience in these markets, recruiting professionals to

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manage these new business lines and developing and capitalizing on new marketing relationships with experienced market participants. The marketing and sale of hotel condominiums and fractional ownership interests are subject to extensive regulation by the federal government and the states in which the properties are located, and in the case of fractional ownership interests, in the states where the fractional ownership interests are marketed and sold. Changes in the legal requirements or a determination that we are not in compliance with applicable laws could adversely affect our hotel condominium and fractional ownership business.

### **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 would likely adversely affect 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 and results of operations, which may affect our ability to make distributions to our stockholders.

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

Various types of catastrophic losses, such as losses due to wars, terrorist acts, earthquakes, floods, hurricanes or pollution or other 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. Although our earthquake insurance coverage is limited, as of February 28, 2008, six of our hotels are located in California, which has been historically at a greater risk for certain acts of nature (such as fire, floods and earthquakes) than other states. Our Four Seasons hotel in Mexico City is also in an area exposed to greater risk of earthquakes. Our InterContinental Miami and Four Seasons Punta Mita Resort are located in areas that are prone to hurricanes and/or floods.

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 that is covered by insurance, our deductible may be high 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 in the damaged or destroyed property.

Certain events, such as Hurricanes Katrina and Rita in 2005, have historically made it more difficult and expensive to obtain property and casualty insurance, including coverage for windstorm, flood and earthquake damage, and such events could occur again. We may encounter difficulty in obtaining or renewing property insurance, including coverage for windstorm, flood and earthquake damage, or casualty insurance on our properties at the same levels of coverage, under similar terms and in a timely manner due to a lack of capacity in the insurance markets or a lack of availability of such insurance at commercially reasonable rates. Insurance we would be able to obtain may be more limited and for

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some catastrophic risks (e.g., earthquake, flood, windstorm and terrorism) may not be generally available to fully cover potential losses. Even if we would be able to renew our policies or to obtain

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new policies at levels and with limitations consistent with our current policies, we cannot be sure that we would be able to obtain such insurance at premium rates that are commercially reasonable or that there would not be gaps in our coverage. If we were unable to obtain adequate insurance on our properties for certain risks or in a timely manner, it would expose us to uninsured losses and could cause us to be in default under specific covenants on certain of our indebtedness or other contractual commitments 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 damage which would otherwise have been covered by insurance, it could materially adversely affect our financial condition and the operations of our properties.

***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 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 (i.e., nationalization of assets located within a country);

changes in laws, regulations and policies, including land use, zoning and environmental laws, and in real estate and other tax rates;

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

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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.

***The threat of terrorism has historically adversely affected the lodging industry generally and these adverse effects may worsen if there are further terrorist events.***

The threat of terrorism has historically 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. Future terrorist acts, terrorism alerts or outbreaks of hostilities could have a negative effect on travel and on our business.

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*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.

*We consider acquisition and disposition opportunities in the ordinary course of our business, we face competition in the acquisition of properties and properties that we acquire may not perform as anticipated.*

In the ordinary course of our business, we consider strategic acquisitions and dispositions. The acquisition of properties involves risks, including the risk that the acquired property will not perform as anticipated and the risk 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.

*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 U.S. 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 the contamination pre-dated our ownership of the property or we did not know of or were not responsible for the contamination. These laws may also force a party who owned a property at the time of its contamination, but no longer owns the property, to be responsible for the cleanup. 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 (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, which we sold in September 2006, 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; however, there can be no assurance regarding potential future developments concerning this site.

*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 our consultants and 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 impose liability on us. 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, mold or thorium.

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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 distributions 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 (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.

### **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 individual from owning beneficially 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.

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

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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.

*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 U.S. federal taxation, reducing our earnings available for distribution.*

We currently qualify as a REIT under the Internal Revenue Code of 1986, as amended (the Code). The requirements for this qualification, however, are complex and require annual distributions to our stockholders tied to our taxable income (irrespective of available cash from operations), quarterly asset tests and diversity of stock ownership rules. If we fail to meet these requirements in the future, our distributions to our stockholders will not be deductible by us and we will have to pay a corporate U.S. federal level tax on our income. This would substantially reduce our cash available to pay distributions to our stockholders. 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 U.S. 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 U.S. 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 U.S. 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. In addition, the REIT rules impose various taxes and penalties on transactions with taxable REIT subsidiaries that are determined not to be priced at an arm's length, and on a REIT that has to avail itself of certain cure provisions in the Code for the failure to meet all of the REIT qualification requirements. 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.



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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. federal 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 our Affiliate Leases 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 to our Strategic Ownership Entities pursuant to our Affiliate Leases will only qualify for purposes of the gross income tests if such Affiliate Leases are respected as true leases for U.S. federal income tax purposes and are not treated as service contracts, joint ventures or some other type of arrangement. If our Affiliate Leases are not respected as true leases for U.S. federal income tax purposes, we would fail to qualify as a REIT.

*Our TRSs are subject to special rules that may result in increased taxes.*

SHR has to pay a 100% penalty tax on some payments that it receives from its TRSs if the economic arrangements between SHR and the TRSs in question are not comparable to similar arrangements between unrelated parties. The Internal Revenue Service may successfully assert that the economic arrangements of any of our inter-company transactions, including our Affiliate 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 U.S. 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 laws, 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 Internal Revenue Service may successfully assert that one or more of our sales are prohibited transactions; consequently, we may be required to pay a penalty tax.

*Dividends payable by REITs do not qualify for the reduced tax rates applicable to certain dividends.*

The maximum federal tax rate for certain dividends payable to domestic stockholders that are individuals, trusts and estates is 15% (through 2010). Dividends payable by REITs, however, are generally not eligible for this reduced rate. Although this legislation does not adversely affect the taxation of REITs or dividends paid by REITs, the more favorable rates applicable to regular corporate dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less competitive than investments in stock of non-REIT corporations that pay dividends, which could adversely affect the value of the stock of REITs, including our common stock.

### **ITEM 1B. UNRESOLVED STAFF COMMENTS.**

None.

### **ITEM 2. PROPERTIES.**

*Offices.* We lease our headquarters located at 200 West Madison Street, Suite 1700, Chicago, Illinois 60606.

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**Property Overview and Performance.** The following table presents certain information related to our hotel properties. All of the hotel properties in the following table relate to our one reportable business segment, hotel ownership.

Hotel	Location	Date Acquired	Number of Rooms	Year Ended December 31, 2007(1)			% Change 2007- 2006(2)		
				Average Occupancy	Average Daily Rate	RevPAR	Total RevPAR	RevPAR	Total RevPAR
<b>Fee Simple Property Interest</b>									
Westin St. Francis(*)	San Francisco, CA	6/2006	1,195	80.0%	\$ 211.64	\$ 169.39	\$ 317.81	6.0%	5.1%
InterContinental Chicago(3)(*)	Chicago, IL	4/2005	792	83.1%	\$ 212.56	\$ 176.61	\$ 280.88	7.6%	12.4%
Hotel del Coronado(4)	Coronado, CA	1/2006	757	74.4%	\$ 354.52	\$ 263.92	\$ 545.56	(2.3)%	0.2%
Hyatt Regency Phoenix	Phoenix, AZ	1/1998	696	69.2%	\$ 139.01	\$ 96.14	\$ 159.19	6.4%	7.4%
Fairmont Chicago(*)	Chicago, IL	9/2005	687	75.3%	\$ 221.82	\$ 167.02	\$ 278.14	6.6%	5.9%
Fairmont Scottsdale Princess(5)(*)	Scottsdale, AZ	9/2006	651	73.7%	\$ 239.44	\$ 176.54	\$ 397.85	0.6%	(1.0)%
InterContinental Miami(*)	Miami, FL	4/2005	641	71.1%	\$ 190.80	\$ 135.70	\$ 233.52	15.8%	17.3%
Hyatt Regency La Jolla(3)(*)	La Jolla, CA	7/1999	419	79.7%	\$ 184.96	\$ 147.49	\$ 279.84	5.7%	4.2%
Ritz-Carlton Laguna Niguel(**)	Dana Point, CA	7/2006	396	66.9%	\$ 382.64	\$ 255.92	\$ 564.35	(0.1)%	5.3%
InterContinental Prague(6)(*)	Prague, Czech Republic	8/1998	372	76.6%	\$ 240.31	\$ 183.97	\$ 292.92	10.5%	11.4%
Loews Santa Monica Beach Hotel(7)(*)	Santa Monica, CA	3/1998	342	85.6%	\$ 300.22	\$ 256.89	\$ 388.91	9.2%	7.0%
Ritz-Carlton Half Moon Bay(*)	Half Moon Bay, CA	8/2004	261	71.5%	\$ 368.51	\$ 263.46	\$ 631.48	9.0%	7.7%
Four Seasons Mexico City(**)	Mexico City, Mexico	12/1997	240	68.3%	\$ 260.08	\$ 177.67	\$ 320.19	22.2%	20.7%
Four Seasons Washington, D.C.(**)	Washington, D.C.	3/2006	211	71.5%	\$ 542.58	\$ 388.00	\$ 696.88	11.8%	9.6%
Four Seasons Punta Mita Resort(**)	Punta Mita, Mexico	2/2001	173	76.0%	\$ 734.73	\$ 558.45	\$ 950.09	3.6%	8.1%
Hotel Le Parc	Paris, France	7/2007	116	73.5%	\$ 340.48	\$ 250.20	\$ 426.19	20.7%	12.3%
<b>Ground Lease Property Interest</b>									
Marriott Lincolnshire(**)	Lincolnshire, IL	9/1997	389	65.6%	\$ 135.42	\$ 88.83	\$ 287.04	1.5%	1.3%
Marriott London Grosvenor Square(*)	London, England	8/2006	236	81.2%	\$ 417.97	\$ 339.57	\$ 525.49	19.6%	18.9%
<b>Leasehold Property Interest</b>									
Marriott Hamburg(8)	Hamburg, Germany	6/2000	278	84.2%	\$ 185.03	\$ 155.74	\$ 223.74	8.7%	8.7%
Marriott Champs Elysees Paris(8)	Paris, France	2/1998	192	88.5%	\$ 566.73	\$ 501.45	\$ 618.07	18.3%	15.8%
Total			9,044	75.9%	\$ 263.78	\$ 200.09	\$ 366.12	7.8%	7.6%

(1) The table includes statistical information only for our period of ownership.

(2) The year-over-year comparisons are calculated using full year results which may include prior ownership periods.

(3) We own a 51% controlling interest in affiliates that own each of these properties.

(4) We have a 45% interest in the joint venture that owns this property, which is subject to a mortgage.

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- (5) We have a ground lease interest in one land parcel at this property.
- (6) On August 3, 2006, we purchased our joint venture partner's 65% interest in the entity that owns this property.
- (7) 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.
- (8) These properties were originally acquired on the dates indicated in the table but were subsequently sold to a third party and leased back to us in transactions that are more fully described under Item 8. Financial Statements and Supplementary Data Note 8 Operating Lease Agreements .
- (\* ) These properties are subject to mortgages as more fully described under Item 8. Financial Statements and Supplementary Data Note 9 Indebtedness .
- (\*\* ) Under the provisions of the credit agreement dated March 9, 2007 as more fully described under Item 8. Financial Statements and Supplementary Data Note 9 Indebtedness , these properties are included in the initial borrowing base and must remain unencumbered by mortgage debt agreements or availability under the credit line is reduced.

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**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 which is expected to be covered by insurance.

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

None.

**Table of Contents****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 (NYSE) under the symbol BEE. As of February 27, 2008, the number of registered holders of record of our common stock was 100.

The following table sets forth the high and low sale prices for our common stock as reported on the NYSE composite transaction tape and the per share cash dividends declared on our common stock for the period January 1, 2006 through December 31, 2007.

	2007 Per Share of Common Stock			2006 Per Share of Common Stock		
	Market Price		Dividend Paid	Market Price		Dividend Paid
	High	Low		High	Low	
First Quarter	\$ 24.31	\$ 19.76	\$ 0.24	\$ 23.30	\$ 19.85	\$ 0.23
Second Quarter	24.24	21.10	0.24	23.56	19.24	0.23
Third Quarter	24.35	18.71	0.24	21.48	18.43	0.23
Fourth Quarter	22.74	16.15	0.24	22.18	19.34	0.23
Year	\$ 24.35	\$ 16.15	\$ 0.96	\$ 23.56	\$ 18.43	\$ 0.92

We generally intend to distribute each year substantially all of our taxable income (which does not necessarily equal net income as calculated in accordance with generally accepted accounting principles) to our shareholders so as to comply with REIT provisions of the Code. We intend to make dividend distributions quarterly, and, if necessary for REIT qualification purposes, we may need to distribute any taxable income remaining after the distribution of the final regular quarterly dividend each year, together with the first regular quarterly dividend payment of the following taxable year or, at our discretion, in a special dividend distributed prior thereto. Our dividend policy is subject to revision at the discretion of our board of directors. All distributions will be made at the discretion of our board of directors and will depend on our taxable income, our financial condition, our maintenance of REIT status and other factors as our board of directors deems relevant.

**Equity Compensation Plan Information**

There are 3,000,000 shares of common stock authorized for issuance under our 2004 Incentive Plan (the Plan). The following table sets forth certain information with respect to securities authorized and available for issuance under the Plan as of December 31, 2007

	Number of securities to be issued upon exercise of outstanding awards (a)	Weighted-average exercise price of outstanding awards (b)	Number of securities remaining available for future issuance under the Plan (excluding securities reflected in column a) (c)
<b>Equity compensation plans approved by security holders:</b>			
Stock options	736,221	\$ 20.39	
Restricted stock units	1,058,873	N/A	
Total	1,795,094		1,055,461

**Repurchases of Equity Securities**

We did not repurchase equity securities during the fourth quarter of 2007.

