Sunstone Hotel Investors, Inc.
Form 10-K/A
February 25, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

x **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 number 001-32319

Sunstone Hotel Investors, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Maryland	**20-1296886**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification Number)**
903 Calle Amanecer, Suite 100 San Clemente, California	**92673**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s telephone number, including area code: (949) 369-4000

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

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

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

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

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

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

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 (as defined in Rule 12b-2 of the Exchange Act). Check one:

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

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

The aggregate market value of the voting stock held by non-affiliates of the registrant based upon the closing sale price of the registrant s common stock on June 29, 2007 as reported on the New York Stock Exchange was approximately $1.7 billion. This amount excludes 588,599 shares of the registrant s common stock held by the executive officers and directors. Exclusion of such shares should not be construed to indicate that any such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the registrant or that such person is controlled by or under common control with the registrant.

The number of shares of the registrant s Common Stock outstanding as of February 20, 2008 was 59,763,720.

Documents Incorporated by Reference

Part III of this Report incorporates by reference information from the definitive Proxy Statement for the registrant s 2008 Annual Meeting of Stockholders.

EXPLANATORY NOTE

We are filing this Amendment on Form 10-K/A to our Annual Report on Form 10-K for the period ended December 31, 2007, which was filed February 21, 2008 (the Form 10-K), to amend Part IV, Item 15. This Amendment includes Footnote 11, Series C Cumulative Convertible Redeemable Preferred Stock, which was inadvertently omitted from the Consolidated Financial Statements in the original filing, renumbers the remaining footnotes, deletes a duplicated paragraph in Footnote 2, Summary of Significant Accounting Policies, and makes minor revisions to the Exhibit list. In addition, the registrant s principal executive officer and principal financial officer are providing new Rule 13a-14 certifications in connection with this Form 10-K/A and are also furnishing, but not filing, written statements pursuant to Title 18 United States Code Section 1350, as added by Section 906 of the Sarbanes-Oxley Act of 2002. The Exhibit section has also been revised to include an updated Independent Registered Public Accounting Firm s Consent. Except as described above, no other changes have been made to the Form 10-K. This Amendment does not reflect events that have occurred after the original filing of the Form 10-K on February 21, 2008, and does not update the disclosures in the Form 10-K in any way except as specifically described in this Explanatory Note.

Item 15 Exhibits and Financial Statement Schedules

(a)(1) Financial Statements. See Index to Financial Statements and Schedule on page F-1.

(a)(2) Financial Statement Schedule. See Index to Financial Statements and Schedule on page F-1.

(a)(3) Exhibits. The following exhibits are filed (or incorporated by reference herein) as a part of this Annual Report on Form 10-K:

Exhibit Number	Description
3.1	Articles of Amendment and Restatement of Sunstone Hotel Investors, Inc. (incorporated by reference to Exhibit 3.1 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
3.2	Amended and Restated Bylaws of Sunstone Hotel Investors, Inc. (incorporated by reference to Exhibit 3.1 to the Form 8-K filed by the Company on February 12, 2008).
3.3	Form of Articles Supplementary for Series A Preferred Stock (incorporated by reference to Exhibit 3.3 to the registration statement on Form S-11 (File No. 333-123102) filed by the Company).
3.4	Form of Articles Supplementary for Series C Preferred Stock (incorporated by reference to Exhibit 3 to Form 8-K filed by the Company on July 13, 2005).
3.5	Articles Supplementary increasing the authorized number of shares of Series A Preferred Stock (incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed by the Company on April 11, 2006).
4.1	Specimen Certificate of Common Stock of Sunstone Hotel Investors, Inc. (incorporated by reference to Exhibit 4.1 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
4.2	Letter furnished to Securities and Exchange Commission agreeing to furnish certain debt instruments (incorporated by reference to Exhibit 4.2 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
4.3	Form of Specimen Certificate of Series A Preferred Stock of Sunstone Hotel Investors, Inc. (incorporated by reference to Exhibit 4.1 to the registration statement on Form S-11 (File No. 333-123102) filed by the Company).
4.4	Form of Specimen Certificate of Series C Preferred Stock of Sunstone Hotel Investors, Inc. (incorporated by reference to Exhibit 4.5 to Form 10-Q filed by the Company on June 30, 2005).
4.5	Indenture, dated as of June 18, 2007, among Sunstone Hotel Partnership, LLC, Sunstone Hotel Investors, Inc., certain subsidiaries of Sunstone Hotel Investors, Inc. and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.1 to Form 10-Q filed by the Company on August 8, 2007).
4.6	First Supplemental Indenture, dated as of June 18, 2007, among Sunstone Hotel Partnership, LLC, Sunstone Hotel Investors, Inc., certain subsidiaries of Sunstone Hotel Investors, Inc. and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.2 to Form 10-Q filed by the Company on August 8, 2007).
4.7	Second Supplemental Indenture, dated as of June 27, 2007, among Sunstone Hotel Partnership, LLC, Sunstone Hotel Investors, Inc., certain subsidiaries of Sunstone Hotel Investors, Inc. and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 4.3 to Form 10-Q filed by the Company on August 8, 2007).
10.1	Registration Rights Agreement between Security Capital Preferred Growth Incorporated and Sunstone Hotel Investors, Inc., dated June 28, 2005 (incorporated by reference to Exhibit 10.23 to the registration statement on Form S-11 (File No. 333-127975) filed by the Company.
10.2	Form of Master Agreement with Management Company (incorporated by reference to Exhibit 10.2 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
10.3	Form of Hotel Management Agreement (incorporated by reference to Exhibit 10.3 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
10.3.1	Management Agreement Amendment dated as of July 1, 2005 (incorporated by reference to Exhibit 10.10.1 to Form 10-K filed by the Company on February 22, 2005).