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**ITEM 6. SELECTED FINANCIAL DATA.**

The following sets forth our selected consolidated financial and operating information on a historical basis. 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 are 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 IPO) in June 2004 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 (Distributed Properties) by SHC Funding to SHC LLC (see Item 8. Financial Statements and Supplementary Data Note 1 General ).

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	2007(1)	Historical as of and for the Years Ended December 31,			2003(1)
		2006(1)	2005(1)	2004(1)(2)	
		(In thousands, except per share and statistical data)			
<b>Statistical Data:</b>					
Number of hotels at the end of the year excluding unconsolidated joint venture hotels	19	19	15	14	20
Number of rooms at the end of the year excluding unconsolidated joint venture hotels	8,287	9,321	7,213	5,820	9,567
Average occupancy rate	76.0%	74.8%	70.8%	68.7%	69.1%
<b>Operating Data:</b>					
Revenue:					
Rooms	\$ 532,109	\$ 381,019	\$ 201,036	\$ 203,507	\$ 269,515
Food and beverage	342,468	244,007	131,513	112,794	140,500
Other hotel operating revenue	110,010	73,304	40,195	38,137	44,006
Lease revenue	23,405	20,257	16,787	13,863	7,488
<b>Total revenues</b>	<b>1,007,992</b>	<b>718,587</b>	<b>389,531</b>	<b>368,301</b>	<b>461,509</b>
Operating costs and expenses:					
Rooms	130,784	94,764	47,520	50,850	70,607
Food and beverage	231,407	170,054	91,754	86,279	108,673
Other departmental expenses	248,815	181,436	104,388	97,984	119,427
Management fees	39,264	26,774	11,713	13,476	16,649
Other hotel expenses	67,975	44,526	22,480	22,203	31,728
Lease expense	15,700	13,682	13,178	6,446	
Depreciation and amortization	106,091	75,135	39,797	45,318	67,099
Corporate expenses	30,179	25,383	21,023	28,845	21,912
Other charges	7,372				
<b>Total operating costs and expenses</b>	<b>877,587</b>	<b>631,754</b>	<b>351,853</b>	<b>351,401</b>	<b>436,095</b>
<b>Operating income</b>	<b>130,405</b>	<b>86,833</b>	<b>37,678</b>	<b>16,900</b>	<b>25,414</b>
Interest expense	(88,906)	(50,973)	(29,463)	(51,545)	(90,657)
Equity in earnings (losses) of joint ventures	8,344	(1,066)	2,818	739	(544)
Minority interests	(1,776)	(1,504)	(1,949)	1,464	(2,895)
<b>Income (loss) from continuing operations</b>	<b>111,233</b>	<b>35,507</b>	<b>5,296</b>	<b>(52,696)</b>	<b>(84,281)</b>
(Loss) income from discontinued operations	(42,075)	84,622	24,964	66,029	28,087
<b>Net income (loss)</b>	<b>\$ 69,158</b>	<b>\$ 120,129</b>	<b>\$ 30,260</b>	<b>\$ 13,333</b>	<b>\$ (56,194)</b>
<b>Net income (loss) available to common shareholders</b>	<b>\$ 39,051</b>	<b>\$ 95,586</b>	<b>\$ 23,507</b>	<b>\$ 13,333</b>	<b>\$ (56,194)</b>
<b>Income (loss) from continuing operations per common share basic</b>	<b>\$ 1.08</b>	<b>\$ 0.16</b>	<b>\$ (0.04)</b>	<b>\$ (2.16)</b>	<b>\$ (4.96)</b>
<b>Cash flows provided by (used in) operating activities</b>	<b>\$ 174,681</b>	<b>\$ 141,206</b>	<b>\$ 76,456</b>	<b>\$ (7,839)</b>	<b>\$ 36,638</b>
<b>Cash dividends declared per common share</b>	<b>\$ 0.96</b>	<b>\$ 0.92</b>	<b>\$ 0.88</b>	<b>\$ 0.44</b>	<b>\$</b>
<b>Balance Sheet Data:</b>					
Total assets	\$ 3,366,296	\$ 3,255,709	\$ 1,448,110	\$ 990,350	\$ 2,079,521
Total liabilities	2,087,292	1,914,991	861,367	732,744	1,832,845
Minority interests	42,165	23,428	87,646	61,053	107,608
Shareholders equity	1,236,839	1,317,290	499,097	196,553	139,068

(1) We sold one hotel property in 2007, two hotel properties in 2006, two hotel properties in 2005, one hotel property in 2004 and five hotel properties in 2003. The operations of the sold hotels are included as discontinued operations in the operating data above for all years



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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 IPO.

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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 Hotels & Resorts, Inc. and its subsidiaries for the years presented and should be read together with the notes thereto contained in this annual report on 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 Hotels & Resorts, Inc. (SHR or the Company) was incorporated in Maryland in January 2004 to own and asset manage upper upscale and luxury hotels. Our accounting predecessor, Strategic Hotel Capital, L.L.C. (SHC LLC) was founded in 1997 by Laurence Geller, our President and Chief Executive Officer, Goldman, Sachs & Co.'s Whitehall Fund and others. We made an election to be taxed as a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended (the Code). On June 29, 2004, we completed our initial public offering (IPO) of common stock. Prior to the IPO, 21 hotel interests were owned by SHC LLC. Concurrent with and as part of the transactions relating to the IPO, a reverse spin-off distribution to shareholders separated SHC LLC into two companies, a new, privately-held SHC LLC, with interests, at that time, in seven hotels and Strategic Hotels & Resorts, Inc., a public entity with interests, at that time, in 14 hotels. See Item 8. Financial Statements and Supplementary Data Note 1 General for the hotel interests owned by us as of December 31, 2007.

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. (SH Funding), which currently holds substantially all of our assets. We are the managing member of SH Funding and hold approximately 99% of its membership units as of December 31, 2007. We manage all business aspects of SH Funding, including the sale and purchase of hotels, the investment in these hotels and the financing of SH Funding and its assets.

Throughout this Management's Discussion and Analysis of Financial Condition and Results of Operations section, references to we, our and us are references to SHR and, except as the context otherwise requires, its consolidated subsidiaries, including SH Funding.

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, 2007, as applicable, unless otherwise noted.

**Table of Contents****Factors Affecting Our Results of Operations****Acquisition and Sale of Interests in Hotel Properties.**

During 2005 through 2007, we completed the following acquisitions:

Property	Acquisition Date	Amount Paid (in millions)
InterContinental Chicago & Miami(1)	April 1, 2005	\$ 316.8
Fairmont Chicago	September 1, 2005	\$ 158.6
Hotel del Coronado(2)	January 9, 2006	\$ 71.4
Four Seasons Washington, D.C.	March 1, 2006	\$ 170.0
Westin St. Francis	June 1, 2006	\$ 439.3
Ritz-Carlton Laguna Niguel	July 7, 2006	\$ 336.3
InterContinental Prague(3)	August 3, 2006	\$ 163.6
Marriott London Grosvenor Square	August 31, 2006	\$ 208.1
Fairmont Scottsdale Princess(4)	September 1, 2006	\$ 350.8
Hotel Le Parc	July 31, 2007	\$ 95.0

- (1) On April 1, 2005, we purchased 85% controlling interests in the InterContinental hotels in Chicago and Miami for \$285.4 million. In 2007, we purchased the remaining 15% interests in these properties for \$31.4 million.
  - (2) We acquired 45% ownership interests in the joint ventures that own Hotel del Coronado and an adjacent land parcel under development.
  - (3) We purchased our partner's 65% interest in the entity that owns the InterContinental Prague.
  - (4) We purchased the Fairmont Scottsdale Princess hotel and an adjacent 10-acre development parcel.
- During 2005 through 2007, we sold the following properties:

Property	Disposition Date	Net Sales Proceeds (in millions)
Hyatt Regency New Orleans	December 28, 2007	\$ 28.0
InterContinental Chicago & Hyatt Regency La Jolla(1)	August 31, 2007	\$ 111.2
Hilton Burbank Airport	September 7, 2006	\$ 123.3
Marriott Rancho Las Palmas Resort	July 14, 2006	\$ 54.8
Embassy Suites Lake Buena Vista	October 27, 2005	\$ 54.8
Marriott Schaumburg	October 7, 2005	\$ 21.5

- (1) We sold a 49% interest in each of the InterContinental Chicago and Hyatt Regency La Jolla hotels.

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Below is a summary of changes in our portfolio which have occurred during the years ended December 31, 2007, 2006 and 2005. The table summarizes the number of hotels and number of rooms, excluding unconsolidated joint ventures:

	2007	2006	2005
<b>Hotels</b>			
Number of hotels, beginning of year	19	15	14
Acquisitions	1	6	3
Dispositions	(1)	(2)	(2)
Number of hotels, end of year	19	19	15
<b>Rooms</b>			
Number of rooms, beginning of year	9,321	7,213	5,820
Acquisitions	116	3,058	2,140
Room expansions	34	5	
Dispositions	(1,184)	(932)	(731)
Rooms converted to other uses		(23)	(16)
Number of rooms, end of year	8,287	9,321	7,213

We define our Total Portfolio as properties that are wholly or partially owned or leased by us. We present certain information about our hotel operating results and statistics on a comparable hotel basis, which we refer to as our Same Store analysis. We define our Same Store Assets as those hotels (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 entire reporting periods being presented.

Our Same Store Assets for purposes of the comparison of the years ended December 31, 2007 and 2006 exclude the Hotel Le Parc, the Four Seasons Washington, D.C., the Westin St. Francis, the Ritz-Carlton Laguna Niguel, the InterContinental Prague, the Marriott London Grosvenor Square, the Fairmont Scottsdale Princess, the Hotel del Coronado, which we account for using the equity method of accounting, and all sold properties included in discontinued operations.

Our Same Store Assets for purposes of the comparison of the years ended December 31, 2006 and 2005 exclude the InterContinental Chicago and Miami hotels, the Fairmont Chicago, the Four Seasons Washington, D.C., the Westin St. Francis, the Ritz-Carlton Laguna Niguel, the InterContinental Prague, the Marriott London Grosvenor Square, the Fairmont Scottsdale Princess, the Hotel del Coronado, which we account for using the equity method of accounting, and all sold properties included in discontinued operations.

We present these Same Store Asset results because we believe that doing so provides 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 in distinguishing whether increases or decreases in revenues and/or expenses are due to operations of the Same Store Assets or from acquisition or disposition activity.

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**Revenues.** Substantially all of our revenue is derived from the operation of our hotels. Specifically, our revenue for the years ended December 31, 2007 and 2006 consists of:

	Total Portfolio		Same Store Assets	
	% of Total Revenues 2007	% of Total Revenues 2006	% of Total Revenues 2007	% of Total Revenues 2006
<b>Revenues:</b>				
Rooms	52.8%	53.0%	53.1%	53.5%
Food and beverage	34.0%	34.0%	32.8%	32.9%
Other hotel operating revenue	10.9%	10.2%	9.8%	9.5%
	97.7%	97.2%	95.7%	95.9%
Lease revenue	2.3%	2.8%	4.3%	4.1%
<b>Total revenues</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

**Rooms revenue.** Occupancy and average daily rate are the major drivers of rooms revenue.

**Food and beverage revenue.** Occupancy, local catering and banquet events are the major drivers of food and beverage revenue.

**Other hotel operating revenue.** Other hotel operating revenue consists of ancillary revenue such as internet access, telephone, parking, golf course, spa, space rentals, retail and other guest services and is also driven by occupancy.

**Lease revenue.** We earn lease revenue from the Marriott Hamburg and the Marriott Champs Elysees Paris (Paris Marriott). In accordance with our lease agreements, we earn an annual base rent plus additional rent contingent on these hotels meeting performance thresholds.

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

average daily occupancy,

average daily rate (ADR)

revenue per available room (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, and

total revenue per available room (Total RevPAR) which captures food and beverage and other hotel operating revenue.

Fluctuations in revenues, which, for our domestic hotels, 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 rooms revenues. However, a greater percentage of certain group guests, which do not include the highest corporate premium but do consume larger relative amounts of food and

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beverage and other services, may contribute to higher total revenue. 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.

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Overall, our Total Portfolio RevPAR, excluding leased properties and unconsolidated joint ventures, increased by 10.6% to \$188.35 during the year ended December 31, 2007 from \$170.28 during the year ended December 31, 2006. With respect to Same Store Assets, RevPAR, excluding leased properties, increased by 9.5% to \$172.05 for the year ended December 31, 2007 from \$157.15 for the year ended December 31, 2006.

**Hotel Operating Costs and Expenses.** Our hotel operating costs and expenses for the years ended December 31, 2007 and 2006 consist of the costs to provide hotel services, including:

	Total Portfolio		Same Store Assets	
	% of Total Hotel Operating Expenses		% of Total Hotel Operating Expenses	
	2007	2006	2007	2006
Hotel Operating Costs and Expenses:				
Rooms	18.2%	18.3%	18.0%	18.4%
Food and beverage	32.2%	32.9%	31.3%	32.3%
Other departmental expenses	34.6%	35.1%	35.2%	35.9%
Management fees	5.5%	5.2%	5.2%	4.7%
Other hotel expenses	9.5%	8.5%	10.3%	8.7%
Total hotel operating costs and expenses	100.0%	100.0%	100.0%	100.0%

**Rooms expense.** Like rooms revenue, occupancy is a major driver of rooms expense, which has a significant correlation with rooms revenue.

**Food and beverage expense.** Like food and beverage revenue, occupancy, local catering and banquet events are the major drivers of food and beverage expense, which has a significant correlation with food and beverage revenue.

**Other departmental expenses.** Other departmental expenses consist of general and administrative, marketing, repairs and maintenance, utilities and expenses related to earning ancillary revenue.

**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.

**Other hotel expenses.** Other hotel expenses consist primarily of insurance costs and property taxes.

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.

**Lease expense.** As a result of sale and leaseback transactions applicable to the Paris Marriott and Marriott Hamburg hotels, we record lease expense in our statements of operations. In conjunction with the sale and leaseback transactions, we also recorded a deferred gain. Net lease expense includes an offset for the amortization of the deferred gain of \$4.8 million, \$4.4 million and \$4.4 million for the years ended December 31, 2007, 2006 and 2005, respectively.

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**Corporate expenses.** Corporate expenses include our corporate level expenses such as payroll and related costs, professional fees, travel expenses and office rent.



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**Recent Events.** We expect that the following events will cause our future results of operations to differ from our historical performance:

**Hotel Acquisitions.** On October 1, 2007, we entered into an agreement to purchase a 60-acre oceanfront land parcel in Punta Mita, Nayarit, Mexico, near the Four Seasons Punta Mita Resort, for a purchase price of approximately \$45.8 million payable in three installments through 2009. We paid the first installment of \$15.0 million plus closing costs on October 4, 2007. We are exploring partnerships with unaffiliated third parties to develop all or part of the site.

On July 31, 2007, we purchased the 116-room Hotel Le Parc in Paris, France for \$95.0 million, including acquisition costs. The acquisition was financed using borrowings under the bank credit facility and the facility secured by the Marriott London Grosvenor Square hotel.

**Sales of Hotels.** On December 28, 2007, we sold the Hyatt Regency New Orleans hotel for a net sales price of \$28.0 million, of which \$9.0 million is in the form of a promissory note.

On August 31, 2007, we sold a 49% interest in each of the InterContinental Chicago and Hyatt Regency La Jolla hotels to DND Hotel JV Pte Ltd., an affiliate of GIC Real Estate Pte Ltd., a real estate investment company and subsidiary of the Government of Singapore Investment Corporation Pte Ltd., for an approximate aggregate sales price of \$220.5 million. We recognized a gain on the sale of approximately \$84.7 million during the year ended December 31, 2007. We hold the remaining 51% interests and have entered into long-term asset management agreements with the ventures.

**BuyEfficient, L.L.C.** Effective December 7, 2007, we acquired a 50% interest in BuyEfficient, L.L.C., an electronic purchasing platform that allows members to procure food, operating supplies, furniture, fixtures and equipment, for a purchase price of \$6.3 million.

**Hyatt Regency New Orleans.** In August 2005, Hurricane Katrina caused substantial damage to the Hyatt Regency New Orleans property. The hurricane damage also caused significant interruption to the hotel's business, and the hotel effectively ceased operations. On August 1, 2007, we entered into a complete and final settlement with our insurer for the property with respect to the property damage and business interruption insurance claims relating thereto. The total settlement, net of deductibles, was for \$143.0 million.

In connection with completing the insurance settlement process, we updated our ongoing evaluation and assessment of our strategic options with respect to the Hyatt Regency New Orleans property, including updating our estimate of the fair market value of the property. Based on this assessment, we recognized an impairment loss of \$37.7 million during the year ended December 31, 2007, of which \$12.1 million related to goodwill and \$25.6 million related to property and equipment.

**Preferred Stock Offerings.** In October 2007, we completed a public offering of 488,750 additional shares of 8.50% Series A Cumulative Redeemable Preferred Stock, par value \$0.01 per share (liquidation preference \$25.00 per share). After discounts, commissions and expenses, we raised net proceeds of approximately \$10.7 million. These proceeds were used to repay existing indebtedness under our bank credit facility.

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*Financings.* During the year ended December 31, 2007, we entered into the following mortgage loan and facility agreements:

<b>Property</b>	<b>Date</b>	<b>Principal (in millions)</b>	<b>Interest</b>
InterContinental Prague(1)	March 7, 2007	104.0 (\$136.3)	EURIBOR + 1.25%
Fairmont Chicago	March 9, 2007	\$123.8	LIBOR + 0.70%
Loews Santa Monica Beach Hotel	March 9, 2007	\$118.3	LIBOR + 0.63%
Ritz-Carlton Half Moon Bay	March 9, 2007	\$76.5	LIBOR + 0.67%
Hyatt Regency La Jolla	August 31, 2007	\$97.5	LIBOR + 1.00%

(1) In this table, the principal amount of the facility agreement in U.S. dollars is based on the foreign exchange rate on March 7, 2007. The principal amount of the facility in U.S. dollars based on the foreign exchange rate on December 31, 2007 is \$151.8 million. In addition to the agreements described above, we also completed the following financing transactions during the year ended December 31, 2007:

On March 9, 2007, we entered into a new \$415.0 million bank credit facility agreement that replaced the previous \$225.0 million bank credit facility agreement. Interest accrues at LIBOR plus a spread of 0.80% to 1.50% per annum depending on a leverage test. On April 18, 2007, we increased our borrowing capacity on the bank credit facility to \$500.0 million.

We used the proceeds from the mortgage loans that closed on March 9, 2007 to repay the \$292.5 million balance of a floating rate loan portfolio secured by six hotel properties.

We used the proceeds from the 104.0 million InterContinental Prague facility to repay the 66.0 million mortgage debt secured by the InterContinental Prague hotel and to repay £20.0 million of the £77.3 million mortgage debt secured by the Marriott London Grosvenor Square hotel.

We repaid the \$90.0 million mezzanine loan secured by interests in the Fairmont Scottsdale Princess hotel, which matured on March 9, 2007.

We defeased the \$199.5 million outstanding balance of a fixed rate portfolio loan secured by the Hyatt Regency New Orleans, the Hyatt Regency Phoenix and the Hyatt Regency La Jolla hotels.

We purchased interest rate caps with a total notional amount of \$194.8 million and LIBOR strike rate of 6.50% covering the Loews Santa Monica Beach Hotel and Ritz-Carlton Half Moon Bay mortgage loan balances. We entered into a sold forward-starting interest rate cap agreement with a notional amount of \$9.0 million and a LIBOR strike rate of 5.0%.

We executed interest rate swap agreements with a total notional amount of \$200.0 million that convert floating rates to fixed rates ranging from 4.81% to 4.84% and a £77.3 million interest rate swap agreement that has a fixed pay rate against GBP LIBOR of 5.72%. We executed forward-starting interest rate swap agreements with a total notional amount of \$475.0 million that will convert floating rates to fixed rates ranging from 4.90% to 5.42%.

*Exchangeable senior notes (Exchangeable Notes).* On April 4, 2007, we issued \$150.0 million in aggregate principal amount of Exchangeable Notes and on April 25, 2007, issued an additional \$30.0 million of Exchangeable Notes in connection with the exercise by the initial purchasers

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of their over-allotment option. The Exchangeable Notes were issued at 99.5% of par value. We received proceeds of \$175.6 million, net of underwriting fees and expenses and original issue discount. The Exchangeable Notes bear interest at 3.5% payable semi-annually in arrears on April 1 and October 1 of each year beginning October 1, 2007 and mature on April 1, 2012 unless previously redeemed by us, repurchased by us or exchanged in accordance with their terms prior to such date. The Exchangeable Notes can be exchanged for cash or shares of our common stock or a combination thereof, at our option, based on the applicable exchange rate prior to the close of business on the

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business day immediately preceding the stated maturity date at any time on or after November 1, 2011 and also under certain circumstances (See Item 8. Financial Statements and Supplementary Data Note 9 Indebtedness ).

In connection with the issuance of the Exchangeable Notes, we purchased call options for \$9.9 million to purchase approximately 0.9 million shares of our common stock at a strike price of \$27.70 up to a cap price of \$32.31 per share (subject to adjustment in certain circumstances). The call option transactions are expected to generally reduce the potential dilution upon exchange in the event the market value per share of our common stock is greater than the strike price of the call option transaction. These call options will terminate April 1, 2012, subject to earlier exercise.

We also entered into our registration rights agreement. As required under the registration rights agreement, we filed a shelf registration statement, which became effective August 23, 2007. We must also use reasonable efforts to keep the shelf registration statement effective until the earlier of 1) the date one year following the last date on which Exchangeable Notes have been exchanged and settlement has occurred or 2) the date on which there are no longer any Exchangeable Notes or restricted shares of our common stock outstanding.

Contemporaneously with the closing of the sale of the Exchangeable Notes, approximately \$25.0 million of the net proceeds were used to repurchase and retire approximately 1.1 million shares of our common stock. The remaining net proceeds were used to repay amounts outstanding under the bank credit facility.

**Table of Contents****Comparison of Year Ended December 31, 2007 to Year Ended December 31, 2006****Operating Results**

The following table presents the operating results for the years ended December 31, 2007 and 2006, including the amount and percentage change in these results between the two periods of our Total Portfolio and Same Store Assets, as defined on page 28. Our Total Portfolio represents the results of operations included in the consolidated statements of operations (in thousands, except operating data).

	Total Portfolio				Same Store Assets			
	2007	2006	Change (\$)	Change (%)	2007	2006	Change (\$)	Change (%)
<b>Revenues:</b>								
Rooms	\$ 532,109	\$ 381,019	\$ 151,090	39.7%	\$ 290,881	\$ 264,542	\$ 26,339	10.0%
Food and beverage	342,468	244,007	98,461	40.4%	179,628	162,876	16,752	10.3%
Other hotel operating revenue	110,010	73,304	36,706	50.1%	53,395	47,134	6,261	13.3%
	984,587	698,330	286,257	41.0%	523,904	474,552	49,352	10.4%
Lease revenue	23,405	20,257	3,148	15.5%	23,405	20,257	3,148	15.5%
<b>Total revenues</b>	<b>1,007,992</b>	<b>718,587</b>	<b>289,405</b>	<b>40.3%</b>	<b>547,309</b>	<b>494,809</b>	<b>52,500</b>	<b>10.6%</b>
<b>Operating Costs and Expenses:</b>								
Hotel operating expenses	718,245	517,554	200,691	38.8%	383,280	350,183	33,097	9.5%
Lease expense	15,700	13,682	2,018	14.7%	15,700	13,682	2,018	14.7%
Depreciation and amortization	106,091	75,135	30,956	41.2%	50,274	49,242	1,032	2.1%
Corporate expenses	30,179	25,383	4,796	18.9%				
Other charges	7,372		7,372	100.0%				
<b>Total operating costs and expenses</b>	<b>877,587</b>	<b>631,754</b>	<b>245,833</b>	<b>38.9%</b>	<b>449,254</b>	<b>413,107</b>	<b>36,147</b>	<b>8.8%</b>
<b>Operating income</b>	<b>130,405</b>	<b>86,833</b>	<b>43,572</b>	<b>50.2%</b>	<b>\$ 98,055</b>	<b>\$ 81,702</b>	<b>\$ 16,353</b>	<b>20.0%</b>
Interest expense, net	(86,131)	(47,012)	(39,119)	83.2%				
Loss on early extinguishment of debt	(10,268)	(2,150)	(8,118)	377.6%				
Equity in earnings (losses) of joint ventures	8,344	(1,066)	9,410	882.7%				
Foreign currency exchange (loss) gain	(3,701)	756	(4,457)	589.6%				
Other (expenses) income, net	(584)	3,596	(4,180)	116.2%				
<b>Income before income taxes, minority interests, gain on sale of minority interests in hotel properties and discontinued operations</b>	<b>38,065</b>	<b>40,957</b>	<b>(2,892)</b>	<b>7.1%</b>				
Income tax expense	(9,714)	(3,946)	(5,768)	146.2%				
Minority interests	(1,776)	(1,504)	(272)	18.1%				
<b>Income before gain on sale of minority interests in hotel properties and discontinued operations</b>	<b>26,575</b>	<b>35,507</b>	<b>(8,932)</b>	<b>25.2%</b>				
Gain on sale of minority interests in hotel properties	84,658		84,658	100.0%				
<b>Income from continuing operations</b>	<b>111,233</b>	<b>35,507</b>	<b>75,726</b>	<b>213.3%</b>				
(Loss) income from discontinued operations, net of tax and minority interests	(42,075)	84,622	(126,697)	149.7%				
<b>Net income</b>	<b>\$ 69,158</b>	<b>\$ 120,129</b>	<b>\$ (50,971)</b>	<b>42.4%</b>				

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<b>Reconciliation of Same Store Assets Operating Income to Operating Income:</b>				
Same Store Assets operating income	\$ 98,055	\$ 81,702	\$ 16,353	20.0%
Corporate expenses	(30,179)	(25,383)	(4,796)	18.9%
Corporate depreciation and amortization	(585)	(227)	(358)	157.7%
Other charges	(7,372)		(7,372)	100.0%
Non-Same Store Assets operating income	70,486	30,741	39,745	129.3%
<b>Operating income</b>	<b>\$ 130,405</b>	<b>\$ 86,833</b>	<b>\$ 43,572</b>	<b>50.2%</b>

**Operating Data(1):**

Number of hotels	19	18	12	12
Number of rooms	8,287	8,137	5,110	5,079

(1) Operating data includes leased properties and excludes unconsolidated joint ventures and properties included in discontinued operations.

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During the fourth quarter of 2007, we sold one hotel property and in the third quarter of 2006, we sold two hotels. The results of operations for these sold hotels are included in (loss) income from discontinued operations for the years ended December 31, 2007 and 2006.