10.4	Amended and Restated Loan Agreement, dated October 26, 2004, among the borrowers named therein, the Lenders and Massachusetts Mutual Life Insurance Company, as Administrative Agent (incorporated by reference to Exhibit 10.4.1 to Form 10-K filed by the Company on February 22, 2005).

10.4.1	Joinder, Amendment, Ratification and Consent to Amended and Restated Loan Agreement, dated December 22, 2005, among the borrowers named therein, the Lenders and Massachusetts Mutual Life Insurance Company, as Administrative Agent (incorporated by reference to Exhibit 10.11.1 to Form 10-K filed by the Company on February 15, 2006).
10.4.2	Second Amendment to Amended and Restated Loan Agreement, dated as of April 13, 2007, among the borrowers named therein, the Lenders and Massachusetts Mutual Life Insurance Company, as Administrative Agent (incorporated by reference to Exhibit 10.2 to Form 10-Q filed by the Company on August 8, 2007).
10.5	Amended and Restated Loan Agreement, dated January 31, 2003, between the borrowers named therein and Bear Stearns Commercial Mortgage, Inc., as Lender (incorporated by reference to Exhibit 10.5 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
10.5.1	First Amendment to Amended and Restated Loan Agreement, dated February 25, 2003, between the borrowers named therein and LaSalle Bank National Association, as Trustee, in trust for the Holders of Bear Stearns Commercial Mortgage Securities Inc. Commercial Mortgage Pass-Through Certificates, Series 2003-West, as Lender (incorporated by reference to Exhibit 10.5.1 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
10.6	Form of 2004 Long-Term Incentive Plan of Sunstone Hotel Investors, Inc. (incorporated by reference to the proxy statement on Schedule 14A filed by the Company on March 26, 2007).
10.7	Form of Restricted Stock Award Agreement (incorporated by reference to Exhibit 10.1 to Form 8-K, filed by the Company on February 23, 2005).
10.8	Form of Restricted Stock Award Certificate (Directors) (incorporated by reference to Exhibit 10.2 to Form 8-K, filed by the Company on February 23, 2005).
10.9	Form of TRS Lease (incorporated by reference to Exhibit 10.10 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
10.10	Revolving Credit Agreement, dated as of July 17, 2006, among Sunstone Hotel Partnership, LLC, Sunstone Hotel Investors, Inc. the Subsidiary Guarantors named therein, the Initial Lenders, the Initial Issuing Bank, the Swing Line Bank, Citicorp North America, Inc., as Administrative Agent, Wachovia Capital Markets, LLC, as syndication agent, Calyon New York Branch as co-syndication agent, Keybank National Association, as documentation agent, and Citigroup Global Markets Inc. and Wachovia Capital Markets LLC, as joint lead managers and joint book running managers (incorporated by reference to Exhibit 99.1 to Form 8-K, filed by the Company on July 18, 2006).
10.10.1	First Letter Amendment, dated as of August 14, 2006, to Revolving Credit Agreement dated as of July 17, 2006 among Sunstone Hotel Partnership, LLC, Sunstone Hotel Investors, Inc. the Subsidiary Guarantors named therein, the Initial Lenders, the Initial Issuing Bank, the Swing Line Bank, Citicorp North America, Inc., as Administrative Agent, Wachovia Capital Markets, LLC, as syndication agent, Calyon New York Branch as co-syndication agent, Keybank National Association, as documentation agent, and Citigroup Global Markets Inc. and Wachovia Capital Markets LLC, as joint lead managers and joint book running managers (incorporated by reference to Exhibit 10.3 to Form 10-Q, filed by the Company on November 1, 2006).
10.10.2	Second Letter Amendment, dated as of May 23, 2007, to Revolving Credit Agreement dated as of July 17, 2006 among Sunstone Hotel Partnership, LLC, Sunstone Hotel Investors, Inc. the Subsidiary Guarantors named therein, the Initial Lenders, the Initial Issuing Bank, the Swing Line Bank, Citicorp North America, Inc., as Administrative Agent, Wachovia Capital Markets, LLC, as syndication agent, Calyon New York Branch as co-syndication agent, Keybank National Association, as documentation agent, and Citigroup Global Markets Inc. and Wachovia Capital Markets LLC, as joint lead managers and joint book running managers (incorporated by reference to Exhibit 10.3 to Form 10-Q, filed by the Company on August 8, 2007).
10.11	Form of Senior Management Incentive Plan of Sunstone Hotel Investors, Inc. (incorporated by reference to Exhibit 10.14 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).