**Operating Income.** Operating income for the Total Portfolio increased \$43.6 million, or 50.2%. This increase in operating income is primarily due to the following:

- (a) a \$16.4 million increase attributable to the Same Store Assets as described below;
- (b) a \$9.0 million increase attributable to the Fairmont Scottsdale Princess, which we purchased in September 2006;
- (c) a \$8.9 million increase attributable to the Marriott London Grosvenor Square, which we purchased in August 2006;
- (d) a \$7.3 million increase attributable to the Westin St. Francis, which we purchased in June 2006;
- (e) a \$7.0 million increase attributable to the InterContinental Prague, as we purchased our joint venture partner's 65% interest in August 2006 and began consolidating the operating results of the hotel;
- (f) a \$6.1 million increase attributable to the Ritz-Carlton Laguna Niguel, which we purchased in July 2006;
- (g) a \$0.8 million increase attributable to the Four Seasons Washington, D.C., which we purchased in March 2006; and
- (h) a \$0.5 million increase attributable to the Hotel Le Parc, which we purchased in July 2007; partially offset by
- (i) a \$7.4 million charge related to the write-off of previously deferred costs related to our decision to abandon the planned public listing of our European hotel assets; and
- (j) a \$4.8 million increase in corporate expenses as described below.

The events mentioned above have had a significant impact on our overall operations, including increases in both revenue and operating expenses; therefore, we believe that an analysis of changes in each line item comprising the Total Portfolio hotel operating income is not meaningful in addressing the factors that drive year over year operating results. A more relevant approach is to analyze the changes in hotel operating income of the Same Store Assets for the years ended December 31, 2007 and 2006, as described below.

**Rooms.** For the Total Portfolio, rooms revenue increased \$151.1 million, or 39.7%. A significant factor related to the overall portfolio rooms revenue increase is the acquisition of new properties. In addition, RevPAR from our Total Portfolio excluding leased properties and unconsolidated joint ventures for the year ended December 31, 2007 increased by 10.6% from the year ended December 31, 2006. The components of RevPAR from our Total Portfolio excluding leased properties and unconsolidated joint ventures for the years ended December 31, 2007 and 2006 are summarized as follows:

<b>Years Ended December 31,</b>	
<b>2007</b>	<b>2006</b>

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Occupancy	75.4%	74.0%
Average daily rate	\$ 249.89	\$ 230.21
RevPAR	\$ 188.35	\$ 170.28



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For the Same Store Assets, rooms revenue increased \$26.3 million, or 10.0%. RevPAR from our Same Store Assets excluding leased properties for the year ended December 31, 2007 increased by 9.5% from the year ended December 31, 2006. The components of RevPAR from our Same Store Assets excluding leased properties for the years ended December 31, 2007 and 2006 are summarized as follows:

	Years Ended December 31,	
	2007	2006
Occupancy	74.9%	72.6%
Average daily rate	\$ 229.63	\$ 216.47
RevPAR	\$ 172.05	\$ 157.15

The 9.5% increase in RevPAR for the Same Store Assets excluding leased properties resulted from a 2.3 percentage-point increase in occupancy and a 6.1% increase in the average daily rate. Significant RevPAR increases within the Same Store Assets were noted at the Four Seasons Mexico City with a 22.2% increase and the InterContinental Miami with a 15.8% increase. At the Four Seasons Mexico City, the increase in RevPAR was due to political unrest and protests surrounding Mexico's presidential election that decreased the hotel's 2006 RevPAR, in addition to a significant increase in transient demand during 2007 which allowed the hotel to yield a higher rate. The increase at the InterContinental Miami hotel was attributed to the City of Miami hosting the Superbowl in February 2007, two large bi-annual groups, and no serious hurricane threats during the year, all of which increased occupancy by approximately four percentage points and average daily rate by approximately 9.6% at this property.

**Food and Beverage.** For the Total Portfolio, food and beverage revenue increased \$98.5 million, or 40.4%, which was primarily due to the acquisition of hotels. For the Same Store Assets, food and beverage revenue increased \$16.8 million, or 10.3%. This Same Store increase is primarily driven by the increase in food and beverage revenue of 22.2% at the InterContinental Miami, 21.9% at the Four Seasons Punta Mita Resort and 18.9% at the InterContinental Chicago.

Most of the food and beverage increase at the InterContinental Miami was due to group occupied rooms increasing by approximately 14.9% which increased banquet revenues by \$3.2 million, or 28.1%. The Four Seasons Punta Mita Resort expanded by 28 rooms in 2007 and total occupied rooms increased by approximately 8.8%. This resulted in increased usage of the food and beverage outlets. In addition, a new restaurant opened in late 2006, which contributed \$2.2 million in revenues. At the InterContinental Chicago, group occupied rooms increased by 8.0%, which resulted in an increase in banquet revenues of \$2.5 million, or 14.5%. Additionally, the hotel opened a wine room, which contributed \$1.3 million in additional food and beverage revenue.

**Other Hotel Operating Revenue.** For the Total Portfolio, other hotel operating revenue increased \$36.7 million, or 50.1%, which was primarily due to the acquisition of hotels. The significant other operating revenues generated by these acquired properties during the year ended December 31, 2007 include spa and health club revenue of approximately \$7.7 million, cancellation fees of approximately \$3.7 million, gift shop revenue of approximately \$3.1 million, garage parking revenue of approximately \$2.8 million, recreation revenue of approximately \$2.8 million, telephone services revenue of approximately \$2.0 million, space rental revenue of \$1.9 million, laundry revenue of approximately \$0.3 million and other incidental hotel services such as in house movies of approximately \$0.2 million. Additionally, we recognized \$0.9 million related to a performance guarantee at the Hotel Le Parc for the year ended December 31, 2007.

For the Same Store Assets, other hotel operating revenue increased \$6.3 million, or 13.3%. Approximately \$3.6 million of the increase relates to retail revenue generated from four new boutiques that opened in late 2006, cancellation fees, commissions related to the villa rental program and spa revenue at the Four Seasons Punta Mita Resort. Other hotel operating revenue increased \$1.1 million at the InterContinental Chicago primarily due to cancellation fees and \$1.0 million at the Marriott Lincolnshire primarily due to theatre revenue.

**Lease Revenue.** For the Total Portfolio and Same Store Assets, lease revenue increased 15.5%. The increase in the lease revenue was driven by a 17.1% increase in ADR at the Paris Marriott. The strong performance at the

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Paris Marriott resulted in higher lease revenue because, in accordance with our lease agreements, we earn an annual base rent plus additional rent contingent on the hotel meeting performance thresholds.

**Hotel Operating Expenses.** The following table presents the components of our hotel operating expenses for the years ended December 31, 2007 and 2006, including the amount and percentage changes in these expenses between the two periods (in thousands).

	Total Portfolio				Same Store Assets			
	2007	2006	Change(\$)	Change(%)	2007	2006	Change(\$)	Change(%)
<b>Hotel operating expenses:</b>								
Rooms	\$ 130,784	\$ 94,764	\$ 36,020	38.0%	\$ 69,040	\$ 64,607	\$ 4,433	6.9%
Food and beverage	231,407	170,054	61,353	36.1%	119,788	113,098	6,690	5.9%
Other departmental expenses	248,815	181,436	67,379	37.1%	134,729	125,629	9,100	7.2%
Management fees	39,264	26,774	12,490	46.6%	20,122	16,302	3,820	23.4%
Other hotel expenses	67,975	44,526	23,449	52.7%	39,601	30,547	9,054	29.6%
<b>Total hotel operating expenses</b>	<b>\$ 718,245</b>	<b>\$ 517,554</b>	<b>\$ 200,691</b>	<b>38.8%</b>	<b>\$ 383,280</b>	<b>\$ 350,183</b>	<b>\$ 33,097</b>	<b>9.5%</b>

For the Total Portfolio, hotel operating expenses increased \$200.7 million, or 38.8%. For the Same Store Assets, hotel operating expenses increased \$33.1 million, or 9.5%. The Same Store increase in hotel operating expenses is primarily related to an increase in salaries, wages and related benefits (\$8.1 million), base and incentive management fees (\$3.8 million) primarily due to increases in base management fee percentages at certain of our hotels in addition to increased revenues, cost of food and beverage (\$2.2 million), insurance (\$2.0 million), credit card commissions (\$1.6 million), utilities (\$1.3 million), real estate taxes (\$0.8 million), expenses related to the Four Seasons Punta Mita Resort villa rental program (\$0.8 million), travel agent commissions (\$0.7 million), marketing costs (\$0.6 million), laundry and dry cleaning (\$0.4 million) and customer loyalty incentives (\$0.4 million).

The increase also includes a \$1.2 million write-off of deferred costs related to a potential condominium-hotel project at the Fairmont Chicago. The project was delayed indefinitely during the third quarter of 2007 due to market conditions. In addition, we recognized a charge of approximately \$1.8 million related to the termination of a sublease arrangement at the Paris Marriott whereby we lease our interest in the hotel to a third party. During the third quarter 2007, we determined that we would terminate this sublease arrangement and enter into a management agreement directly with Marriott beginning January 1, 2008. Therefore, effective in January 2008, we will consolidate the hotel operating revenues and expenses in our consolidated statements of operations.

**Depreciation and Amortization.** For the Total Portfolio, depreciation and amortization increased \$31.0 million, or 41.2%, for the year ended December 31, 2007 when compared to the same period in 2006 primarily due to the acquisitions of new hotels.

**Corporate Expenses.** Corporate expenses increased \$4.8 million, or 18.9% for the year ended December 31, 2007 compared to the same period in 2006. These expenses consist primarily of payroll and related costs, professional fees, travel expenses and office rent. The overall increase in corporate expenses is primarily attributable to:

a \$1.8 million increase in audit and accounting and tax fees related to the increased size of the hotel portfolio;

a \$1.7 million increase in payroll and related costs primarily due to an increase in share-based employee compensation expense of \$1.1 million; and

a \$1.0 million increase in consulting fees, which primarily relate to the implementation of a new capital projects management and accounting system.

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**Other Charges.** During the year ended December 31, 2007, we recorded a charge of \$7.4 million to write off previously deferred costs related to our decision to abandon the planned public listing of our European hotel assets.

**Interest Expense, Net.** The \$39.1 million, or 83.2%, increase in interest expense, net for the year ended December 31, 2007 as compared to the year ended 2006 was primarily due to:

a \$41.8 million increase attributable to higher average borrowings;

a \$3.0 million increase in amortization of deferred financing costs; and

a \$1.2 million decrease in interest income; partially offset by

a \$4.1 million decrease due to lower average rates; and

a \$2.7 million increase in capitalized interest.

The components of interest expense, net for the years ended December 31, 2007 and 2006 are summarized as follows (in thousands):

	<b>Years Ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
Mortgage and other debt	\$ (76,210)	\$ (48,231)
Bank credit facility	(9,107)	(4,206)
Exchangeable senior notes	(4,781)	
Amortization of deferred financing costs	(4,713)	(1,749)
Interest income	2,775	3,961
Capitalized interest	5,905	3,213
<b>Total interest expense, net</b>	<b>\$ (86,131)</b>	<b>\$ (47,012)</b>

The weighted average debt outstanding for the years ended December 31, 2007 and 2006 amounted to \$1.6 billion and \$852.1 million, respectively, and the weighted average interest rates, including the effect of interest rate swaps, were 5.67% and 6.15%. At December 31, 2007, including the effect of interest rate swaps, 18.9% of our total debt had variable interest rates and 81.1% had fixed interest rates.

**Loss on Early Extinguishment of Debt.** There was a loss of early extinguishment of debt of \$10.3 million for the year ended December 31, 2007. Approximately \$5.9 million of the loss was driven by costs related to the defeasance of a fixed rate portfolio on August 23, 2007. Approximately \$3.0 million resulted from the prepayment premium and the write-off of unamortized deferred financing costs related to the March 9, 2007 repayment of a floating rate loan portfolio secured by six hotel properties. Another \$0.8 million related to the unamortized deferred financing costs written off in conjunction with the March 9, 2007 refinancing of the bank credit facility.

On October 6, 2006, we refinanced the debt related to the InterContinental Miami and Chicago hotels and wrote off the applicable unamortized deferred financing costs. This write-off, as well as a prepayment penalty, amounted to \$2.2 million, which has been reported as loss on early extinguishment of debt in the consolidated statement of operations for the year ended December 31, 2006.

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**Equity in Earnings (Losses) of Joint Ventures.** The following tables present equity in earnings (losses) and certain components included in the calculation of equity in earnings (losses) resulting from our unconsolidated joint ventures.

Year ended December 31, 2007 (in thousands):

	<b>Hotel del Coronado/North Beach Ventures</b>	<b>Residence Club Punta Mita</b>	<b>Buy Efficient</b>	<b>Total</b>
Equity in earnings	\$ 8,075	\$ 231	\$ 38	\$ 8,344
Depreciation	6,844			6,844
Interest	20,943	247		21,190
Income tax	2,520	49		2,569

Year ended December 31, 2006 (in thousands):

	<b>InterContinental Prague</b>	<b>Hotel del Coronado/North Beach Ventures</b>	<b>Residence Club Punta Mita</b>	<b>Total</b>
Equity in earnings (losses)	\$ 222	\$ (1,776)	\$ 488	\$ (1,066)
Depreciation	1,126	5,151		6,277
Interest	793	19,305	164	20,262
Income tax	302	400	191	893

During the years ended December 31, 2007 and 2006, we recorded \$8.3 million of equity in earnings and \$1.1 million of equity in losses, respectively, related to joint ventures. The significant increase in equity in earnings (losses) is primarily due to the sale of residential condominium-hotel units which were completed by the North Beach Venture, a development adjacent to the Hotel del Coronado, during 2007.

**Foreign Currency Exchange (Loss) Gain.** Foreign currency exchange (loss) gain was a \$3.7 million loss for the year ended December 31, 2007 compared to a \$0.8 million gain for the year ended December 31, 2006. The decrease is primarily related to a \$5.3 million loss on a Euro-denominated mortgage loan applicable to the Inter Continental Prague hotel, which became a consolidated entity in August 2006 partially offset by a \$1.6 million gain on a loan related to the Marriott London Grosvenor Square hotel.

**Other (Expenses) Income, Net.** Other (expenses) income, net includes asset management fees, non-income related state, local and franchise taxes, as well as other miscellaneous income and expenses. The decrease of \$4.2 million is primarily attributable to:

\$1.9 million of asset management fees earned in 2006 under an agreement with SHC LLC that was terminated in November 2006;

\$1.1 million in asset management fees resulting from a financing fee earned in 2006 relating to an asset management agreement with the Hotel del Coronado and North Beach joint ventures;

a \$0.9 million increase in state and local taxes; and

a \$0.4 million decrease in asset management fees resulting from fees earned on the Paris Marriott.

**Income Tax Expense.** Beginning in our 2004 tax year, we made an election to qualify as a REIT under Sections 856 through 860 of the 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

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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 TRSs is subject to U.S. federal, state and local income taxes. Also, the foreign countries where we have operations do not recognize REITs under their respective tax law. Accordingly, we recognize income taxes for these jurisdictions in accordance with GAAP.

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Income tax expense increased to \$9.7 million for the year ended December 31, 2007 from \$3.9 million for the year ended December 31, 2006. The increase is primarily due to income tax expense related to residential sales at the North Beach Venture, a development adjacent to the Hotel del Coronado, and an increase in current tax expense as a result of consolidating InterContinental Prague for the entire year in 2007 compared to five months in 2006 due to our purchase of our joint venture partner's 65% interest in the entity that owns the InterContinental Prague in August 2006. This increase in income tax expense was partially offset by an increase in the deferred tax benefit at the InterContinental Prague due to the enactment of lower tax rates effective after January 1, 2008.

**Minority Interests.** We record minority interest income or expense based on the percentage of SH Funding we do not own. In addition, we record minority interest for the non-ownership interests in hotels that are partially owned by us. Minority interest (excluding discontinued operations) in SH Funding decreased to a \$0.4 million expense for the year ended December 31, 2007 from a \$0.7 million expense for the year ended December 31, 2006.

Minority interest in consolidated affiliates increased to a \$1.4 million expense for the year ended December 31, 2007 from a \$0.8 million expense for the year ended December 31, 2006. The change reflects the effect of the sale of 49% minority interests in the InterContinental Chicago and Hyatt Regency La Jolla hotels in 2007, offset by a reduction due to the acquisition of the remaining minority interest in the InterContinental Miami hotel in 2007.

**Gain on Sale of Minority Interests in Hotel Properties.** On August 31, 2007, we sold a 49% interest in each of the InterContinental Chicago and Hyatt Regency La Jolla hotels. We recognized a gain on the sale of approximately \$84.7 million during the year ended December 31, 2007.

**(Loss) Income from Discontinued Operations.** We sold one hotel in the fourth quarter of 2007 and two hotels in the third quarter of 2006. We reclassified the results of operations for these hotels as discontinued operations for the years ended December 31, 2007 and 2006. (Loss) income from discontinued operations amounted to \$(42.1) million and \$84.6 million for the years ended December 31, 2007 and 2006, respectively. The income from discontinued operations in 2006 includes the gain of \$88.9 million recognized from the sale of the two hotels.

**Table of Contents****Comparison of Year Ended December 31, 2006 to Year Ended December 31, 2005****Operating Results**

The following table presents the operating results for the years ended December 31, 2006 and 2005, including the amount and percentage change in these results between the two periods of our Total Portfolio and Same Store Assets, as defined on page 28. Our Total Portfolio represents the results of operations included in the consolidated statements of operations (in thousands, except operating data).

	Total Portfolio				Same Store Assets			
	2006	2005	Change (\$)	Change (%)	2006	2005	Change (\$)	Change (%)
<b>Revenues:</b>								
Rooms	\$ 381,019	\$ 201,036	\$ 179,983	89.5%	\$ 150,299	\$ 137,202	\$ 13,097	9.5%
Food and beverage	244,007	131,513	112,494	85.5%	101,567	94,991	6,576	6.9%
Other hotel operating revenue	73,304	40,195	33,109	82.4%	37,887	35,895	1,992	5.5%
	698,330	372,744	325,586	87.3%	289,753	268,088	21,665	8.1%
Lease revenue	20,257	16,787	3,470	20.7%	20,257	16,787	3,470	20.7%
<b>Total revenues</b>	<b>718,587</b>	<b>389,531</b>	<b>329,056</b>	<b>84.5%</b>	<b>310,010</b>	<b>284,875</b>	<b>25,135</b>	<b>8.8%</b>
<b>Operating Costs and Expenses:</b>								
Hotel operating expenses	517,554	277,855	239,699	86.3%	215,998	204,260	11,738	5.7%
Lease expense	13,682	13,178	504	3.8%	13,682	13,178	504	3.8%
Depreciation and amortization	75,135	39,797	35,338	88.8%	27,111	26,787	324	1.2%
Corporate expenses	25,383	21,023	4,360	20.7%				
<b>Total operating costs and expenses</b>	<b>631,754</b>	<b>351,853</b>	<b>279,901</b>	<b>79.6%</b>	<b>256,791</b>	<b>244,225</b>	<b>12,566</b>	<b>5.1%</b>
Operating income	86,833	37,678	49,155	130.5%	\$ 53,219	\$ 40,650	\$ 12,569	30.9%
Interest expense, net	(47,012)	(27,523)	(19,489)	70.8%				
Loss on early extinguishment of debt	(2,150)	(6,540)	4,390	67.1%				
Equity in (losses) earnings of joint ventures	(1,066)	2,818	(3,884)	137.8%				
Foreign currency exchange gain	756	68	688	1,011.8%				
Other income, net	3,596	5,431	(1,835)	33.8%				
Income before income taxes, minority interests and discontinued operations	40,957	11,932	29,025	243.3%				
Income tax expense	(3,946)	(4,687)	741	15.8%				
Minority interests	(1,504)	(1,949)	445	22.8%				
Income from continuing operations	35,507	5,296	30,211	570.4%				
Income from discontinued operations, net of tax and minority interests	84,622	24,964	59,658	239.0%				
<b>Net income</b>	<b>\$ 120,129</b>	<b>\$ 30,260</b>	<b>\$ 89,869</b>	<b>297.0%</b>				
<b>Reconciliation of Same Store Assets Operating Income to Operating Income:</b>								
Same Store Assets operating income					\$ 53,219	\$ 40,650	\$ 12,569	30.9%
Corporate expenses					(25,383)	(21,023)	(4,360)	20.7%
Corporate depreciation and amortization					(227)	(137)	(90)	65.7%
Non-Same Store Assets operating income					59,224	18,188	41,036	225.6%
<b>Operating Income</b>					<b>\$ 86,833</b>	<b>\$ 37,678</b>	<b>\$ 49,155</b>	<b>130.5%</b>

**Operating Data(1):**

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Number of hotels	18	12	9	9
Number of rooms	8,137	5,097	2,961	2,957

(1) Operating data includes leased properties and excludes unconsolidated joint ventures and properties included in discontinued operations.



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During the fourth quarter of 2007, we sold one hotel property. In the third quarter of 2006, we sold two hotels and, in October 2005, we sold two hotels. The results of operations for these hotels are included in income from discontinued operations for the years ended December 31, 2006 and 2005.

**Operating Income.** Operating income for the Total Portfolio increased \$49.2 million, or 130.5%. This increase in operating income is due to the following events:

- (a) a \$12.6 million increase attributable to the Same Store Assets as described below;
- (b) a \$7.9 million increase attributable to Westin St. Francis, which we purchased in June 2006;
- (c) a \$7.2 million increase attributable to the InterContinental Chicago and InterContinental Miami, which we purchased in April 2005;
- (d) a \$5.7 million increase attributable to the Ritz-Carlton Laguna Niguel, which we purchased in July 2006;
- (e) a \$5.4 million increase attributable to the Four Seasons Washington, D.C., which we purchased in March 2006;
- (f) a \$4.3 million increase attributable to the Marriott Grosvenor Square, which we purchased in August 2006;
- (g) a \$4.0 million increase attributable to the InterContinental Prague, as we purchased our joint venture partner's 65% interest in August 2006 and began consolidating the operating results of the InterContinental Prague;
- (h) a \$3.6 million increase attributable to the Fairmont Scottsdale Princess, which we purchased in September 2006; and
- (i) a \$3.1 million increase attributable to the Fairmont Chicago, which we purchased in September 2005; partially offset by
- (j) a \$4.4 million increase in corporate expenses as described below.

The events mentioned above have had a significant impact on our overall operations, including increases in both revenue and operating expenses; therefore, we believe that an analysis of changes in each line item comprising the Total Portfolio hotel operating income is not meaningful in addressing the factors that drive year over year operating results. A more relevant approach is to analyze the changes in hotel operating income of the Same Store Assets for the years ended December 31, 2006 and 2005, as described below.

**Rooms.** For the Total Portfolio, rooms revenue increased \$180.0 million, or 89.5%. Approximately \$166.9 million of the increase in Total Portfolio rooms revenue was due to the acquisition of properties during 2006 and 2005. RevPAR from our Total Portfolio, excluding leased properties and unconsolidated joint ventures, for the year ended December 31, 2006 increased by 17.8% from the year ended December 31, 2005. The components of RevPAR from our Total Portfolio, excluding leased properties and unconsolidated joint ventures, for the years ended December 31, 2006 and 2005 are summarized as follows:

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	Years Ended December 31,	
	2006	2005
Occupancy	74.0%	71.9%
Average daily rate	\$ 230.21	\$ 201.21
RevPAR	\$ 170.28	\$ 144.61

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For the Same Store Assets, rooms revenue increased \$13.1 million, or 9.5% in 2006 when compared 2005. RevPAR from our Same Store Assets, excluding leased properties, for the year ended December 31, 2006 increased 9.4% from the year ended December 31, 2005. The components of RevPAR from our Same Store Assets for the year ended December 31, 2006 and 2005 are summarized as follows:

	Years Ended December 31,	
	2006	2005
Occupancy	71.0%	70.7%
Average daily rate	\$ 232.89	\$ 213.69
RevPAR	\$ 165.32	\$ 151.16

The 9.4% increase in RevPAR for the Same Store Assets resulted from a 0.3 percentage-point increase in occupancy and a 9.0% increase in the average daily rate. Significant RevPAR increases within Same Store Assets were noted at the Four Seasons Punta Mita with a 16.7% increase and the Hyatt Regency La Jolla with an 11.5% increase.

A combination of improved rates and the opening of several beachfront suites at the Four Seasons Punta Mita resulted in the resort's ADR increasing by 16.4% in 2006 over 2005. Demand at the hotel also increased by nearly 3.6% as travel to the west coast of Mexico continued to grow.

Demand in the San Diego market grew faster than the national average. The Hyatt Regency La Jolla leveraged this increased demand to eliminate many discounted transient segments, which increased the hotel's ADR by 10.1%.

**Food and Beverage.** For the Total Portfolio, food and beverage revenue increased \$112.5 million, or 85.5% primarily due to the acquisition of hotels. For the Same Store Assets, food and beverage revenue increased \$6.6 million, or 6.9%. This Same Store increase is primarily driven by the increase of \$2.5 million in food and beverage revenue at the Ritz-Carlton Half Moon Bay, \$1.7 million at the Marriott Lincolnshire and \$0.8 million at the Four Seasons Punta Mita.

Most of the food and beverage increase at the Ritz-Carlton Half Moon Bay was due to additional banquet revenue resulting from a 7.1% increase in group rooms. As a defensive strategy in response to new competition in its market, the Marriott Lincolnshire increased group business in 2006, which drove additional banquet revenue at the hotel. The increased occupancy at the Four Seasons Punta Mita resulted in an increase in volume in the resort's restaurants and bars.

**Other Hotel Operating Revenue.** For the Total Portfolio, other hotel operating revenue increased \$33.1 million, or 82.4%, primarily as a result of hotel acquisitions. The significant other operating revenues generated by these newly acquired properties during the year ended December 31, 2006 include spa and health club revenue of approximately \$6.7 million, garage parking revenue of approximately \$5.5 million, rental income of \$4.6 million and other incidental hotel services such as internet access of \$2.3 million. For the Same Store Assets, other hotel operating revenue increased \$2.0 million, or 5.5%.

**Lease Revenue.** For the Total Portfolio and Same Store Assets, lease revenue increased 20.7%. Lease revenue for the years ended December 31, 2006 and 2005 included lease revenue from the Paris Marriott and the Marriott Hamburg. In accordance with the lease agreements, we earn an annual base rent plus additional rent contingent on meeting performance thresholds. During 2006, hotel operations improved at both of these hotels allowing us to recognize additional lease revenue, which was not recognized in the prior year. The improved performance of the Paris Marriott was due to the Paris market enjoying both strong demand and ADR growth in 2006, which resulted in overall RevPAR increasing 17.0%. The Paris Marriott RevPAR growth was consistent with the market. The World Cup Games in May, June and July 2006 resulted in RevPAR growth of 22% in the Hamburg market, with the Marriott Hamburg achieving RevPAR growth of 24.2%.

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**Hotel Operating Expenses.** The following table presents the components of our hotel operating expenses for the years ended December 31, 2006 and 2005, including the amount and percentage changes in these expenses between the two periods (in thousands).