10.12	Form of Employment Agreement with Robert A. Alter (incorporated by reference to Exhibit 10.15 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
10.12.1	Amendment to Employment Arrangements, dated as of March 19, 2007, between Sunstone Hotel Investors, Inc. and Robert A. Alter (incorporated by reference to Exhibit 10.2 to Form 10-Q, filed by the Company on May 2, 2007).
10.13	Form of Employment Agreement with Jon D. Kline (incorporated by reference to Exhibit 10.16 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
10.13.1	Agreement, dated as of May 24, 2007, between Sunstone Hotel Investors, Inc. and Jon D. Kline (incorporated by reference to Exhibit 10.4 to Form 10-Q, filed by the Company on August 8, 2007).
10.14	Form of Employment Agreement with Gary A. Stougaard (incorporated by reference to Exhibit 10.17 to the registration statement on Form S-11 (File No. 333-117141) filed by the Company).
10.14.1	Agreement, dated as of May 24, 2007, between Sunstone Hotel Investors, Inc. and Gary A. Stougaard (incorporated by reference to Exhibit 10.4 to Form 10-Q, filed by the Company on August 8, 2007).
10.15	Second Amended and Restated Limited Liability Company Agreement of Sunstone Hotel Partnership, LLC (incorporated by reference to Exhibit 10 to Form 8-K, filed by the Company on July 17, 2005).
10.16	Forward Sale Agreement, dated July 18, 2006, between Sunstone Hotel Investors, Inc. and Citigroup Global Markets Inc. (incorporated by reference to Exhibit 10.1 to Form 8-K, filed by the Company on July 24, 2006).
10.17	Employment Agreement, dated as of January 17, 2007, between Sunstone Hotel Investors, Inc. and Steven R. Goldman (incorporated by reference to Exhibit 10.1 to Form 10-Q, filed by the Company on May 2, 2007).
10.18	Change in Control Agreement, dated as of February 15, 2007, between Sunstone Hotel Investors, Inc. and Ken Cruse (incorporated by reference to Exhibit 10.1 to Form 10-Q, filed by the Company on August 8, 2007).
10.19	Form of Indemnification Agreement (incorporated by reference to Exhibit 10.3 to Form 10-Q, filed by the Company on May 3, 2007).
14.1	Code of Business Conduct and Ethics (incorporated by reference to Exhibit 14.1 of Form 10-K filed by the Company on February 22, 2005).
21.1	List of subsidiaries.
23.1	Consent of Ernst & Young LLP.
31.1	Certification of Principal Executive Officer (Section 302 Certification).
31.2	Certification of Principal Financial Officer (Section 302 Certification).
32.1	Certification of Principal Executive Officer and Principal Financial Officer (Section 906 Certification).

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Sunstone Hotel Investors, Inc.