	Total Portfolio				Same Store Assets			
	2006	2005	Change(\$)	Change(%)	2006	2005	Change(\$)	Change(%)
<b>Hotel operating expenses:</b>								
Rooms	\$ 94,764	\$ 47,520	\$ 47,244	99.4%	\$ 33,039	\$ 30,446	\$ 2,593	8.5%
Food and beverage	170,054	91,754	78,300	85.3%	72,310	68,435	3,875	5.7%
Other departmental expenses	181,436	104,388	77,048	73.8%	82,875	79,174	3,701	4.7%
Management fees	26,774	11,713	15,061	128.6%	10,373	10,277	96	0.9%
Other hotel expenses	44,526	22,480	22,046	98.1%	17,401	15,928	1,473	9.2%
<b>Total hotel operating expenses</b>	<b>\$ 517,554</b>	<b>\$ 277,855</b>	<b>\$ 239,699</b>	<b>86.3%</b>	<b>\$ 215,998</b>	<b>\$ 204,260</b>	<b>\$ 11,738</b>	<b>5.7%</b>

For the Total Portfolio, hotel operating expenses increased \$239.7 million, or 86.3%. For the Same Store Assets, hotel operating expenses increased \$11.7 million, or 5.7%. The Same Store increase in hotel operating expenses was primarily related to an increase in salaries, wages and related benefits (\$4.5 million), cost of food and beverage (\$0.9 million), sales and marketing (\$0.8 million), insurance (\$0.7 million), utilities (\$0.7 million), travel agent commissions (\$0.6 million), laundry and linens (\$0.5 million), credit card commissions (\$0.4 million), contract services (\$0.4 million) and travel and entertainment (\$0.4 million).

Demand for labor in the Same Store markets resulted in an increase in average wages and benefits paid to employees. Increases in sales and marketing, travel agent commissions, credit card commissions and laundry and linens were the result of increased revenue volume. Property and earthquake insurance premiums have risen at all properties.

**Depreciation and Amortization.** For the Total Portfolio, depreciation and amortization increased 88.8%, for the year ended December 31, 2006 as compared to the same period in 2005. The increase is attributable to the acquisitions of new hotels during 2006.

**Corporate Expenses.** Corporate expenses increased \$4.4 million, or 20.7% for the year ended compared to the same period in 2005. These expenses consist primarily of payroll and related costs, share-based employee compensation expense, professional fees, travel expenses and office rent. The overall increase in corporate expenses is in accordance with the growth of our hotel portfolio in 2006 and is primarily attributable to:

a \$2.2 million increase in payroll expenses due to an increase in the number of corporate employees;

a \$1.6 million increase related to share-based compensation expense;

a \$1.5 million increase related to legal, audit and consulting fees;

a \$0.7 million increase related to travel expenses; and

a \$0.6 million increase related to severance expense; partially offset by

a \$1.3 million decrease in professional fees primarily applicable to Sarbanes Oxley requirements.

**Interest Expense, Net.** The \$19.5 million increase in interest expense, net for the year ended December 31, 2006 as compared to the year ended 2005 was due to:

a \$22.5 million increase attributable to higher average borrowings; and

a \$2.7 million increase due to higher average rates; partially offset by

a \$2.9 million increase in capitalized interest;

a \$2.0 million increase in interest income;

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a \$0.7 million decrease in amortization of deferred financing costs; and

a \$0.1 million decrease related to the mark-to-market of derivative instruments.

The components of interest expense, net for the years ended December 31, 2006 and 2005 are summarized as follows (in thousands):

	Years ended December 31,	
	2006	2005
Mortgage and other debt	\$ (48,231)	\$ (24,534)
Bank credit facility	(4,206)	(2,702)
Amortization of deferred financing costs	(1,749)	(2,459)
Mark-to-market of derivative instruments		(104)
Interest income	3,961	1,940
Capitalized interest	3,213	336
<b>Total interest expense, net</b>	<b>\$ (47,012)</b>	<b>\$ (27,523)</b>

The weighted average debt outstanding for the years ended December 31, 2006 and 2005 amounted to \$852.1 million and \$486.5 million, respectively, and the weighted average interest rates, including the effect of interest rate swaps, were 6.15% and 5.60%. At December 31, 2006 including the effect of interest rate swaps, 31.1% of our total debt had variable interest rates and 68.9% had fixed interest rates.

**Loss on Early Extinguishment of Debt.** On October 6, 2006, we refinanced the debt related to the InterContinental Miami and Chicago hotels and wrote off the applicable unamortized deferred financing costs. This write-off, as well as a prepayment penalty, amounted to \$2.2 million, which has been reported as a loss on early extinguishment of debt in the consolidated statement of operations for the year ended December 31, 2006.

On November 9, 2005, we replaced a \$175.0 million bank credit agreement and wrote off the applicable unamortized deferred financing costs. This write-off, which amounted to \$2.2 million, has been reported as loss on early extinguishment of debt in the consolidated statement of operations for the year ended December 31, 2005.

On November 9, 2005, we repaid 2004 floating rate mortgage loan financings. In connection with the repayment, we sold the related caps and wrote off the unamortized deferred financing costs applicable to issuing this debt. This amounted to \$5.9 million and has been reported as loss on early extinguishment of debt (\$4.3 million) and income from discontinued operations (\$1.6 million) in the consolidated statement of operations for the year ended December 31, 2005.

**Equity in (Losses) Earnings of Joint Ventures.** The following tables present equity in (losses) earnings and certain components included in the calculation of equity in (losses) earnings resulting from our unconsolidated joint ventures.

Year ended December 31, 2006 (in thousands):

	InterContinental Prague	Hotel del Coronado/North Beach Ventures	Residence Club Punta Mita	Total
Equity in earnings (losses)	\$ 222	\$ (1,776)	\$ 488	\$ (1,066)
Depreciation	1,126	5,151		6,277
Interest	793	19,305	164	20,262
Income tax	302	400	191	893

Year ended December 31, 2005 (in thousands):

**Total**

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	<b>InterContinental Prague</b>	<b>Residence Club Punta Mita</b>	
Equity in earnings (losses)	\$ 2,931	\$ (113)	\$ 2,818
Depreciation	2,096		2,096
Interest	1,337		1,337
Income tax	774	(40)	734

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During the years ended December 31, 2006 and 2005, we recorded \$1.1 million of equity in losses and \$2.8 million of equity in earnings, respectively. As a result of acquiring our joint venture partner's 65% interest in the entity that owns InterContinental Prague in August 2006, equity in earnings at the InterContinental Prague decreased \$2.7 million. Additionally, in January 2006, we acquired a 45% joint venture ownership interest in the Hotel del Coronado and North Beach Ventures and recorded \$1.8 million of equity in losses from these joint ventures.

**Foreign Currency Exchange Gain.** Foreign currency exchange gain increased \$0.7 million for the year ended December 31, 2006 compared to the year ended December 31, 2005. The increase was primarily driven by the \$0.6 million gain on a Euro-denominated mortgage loan applicable to the InterContinental Prague, which became a consolidated entity in August 2006.

**Other Income, Net.** Other income, net includes asset management fees, non-income related state, local and franchise taxes, as well as other miscellaneous income and expenses. The net decrease of \$1.8 million is primarily attributable to the following factors:

We had an asset management agreement with SHC LLC that commenced on June 29, 2004, under which we managed the day-to-day business of SHC LLC and its hotels for an initial annual fee of \$5.0 million. SHC LLC sold three properties in 2005 and three properties in 2006. As a result of the disposition of these properties, the asset management fee was reduced. On November 15, 2006, SHC LLC terminated the agreement. During the years ended December 31, 2006 and 2005, we recognized \$1.9 million and \$5.0 million, respectively, of asset management fees from SHC LLC, which are included in other income, net in the accompanying statements of operations. The \$1.9 million recognized in the year ended December 31, 2006 included a termination fee of \$0.25 million.

SHR earns fees under an asset management agreement with the Hotel del Coronado and North Beach joint ventures. SHR recognized income of 55% of these fees, representing the percentage of the venture not owned by SHR. For the year ended December 31, 2006, we recognized fees of \$2.2 million.

We had non-income related state, local and franchise taxes of \$1.6 million and \$1.0 million for the years ended December 31, 2006 and 2005, respectively.

**Income Tax Expense.** Beginning in our 2004 tax year, we made an election to qualify as a REIT under Sections 856 through 860 of the 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 recognize REITs under their respective tax law. Accordingly, we recognize income taxes for these jurisdictions in accordance with GAAP.

	2006	2005
Current tax (expense) benefit:		
Europe	\$ (25)	\$ 1,659
Mexico	(4,455)	(3,364)
	(4,480)	(1,705)
Deferred tax benefit (expense):		
Europe	(1,029)	(1,307)
Mexico	1,420	(86)
United States	143	(1,589)
	534	(2,982)
Total income tax expense	\$ (3,946)	\$ (4,687)





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**Income from Discontinued Operations.** During the fourth quarter of 2007, we sold one hotel property. In the third quarter of 2006, we sold two hotels and, in October 2005, we sold two hotels. We reclassified the results of operations for these hotels as discontinued operations for the years ended December 31, 2006 and 2005. Income from discontinued operations amounted to \$84.6 million and \$25.0 million for the years ended December 31, 2006 and 2005, respectively. The increase of \$59.7 million in income from discontinued operations is primarily due to the gain of \$88.9 million on sale of the two hotels sold in the third quarter of 2006 compared to the gain of \$21.2 million on sale of the hotels in 2005. These gains were partially offset by the losses on properties in discontinued operations.

## **Liquidity and Capital Resources**

Our short-term liquidity requirements consist primarily of funds necessary to pay for operating expenses and other expenditures, including:

recurring maintenance and capital expenditures necessary to maintain our properties properly;

interest expense and scheduled principal payments on outstanding indebtedness;

acquisitions;

future distributions paid to our common stockholders to maintain our REIT status;

future distributions paid to our preferred stockholders; and

future distributions to minority interests.

Historically, we have satisfied our short-term liquidity requirements through our existing working capital and cash provided by our operations. We believe that our existing working capital, our bank credit facility described below and cash provided by operations will continue to be sufficient to meet our short-term liquidity requirements for at least the next 12 months.

Capital expenditures for the years ended December 31, 2007, 2006 and 2005 amounted to \$129.1 million, \$92.7 million and \$39.4 million, respectively. Included in the 2007 and 2006 amounts are \$8.4 million and \$8.3 million of capitalized interest, respectively. Capital expenditures for the years ended December 31, 2007 and 2006 included approximately \$16.7 million and \$33.1 million, respectively, to redevelop the Hyatt Regency New Orleans. For the year ended December 31, 2008, we expect to fund hotel FF&E reserve projects of approximately \$50.0 million and owner-funded projects of approximately \$125.0-\$150.0 million.

**Bank Credit Facility.** On March 9, 2007, we entered into a bank credit agreement. This agreement replaced the previous \$225.0 million agreement that was entered into on November 9, 2005 and subsequently amended on May 30, 2006 and August 28, 2006. The new agreement provides for a \$500.0 million revolving credit facility. The agreement matures on March 9, 2011, subject to a one-year extension at our option. The agreement includes a \$75.0 million letter of credit subfacility. SHR guaranteed the loan and pledged its interest in SH Funding as collateral for this loan. Certain subsidiaries of SH Funding also guaranteed the loan, and SH Funding's interests in certain subsidiaries have been pledged as collateral for this loan.

Interest accrues at LIBOR plus a spread of 0.80% to 1.50% per annum (0.80 % at December 31, 2007), depending on a leverage test. Additionally, there is an unused commitment fee of 0.125% to 0.20% per annum based on the average daily-unused revolver balance. At February 28, 2008, there was \$146.0 million outstanding under this facility. At February 28, 2008, there were outstanding letters of credit of \$28.8 million.

Our bank credit facility contains financial and other restrictive covenants. As of December 31, 2007, our ability to borrow under this facility is subject to financial covenants including:

minimum tangible net worth of \$946.8 million plus 75% of proceeds we receive from any new issuance of common stock;

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minimum ratio of consolidated EBITDA to fixed charges of 1.20 through the second anniversary of the agreement and 1.30 after the second anniversary;

the ratio of consolidated indebtedness to gross asset value may not exceed 0.65 to 1.0;

total construction costs must not exceed 15% of the gross asset value of all properties combined;

the net asset value of unconsolidated subsidiaries must not exceed 25% of the gross asset value of all properties combined; and

the sum of total construction costs and the net asset value of unconsolidated subsidiaries must not exceed 35% of the gross asset value of all properties combined.

Our compliance with these covenants in future periods will depend substantially on the financial results of our hotels. The credit facility also contains customary restrictive covenants, including, among other things, that asset sales must be for at least 85% cash or cash equivalents, on a bona fide arms-length basis.

As of December 31, 2007, we are compliant with the above financial and other restrictive covenants.

Our long-term liquidity requirements consist primarily of funds necessary to pay for scheduled debt maturities, renovations, expansions and other non-recurring capital expenditures that need to be made periodically to our properties and the costs associated with acquisitions of properties.

Historically, we have satisfied our long-term liquidity requirements through various sources of capital, including our existing working capital, cash provided by operations, sales of properties, long-term property mortgage indebtedness, bank credit facilities, issuance of senior unsecured debt instruments and through the issuance of additional equity securities. We believe that these sources of capital will continue to be available to us in the future to fund our long-term liquidity requirements. However, there are certain factors that may have a material adverse effect on our access to these capital sources. Our ability to incur additional debt is dependent upon a number of factors, including general credit market conditions, our degree of leverage, the value of our unencumbered assets (if any) and borrowing restrictions imposed by existing lenders. Our ability to raise funds through the issuance of equity securities is dependent upon, among other things, general market conditions for REITs and market perceptions about us. We will continue to analyze which source of capital is most advantageous to us at any particular point in time, but equity and debt financing may not be consistently available to us on terms that are attractive or at all.

**Equity Securities**

As of December 31, 2007, we had 980,441 restricted stock units outstanding, of which 446,319 were vested. In addition, we had 736,221 stock options outstanding. The following table presents the changes in our issued and outstanding shares of common stock and operating partnership units since December 31, 2006 (excluding restricted stock units):

	Common Shares	Operating Partnership Units Represented by Minority Interests	Total
Outstanding at December 31, 2006	75,406,727	975,855	76,382,582
Restricted stock units redeemed for common shares	35,332		35,332
Operating partnership units issued		12,359	12,359
Operating partnership units redeemed for common shares	12,359	(12,359)	
Common shares repurchased and retired	(1,083,188)		(1,083,188)
Outstanding at December 31, 2007	74,371,230	975,855	75,347,085



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**Cash Flows**

**Operating Activities.** Net cash provided by operating activities was \$174.7 million for the year ended December 31, 2007 compared to net cash provided by operating activities of \$141.2 million for the year ended December 31, 2006 and net cash provided by operating activities of \$76.5 million for the year ended December 31, 2005. Cash flow from operations increased from 2005 to 2006 and 2006 to 2007 primarily because of the increase in hotel operating income, offset by increases in interest expense. These increases in hotel operating income and interest expense are primarily related to the investment and financing activities described below.

**Investing Activities.** Net cash used in investing activities was \$49.4 million for the year ended December 31, 2007, compared to net cash used in investing activities of \$1.5 billion for the year ended December 31, 2006 and net cash used in investing activities of \$430.0 million for the year ended December 31, 2005. The significant investing activities during these periods are summarized below:

We received \$62.1 million, \$43.5 million and \$10.0 million of insurance proceeds during the years ended December 31, 2007, 2006 and 2005; respectively as a result of the hurricane that struck our Hyatt Regency New Orleans property in August 2005.

In 2007, we completed the acquisition of our partner's 15% interest in the InterContinental Chicago hotel and the InterContinental Miami hotel for approximately \$22.0 million and \$9.4 million, respectively. We acquired joint venture interests in the Chicago and Miami InterContinental hotels for \$285.4 million during the year ended December 31, 2005.

Restricted cash and cash equivalents decreased by \$34.2 million during the year ended December 31, 2007 primarily due to the release of insurance proceeds. Restricted cash and cash equivalents increased by \$33.0 million during the year ended December 31, 2006 primarily due to insurance proceeds received during 2006.

We paid \$5.7 million in escrow deposits in connection with potential hotel acquisitions in 2007. During the fourth quarter of 2005, we paid \$22.3 million in escrow deposits in connection with the acquisitions of the La Solana Hotel and Villa project (\$1.0 million) and our joint venture interest in the Hotel del Coronado (\$21.3 million).

We purchased one hotel for approximately \$95.0 million in 2007, five hotels for \$1.5 billion in 2006 and one hotel for approximately \$158.6 million in 2005. We purchased our joint venture partner's 65% interest in the entity that owns the InterContinental Prague hotel for approximately \$75.8 million in August 2006.

We sold a 49% interest in each of the InterContinental Chicago and Hyatt Regency La Jolla hotels in 2007 and received net proceeds of approximately \$111.2 million.

We purchased a 60-acre oceanfront parcel for development in Punta Mita, Mexico in October 2007 for an initial payment of \$16.1 million, including closing costs. We spent \$31.4 million in connection with our acquisition of the La Solana Hotel and Villas development sites in 2006.

We purchased a 50% interest in BuyEfficient, L.L.C., for approximately \$6.3 million in December 2007. We completed our acquisition of a joint venture interest in the Hotel del Coronado and an adjacent land parcel under development for approximately \$50.1 million in January 2006.

We sold one hotel during the year ended December 31, 2007 for net sale proceeds of \$23.0, two hotels during the year ended December 31, 2006 for net sale proceeds of \$178.1 million and two hotels during the year ended December 31, 2005 for net sales

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proceeds of \$76.3.

During the fourth quarter of 2005, we purchased notes receivable of approximately \$17.9 million in connection with the acquisition of the La Solana Hotel and Villa project.

We disbursed \$129.1 million, \$92.7 million and \$39.4 million during the years ended December 31, 2007, 2006 and 2005, respectively, for capital expenditures primarily related to room renovations and additions; food and beverage and spa facilities; and redevelopment of the Hyatt Regency New Orleans.

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**Financing Activities.** Net cash used in financing activities was \$104.8 million for the year ended December 31, 2007 compared to net cash provided by financing activities of \$1.4 billion for the year ended December 31, 2006 and net cash provided by financing activities of \$379.6 million for the year ended December 31, 2005. The significant financing activities during these periods are summarized below:

We received net proceeds from the issuance of Exchangeable Notes of \$179.1 million during the year ended December 31, 2007 and paid \$9.9 million for call options that were purchased in connection with the issuance of the Exchangeable Notes.

We paid \$25.0 million for the repurchase of common stock during the year ended December 31, 2007.

We paid financing costs of \$23.8 million, \$8.1 million and \$7.0 million for the years ended December 31, 2007, 2006 and 2005, respectively.

In 2006 and 2005, we received proceeds from issuance of common stock, net of offering costs of approximately \$470.2 million and \$217.4 million, respectively.

In 2007, 2006 and 2005, we received proceeds from issuance of preferred stock, net of offering costs of approximately \$10.7 million, \$249.7 million and \$97.6 million, respectively, and distributed \$30.1 million, \$24.5 million and \$6.8 million, respectively to preferred shareholders.

In 2007, we made net payments on mortgage debt and other debt of \$126.0 million, which includes the defeasance of the fixed rate loan portfolio. We received net proceeds from mortgage and other debt of \$707.4 million and \$144.2 million in 2006 and 2005, respectively.

In 2007, 2006 and 2005, we paid quarterly distributions to common shareholders amounting to \$71.4 million, \$58.3 million and \$29.8 million, respectively, and SH Funding also paid quarterly distributions to minority interest holders amounting to \$1.0 million, \$2.6 million and \$8.0 million, respectively.

In 2007, we made net payments on the bank credit facility of \$6.0 million. In 2006, we received net proceeds on the bank credit facility of \$89.0 million and, in 2005, we made net payments on the bank credit facility of \$28.0 million.

**Contractual Obligations**

The following table summarizes our future payment obligations and commitments as of December 31, 2007 (in thousands):

	Total	Payments Due by Period			
		Less than 1 year	1 to 3 years	4 to 5 years	More than 5 years
Long-term debt obligations(1)	\$ 1,652,090	\$ 16,481	\$ 643,362	\$ 992,247	\$
Interest on long-term debt obligations(2)	363,409	85,006	246,587	31,816	
Operating lease obligations - ground leases and office space	11,747	159	1,514	1,416	8,658
Operating leases - Paris Marriott and Marriott Hamburg	484,603	21,912	65,736	43,824	353,131
Construction contracts(3)	9,586	9,586			
Acquisition agreement - portion of mixed use building(3)	83,940	83,940			



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Total	\$ 2,605,375	\$ 217,084	\$ 957,199	\$ 1,069,303	\$ 361,789
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- (1) Long-term debt obligations include our mortgages and other debt, Exchangeable Notes and bank credit facility.
- (2) Interest on variable rate debt obligations is calculated based on the variable rates at December 31, 2007 and includes the effect of our interest rate swaps.
- (3) See Item 8. Financial Statements and Supplementary Data Note 16 Commitments and Contingencies.

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### **Reserve Funds for Capital Expenditures**

We maintain each of our hotels in excellent repair and condition and in conformity with applicable laws and regulations and in accordance with the agreed upon requirements in our management agreements with our preferred operators.

We are obligated to maintain reserve funds for capital expenditures at our hotels (including the periodic replacement or refurbishment of furniture, fixtures and equipment) as determined pursuant to the management agreements with our preferred operators. As of December 31, 2007, \$35.6 million was in restricted cash reserves for future capital expenditures. Our agreements with hotel operators require us to reserve funds at amounts ranging between 3.0% and 5.0% of the individual hotel's annual revenues and require the funds to be set aside in restricted cash. Expenditures are capitalized as incurred and depreciation begins when the related asset is placed in service. Any unexpended amounts will remain our property upon termination of the management and operating contracts.

### **Derivative Financial Instruments**

We use derivative financial instruments to manage, or hedge, interest rate risks related to our borrowings, from lines of credit to medium- and long-term financings. Instruments that meet the hedging criteria are formally designated as hedges at the inception of the derivative contract. We do not use derivatives for trading or speculative purposes and only enter into contracts with major financial institutions based on their credit rating and other factors. We use outside consultants to determine the fair values of our derivative instruments. Such methods incorporate standard market conventions and techniques such as discounted cash flow analysis and option pricing models to determine fair value. All methods of estimating fair value result in general approximation of value and such value may or may not actually be realized.

See Item 7A. Quantitative and Qualitative Disclosures About Market Risk for additional disclosures related to derivatives and interest rate risk.

### **Off-Balance Sheet Arrangements**

On January 9, 2006, our subsidiaries closed the acquisition of a 45% joint venture ownership interest in SHC KSL Partners, LP (Hotel Venture), the owner of the Hotel del Coronado in San Diego, California, and in HdC North Beach Development, LLLP (North Beach Venture), the owner of an adjacent land parcel under development, for our pro rata share of an agreed upon market value of \$745.0 million. The Hotel Venture and the North Beach Venture are collectively referred to as the Partnerships. We own the Hotel Venture and North Beach Venture in partnership with KKR and KSL Resorts. We account for our investments in the Partnerships under the equity method of accounting. The Hotel Venture has obtained \$610.0 million of mortgage and mezzanine debt financings and a \$20.0 million revolving credit facility, concurrent with our acquisition, which are secured by, among other things, a mortgage on the Hotel del Coronado. At December 31, 2007, there was no outstanding balance on the revolving credit facility. There are letters of credit outstanding of \$2.5 million, which are secured by the revolving credit facility. At December 31, 2007, our investment in the Partnerships amounted to \$69.1 million. Our equity in earnings of the Partnerships is \$8.1 million for the year ended December 31, 2007.

Further, on January 9, 2006, the North Beach Venture entered into a \$59.0 million construction loan with GMAC Commercial Mortgage Corporation (GMAC) to be used in connection with the construction of a 78-room beachfront, luxury condominium-hotel development on the North Beach Venture land parcel. During the third quarter 2007, the loan was retired.

We earn fees under an asset management agreement with the Partnerships. We receive fees amounting to 1% of the Ventures' revenues and 2% of the Ventures' development costs. In addition, we earn financing fees of 0.325% of any debt principal placed on behalf of the Hotel Venture as well as certain incentive fees as provided by the asset management agreements. We recognize income of 55% of these fees, representing the percentage of the Partnerships not owned by us.

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We own a 31% interest in and act as asset manager for a joint venture with two unaffiliated parties that is developing the Four Seasons Residence Club Punta Mita, a luxury vacation home product sold in fractional ownership interests on the property adjacent to our Four Seasons Punta Mita Resort hotel in Mexico. We account for this investment under the equity method of accounting. At December 31, 2007, our investment in the joint venture amounted to \$3.4 million. Our equity in earnings of the joint venture is \$0.2 million for the year ended December 31, 2007.

We own a 50% interest in an electronic purchasing platform joint venture called BuyEfficient, L.L.C. with an unaffiliated party. This business allows members to procure food, operating supplies, furniture, fixtures and equipment. We account for this investment under the equity method of accounting. At December 31, 2007, our investment in the joint venture amounted to \$6.4 million. Our equity in earnings of the joint venture is \$38,000 for the year ended December 31, 2007.

## **Related Party Transactions**

We have in the past engaged in and currently engage in transactions with related parties. See Item 8. Financial Statements and Supplementary Data Note 15 Related Party Transactions for a discussion of our transactions with related parties.

## **Critical Accounting Policies**

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

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

***Impairment of Long-Lived Assets and Goodwill.*** We periodically review each property and any related goodwill for possible impairment. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. In this analysis of fair value, we use discounted cash flow analysis to estimate the fair value of our properties taking into account each property's expected cash flow from operations, holding period and proceeds from disposing of the property. The factors addressed in determining estimated proceeds from disposition include anticipated operating cash flow in the year of disposition, terminal capitalization rate and selling price per room. Judgment is required in determining the discount rate applied to estimated cash flows, growth rate of the properties, the need for capital expenditures, as well as specific market and economic conditions. Additionally, the classification of these assets as held for sale requires the recording of these assets at their net realizable value which can affect the amount of impairment recorded. We account for goodwill in accordance with SFAS No. 142, Goodwill and Other Intangible Assets, which states that goodwill has an indefinite useful life that should not be amortized but should be reviewed annually for impairment, or more frequently if events or changes in circumstances indicate that goodwill might be impaired. The goodwill impairment review requires estimates of the fair value of our properties that have goodwill resulting from our purchase price allocations. These estimates of fair value are prepared using the procedures described above. There was no impairment on property and equipment or goodwill for 2006 and 2005. We recorded impairment losses on goodwill and hotel property of \$37.7 million for the year ended December 31, 2007 on the Hyatt Regency New Orleans based on our impairment analysis in the second quarter of 2007.