Date: February 22, 2008

/s/ Kenneth E. Cruse
Kenneth E. Cruse
Chief Financial Officer

INDEX TO FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders

Sunstone Hotel Investors, Inc.:

We have audited the accompanying consolidated balance sheets of Sunstone Hotel Investors, Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders 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 schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Sunstone Hotel Investors, Inc. and subsidiaries at December 31, 2007 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Sunstone Hotel Investors, Inc. s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 5, 2008 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Irvine, California

February 5, 2008

SUNSTONE HOTEL INVESTORS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	December 31, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 67,412	$ 29,029
Restricted cash	48,442	65,669
Accounts receivable, net	36,703	41,695
Due from affiliates	932	1,383
Inventories	3,190	3,089
Prepaid expenses	9,021	7,006
Total current assets	165,700	147,871
Investment in hotel properties, net	2,786,821	2,477,514
Other real estate, net	14,526	14,673
Investment in unconsolidated joint ventures	35,816	68,714
Deferred financing costs, net	12,964	7,381
Goodwill	16,251	22,249
Other assets, net	17,074	21,971
Total assets	$ 3,049,152	$ 2,760,373
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 28,540	$ 31,912
Accrued payroll and employee benefits	18,133	12,338
Due to Interstate SHP	15,051	16,607
Dividends payable	25,995	23,826
Other current liabilities	39,817	32,354
Current portion of notes payable	9,815	23,231
Total current liabilities	137,351	140,268
Notes payable, less current portion	1,712,336	1,476,597
Other liabilities	6,034	6,429
Total liabilities	1,855,721	1,623,294
Commitments and contingencies *(Note 14)*		
Preferred stock, Series C Cumulative Convertible Redeemable Preferred Stock, $0.01 par value, 4,102,564 shares authorized, issued and outstanding at December 31, 2007 and 2006, liquidation preference of $24.375 per share	99,496	99,296
Stockholders equity		
Preferred stock, $0.01 par value, 100,000,000 shares authorized. 8.0% Series A Cumulative Redeemable Preferred Stock, 7,050,000 shares issued and outstanding at December 31, 2007 and 2006, stated at liquidation preference of $25.00 per share	176,250	176,250
Common stock, $0.01 par value, 500,000,000 shares authorized, 58,815,271 shares issued and outstanding at December 31, 2007 and 57,775,089 shares issued and outstanding at December 31, 2006	588	578
Additional paid in capital	987,554	958,591
Retained earnings	191,208	65,545
Cumulative dividends	(261,665)	(163,181)
Total stockholders equity	1,093,935	1,037,783

Total liabilities and stockholders equity	$	3,049,152	$	2,760,373

See accompanying notes to consolidated financial statements.

SUNSTONE HOTEL INVESTORS, INC.

CONSOLIDATED INCOME STATEMENTS

(In thousands, except per share data)

	Year Ended December 31, 2007	Year Ended December 31, 2006	Year Ended December 31, 2005
REVENUES			
Room	$ 688,921	$ 549,834	$ 343,701
Food and beverage	289,655	228,315	147,679
Other operating	78,163	77,106	50,367
Total revenues	1,056,739	855,255	541,747
OPERATING EXPENSES			
Room	152,808	123,004	76,766
Food and beverage	209,971	163,423	103,704
Other operating	41,816	38,095	28,831
Advertising and promotion	55,340	47,312	34,010
Repairs and maintenance	40,449	34,607	22,482
Utilities	37,429	32,863	22,022
Franchise costs	37,493	30,673	18,651
Property tax, ground lease, and insurance	58,706	53,464	29,580
Property general and administrative	119,210	98,057	61,401
Corporate overhead	28,270	19,037	14,483
Depreciation and amortization	119,855	90,392	58,490
Total operating expenses	901,347	730,927	470,420
Operating income	155,392	124,328	71,327
Equity in earnings (losses) of unconsolidated joint ventures	(3,588)	140	
Interest and other income	9,261	4,208	3,079
Interest expense	(98,907)	(91,052)	(51,547)
Income before minority interest and discontinued operations	62,158	37,624	22,859
Minority interest			(1,761)
Income from continuing operations	62,158	37,624	21,098
Income from discontinued operations	63,505	15,613	9,107
NET INCOME	125,663	53,237	30,205
Preferred stock dividends and accretion	(20,795)	(19,616)	(10,973)
Undistributed income allocated to Series C preferred stock	(1,583)		
INCOME AVAILABLE TO COMMON STOCKHOLDERS	$ 103,285	$ 33,621	$ 19,232
Basic per share amounts:			
Income from continuing operations available to common stockholders	$ 0.70	$ 0.31	$ 0.25
Income from discontinued operations available to common stockholders	1.05	0.28	0.22
Net income available to common stockholders per common share	$ 1.75	$ 0.59	$ 0.47