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***Acquisition Related Assets and Liabilities.*** Accounting for the acquisition of a hotel property as a purchase transaction requires an allocation of the purchase price to the assets acquired and the liabilities assumed in the transaction at their respective estimated fair values. The most difficult estimations of individual fair values are those involving long-lived assets, such as property and equipment and intangible assets. We use all available information to make these fair value determinations and, for hotel acquisitions, engage an independent valuation specialist to assist in the fair value determination of the acquired long-lived assets. Due to inherent subjectivity in determining the estimated fair value of long-lived assets, we believe that the recording of acquired assets and liabilities is a critical accounting policy.

***Depreciation and Amortization Expense.*** Depreciation expense is based on the estimated useful life of our assets. The life of the assets is based on a number of assumptions including cost and timing of capital expenditures to maintain and refurbish the asset, as well as specific market and economic conditions. While management believes its estimates are reasonable, a change in the estimated lives could affect depreciation expense and net income or the gain or loss on the sale of any of the assets.

***Derivative Instruments and Hedging Activities.*** Derivative instruments and hedging activities require management to make judgments on the nature of its derivatives and their effectiveness as hedges. These judgments determine if the changes in fair value of the derivative instruments are reported in the consolidated statements of operations as a component of net income or as a component of comprehensive income and as a component of equity on the consolidated balance sheets. While management believes its judgments are reasonable, a change in a derivative's effectiveness as a hedge could affect expenses, net income and equity.

***Disposal of Long-Lived Assets.*** We classify assets as held for sale in accordance with the criteria stated in SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Assets identified as held for sale are reclassified on the balance sheet and the related results of operations are reclassified as discontinued operations on the statement of operations. While these classifications do not have an affect on total assets, net equity or net income, they affect the classifications within each statement. Additionally, a determination to classify an asset as held for sale affects depreciation expense as long-lived assets are not depreciated while classified as held for sale. There were no assets classified as held for sale at December 31, 2007 or 2006.

### **Seasonality**

The lodging business is seasonal in nature, and we experience some seasonality in our business. Revenues for hotels in tourist areas, those with group business, and in areas driven by greater climate changes are generally seasonal. Quarterly revenues also may be adversely affected by events beyond our control, such as extreme weather conditions, terror attacks or alerts, airline strikes, economic factors and other considerations affecting travel.

The Marriott domestic hotels report their results of operations using a fiscal year consisting of thirteen four-week periods. As a result, for our domestic Marriott branded property, for all years presented, the first three quarters consist of 12 weeks each and the fourth quarter consists of 16 weeks.

To the extent that cash flows from operations are insufficient during any quarter, due to temporary or seasonal fluctuations in revenues, we may have to enter into short-term borrowings to pay operating expenses and make distributions to our stockholders.

### **New Accounting Pronouncements**

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations (revised 2007) (SFAS 141(R)). SFAS 141(R) is a revision to previously existing guidance on accounting for business combinations. The statement retains the fundamental concept of the purchase method of accounting, and

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introduces new requirements for the recognition and measurement of assets acquired, liabilities assumed and noncontrolling interests. The statement is effective for fiscal years beginning after December 31, 2008. We are currently evaluating the impact of SFAS 141(R) on our financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (SFAS 160). The statement requires that noncontrolling interests be reported as stockholders equity, a change that will affect our financial statement presentation of minority interests in our consolidated subsidiaries. The statement also establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary as long as that ownership change does not result in deconsolidation. SFAS 160 is required to be applied prospectively in 2009, except for the presentation and disclosure requirements which are to be applied retrospectively. The statement is effective for fiscal years beginning after December 15, 2008. We are currently evaluating the impact of SFAS 160 on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits companies to choose to measure many financial assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The provisions of this statement are required to be applied prospectively. Currently, we do not anticipate electing the fair value option for our financial assets and liabilities.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The effective date for financial assets and liabilities is fiscal years beginning after November 15, 2007. However, the FASB has issued FASB Staff Position FAS 157-2, *Effective Date of FASB Statement No. 157*, that would defer the effective date for non-financial assets and liabilities, except those items recognized or disclosed at fair value on an annual or more frequently recurring basis, until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. We are currently evaluating the impact of SFAS 157 on our financial statements.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

**Interest Rate Risk**

Our future income, cash flows and fair values relevant to financial instruments are dependent upon prevailing market interest rates. Market risk refers to the risk of loss from adverse changes in market prices and interest rates. The majority of our outstanding debt, after considering the effect of interest rate swaps, has a fixed interest rate. We use some derivative financial instruments to manage, or hedge, interest rate risks related to our borrowings, from lines of credit to medium- and long-term financings. We generally require that hedging derivative instruments be effective in reducing the interest rate risk exposure that they are designed to hedge. We do not use derivatives for trading or speculative purposes and only enter into contracts with major financial institutions based on their credit rating and other factors.

See Item 8. Financial Statements and Supplementary Data Note 11 Derivatives for information on our interest rate cap and swap agreements outstanding as of December 31, 2007.

As of December 31, 2007, our total outstanding mortgages and other debt, bank credit facility and Exchangeable Notes were approximately \$1.7 billion, of which approximately \$312.8 million, or 18.9%, was variable rate debt. Total variable debt excludes \$1.1 billion fixed by the interest rate swaps described above. If market rates of interest on our variable rate debt, including the effect of the swaps, increase by 20%, the increase in interest expense on the variable rate debt would decrease future earnings and cash flows by approximately \$3.2 million annually. If market rates of interest on our variable rate debt, including the effect of the swaps, decrease by 10%, the decrease in interest expense on our variable rate debt would increase future earnings and cash flows by approximately \$1.6 million annually.

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Interest risk amounts were determined by considering the impact of hypothetical interest rates on our financial instruments. These analyses do not consider the effect of the reduced level of overall economic activity that could exist in that environment. Furthermore, in the event of a change of that magnitude, we may take actions to further mitigate our exposure to the change. However, due to the uncertainty of the specific actions that would be taken and their possible effects, these analyses assume no changes in our financial structure.

**Currency Exchange Risk**

As we have international operations, currency exchange risk arises as a normal part of our business. In particular, we are subject to fluctuations due to changes in foreign exchange rates in the British pound, Euro, Czech crown and Mexican peso. We reduce this risk by transacting our international business in local currencies. In this manner, assets and liabilities are matched in the local currency, which reduces the need for dollar conversion. Generally, we do not enter into forward or option contracts to manage our currency exchange risk exposure applicable to net operating cash flows.

To manage the currency exchange risk applicable to equity positions in foreign hotels, we may use long-term mortgage debt denominated in the local currency. In addition, we may enter into forward or option contracts. We do not currently have any currency forward or option contracts.

Our exposure to foreign currency exchange rates relates primarily to our foreign hotels. For our foreign hotels, exchange rates impact the U.S. Dollar value of our reported earnings, our investments in the hotels and the intercompany transactions with the hotels.

Approximately 20.0% of our total revenues are generated outside of the U.S., with approximately 8.5% of total revenues generated from the Four Seasons Punta Mita Resort and Four Seasons Mexico City that use the Mexican peso, approximately 4.5% of total revenues generated from the Marriott London Grosvenor Square that uses the British pound, approximately 3.9% of total revenues generated from the InterContinental Prague that uses the Czech crown and approximately 3.1% of total revenues generated from the Paris Marriott, Marriott Hamburg and Hotel Le Parc that use the Euro. As a result, fluctuations in the value of foreign currencies against the U.S. Dollar may have a significant impact on our reported results. Revenues and expenses denominated in foreign currencies are translated into U.S. Dollars at a weighted-average exchange rate for the year. Consequently, as the value of the U.S. Dollar changes relative to the currencies of these markets, our reported results vary.

Throughout 2007, the U.S. Dollar weakened relative to the currencies of our international markets. If the U.S. Dollar had weakened an additional 10% during 2007, total revenues would have approximately increased as follows from the amounts reported (in millions):

	<b>Mexican Peso</b>	<b>Czech Crown</b>	<b>British Pound</b>	<b>Euro</b>	<b>Total</b>
Increase in total revenues	\$ 8.6	\$ 4.0	\$ 4.5	\$ 3.0	\$ 20.1

Fluctuations in currency exchange rates also impact the U.S. Dollar amount of our shareholders' equity. The asset and liabilities of our non-U.S. hotels are translated into U.S. Dollars at exchange rates in effect at year-end. The resulting translation adjustments are recorded in shareholders' equity as a component of accumulated other comprehensive (loss) income. If the U.S. Dollar had weakened an additional 10% during 2007, resulting translation adjustments recorded in shareholders' equity would have increased by approximately \$7.1 million from the amounts reported.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.  
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of

Strategic Hotels & Resorts, Inc.

Chicago, Illinois

We have audited the accompanying consolidated balance sheets of Strategic Hotel & Resorts, Inc. and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of operations and comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2007. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Strategic Hotel & Resorts, Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2008 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Chicago, Illinois

February 28, 2008

**Table of Contents****STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(In Thousands, Except Share Data)**

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Assets</b>		
Investment in hotel properties, net	\$ 2,427,273	\$ 2,375,129
Goodwill	462,536	421,516
Intangible assets, net of accumulated amortization of \$3,271 and \$3,166	45,420	45,793
Investment in joint ventures	78,801	71,349
Cash and cash equivalents	111,494	86,462
Restricted cash and cash equivalents	39,161	73,400
Accounts receivable, net of allowance for doubtful accounts of \$1,965 and \$809	82,217	70,282
Deferred financing costs, net of accumulated amortization of \$4,809 and \$2,194	14,868	10,701
Deferred tax assets	41,790	43,555
Other assets	62,736	57,522
<b>Total assets</b>	<b>\$ 3,366,296</b>	<b>\$ 3,255,709</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities:</b>		
Mortgages and other debt payable	\$ 1,363,855	\$ 1,442,865
Exchangeable senior notes, net of discount	179,235	
Bank credit facility	109,000	115,000
Accounts payable and accrued expenses	266,324	186,293
Distributions payable	18,179	18,175
Deferred tax liabilities	36,407	24,390
Deferred gain on sale of hotels	114,292	107,474
Insurance proceeds received in excess of insurance recoveries receivable		20,794
<b>Total liabilities</b>	<b>2,087,292</b>	<b>1,914,991</b>
Minority interests in SHR's operating partnership	11,512	12,463
Minority interests in consolidated affiliates	30,653	10,965
<b>Shareholders' equity:</b>		
8.50% Series A Cumulative Redeemable Preferred Stock (\$0.01 par value; 4,488,750 and 4,000,000 shares issued and outstanding; liquidation preference \$25.00 per share)	108,206	97,553
8.25% Series B Cumulative Redeemable Preferred Stock (\$0.01 par value; 4,600,000 shares issued and outstanding; liquidation preference \$25.00 per share)	110,775	110,775
8.25% Series C Cumulative Redeemable Preferred Stock (\$0.01 par value; 5,750,000 shares issued and outstanding; liquidation preference \$25.00 per share)	138,940	138,940
Common shares (\$0.01 par value; 150,000,000 common shares authorized; 74,371,230 and 75,406,727 common shares issued and outstanding)	742	753
Additional paid-in capital	1,201,503	1,224,400
Accumulated deficit	(304,922)	(265,435)
Accumulated other comprehensive (loss) income	(18,405)	10,304
<b>Total shareholders' equity</b>	<b>1,236,839</b>	<b>1,317,290</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 3,366,296</b>	<b>\$ 3,255,709</b>

The accompanying notes to the consolidated financial statements are an integral part of these statements.



**Table of Contents****STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS AND****COMPREHENSIVE INCOME****(In Thousands, Except Per Share Data)**

	<b>For the years ended December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>Revenues:</b>			
Rooms	\$ 532,109	\$ 381,019	\$ 201,036
Food and beverage	342,468	244,007	131,513
Other hotel operating revenue	110,010	73,304	40,195
	984,587	698,330	372,744
Lease revenue	23,405	20,257	16,787
<b>Total revenues</b>	<b>1,007,992</b>	<b>718,587</b>	<b>389,531</b>
<b>Operating Costs and Expenses:</b>			
Rooms	130,784	94,764	47,520
Food and beverage	231,407	170,054	91,754
Other departmental expenses	248,815	181,436	104,388
Management fees	39,264	26,774	11,713
Other hotel expenses	67,975	44,526	22,480
Lease expense	15,700	13,682	13,178
Depreciation and amortization	106,091	75,135	39,797
Corporate expenses	30,179	25,383	21,023
Other charges	7,372		
<b>Total operating costs and expenses</b>	<b>877,587</b>	<b>631,754</b>	<b>351,853</b>
<b>Operating income</b>	<b>130,405</b>	<b>86,833</b>	<b>37,678</b>
Interest expense	(88,906)	(50,973)	(29,463)
Interest income	2,775	3,961	1,940
Loss on early extinguishment of debt	(10,268)	(2,150)	(6,540)
Equity in earnings (losses) of joint ventures	8,344	(1,066)	2,818
Foreign currency exchange (loss) gain	(3,701)	756	68
Other (expenses) income, net	(584)	3,596	5,431
Income before income taxes, minority interests, gain on sale of minority interests in hotel properties and discontinued operations	38,065	40,957	11,932
Income tax expense	(9,714)	(3,946)	(4,687)
Minority interest in SHR's operating partnership	(413)	(741)	(1,949)
Minority interest in consolidated affiliates	(1,363)	(763)	
Income before gain on sale of minority interests in hotel properties and discontinued operations	26,575	35,507	5,296
Gain on sale of minority interests in hotel properties	84,658		
<b>Income from continuing operations</b>	<b>111,233</b>	<b>35,507</b>	<b>5,296</b>
(Loss) income from discontinued operations, net of tax and minority interests	(42,075)	84,622	24,964