Diluted per share amounts:						
Income from continuing operations available to common stockholders	$	0.67	$	0.31	$	0.25
Income from discontinued operations available to common stockholders		1.08		0.28		0.22
Net income available to common stockholders per common share	$	1.75	$	0.59	$	0.47
Weighted average common shares outstanding:						
Basic		58,998		57,247		40,655
Diluted		59,139		57,409		40,761
Dividends paid per common share	$	1.31	$	1.22	$	1.155

See accompanying notes to consolidated financial statements.

SUNSTONE HOTEL INVESTORS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In thousands, except per share data)

	Preferred Stock		Common Stock					
	Number of Shares	**Amount**	**Number of Shares**	**Amount**	**Additional Paid in Capital**	**Retained Earnings (Deficit)**	**Cumulative Dividends**	**Total**
Balance at December 31, 2004			34,518,616	$ 345	$ 444,846	$ (17,897)	$ (9,962)	$ 417,332
Net proceeds from sale of Series A preferred stock	4,850,000	$ 121,250			(3,799)			117,451
Offering costs from sale of Series C preferred stock					(130)			(130)
Net proceeds from sale of common stock			13,936,909	140	312,100			312,240
Issuance of unvested restricted common stock			35,552					
Vesting of restricted common stock					1,992			1,992
Common dividends declared and payable at $1.155 per share							(51,616)	(51,616)
Series A preferred dividends declared and payable at $1.578 per share							(7,652)	(7,652)
Series C preferred dividends declared and payable at $0.786 per share							(3,225)	(3,225)
Accretion of discount on Series C preferred stock					(96)			(96)
Conversion of minority interest membership units in the Operating Partnership to common shares			3,699,572	37	43,391			43,428
Net income						30,205		30,205
Balance at December 31, 2005	4,850,000	121,250	52,190,649	522	798,304	12,308	(72,455)	859,929
Net proceeds from sale of Series A preferred stock	2,200,000	55,000			(842)			54,158
Net proceeds from sale of common stock			5,500,000	55	157,652			157,707
Vesting of restricted common stock			84,440	1	3,677			3,678
Common dividends declared and payable at $1.22 per share							(71,277)	(71,277)
Series A preferred dividends declared and payable at $2.00 per share							(13,000)	(13,000)
Series C preferred dividends declared and payable at $1.572 per share							(6,449)	(6,449)
Accretion of discount on Series C preferred stock					(200)			(200)
Net income						53,237		53,237

	Preferred Stock		Common Stock					
	Number of Shares	Amount	Number of Shares	Amount	Additional Paid in Capital	Restained Earnings (Deficit)	Cumulative Dividends	Total
Balance at December 31, 2006	7,050,000	$ 176,250	57,775,089	$ 578	$ 958,591	$ 65,545	$ (163,181)	$ 1,037,783
Net proceeds from sale of common stock			4,000,000	40	110,388			110,428
Vesting of restricted common stock			169,992	1	5,167			5,168
Repurchase of outstanding common stock			(3,129,810)	(31)	(86,392)		834	(85,589)
Common dividends declared and payable at $1.31 per share							(78,723)	(78,723)
Series A preferred dividends declared and payable at $2.00 per share							(14,100)	(14,100)
Series C preferred dividends declared and payable at $1.583 per share							(6,495)	(6,495)
Accretion of discount on Series C preferred stock					(200)			(200)
Net income						125,663		125,663
Balance at December 31, 2007	7,050,000	$ 176,250	58,815,271	$ 588	$ 987,554	$ 191,208	$ (261,665)	$ 1,093,935

See accompanying notes to consolidated financial statements

SUNSTONE HOTEL INVESTORS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Year Ended December 31, 2007	Year Ended December 31, 2006	Year Ended December 31, 2005
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	$ 125,663	$ 53,237	$ 30,205
Adjustments to reconcile net income to net cash provided by operating activities:			
Bad debt expense (recovery)	538	796	(170)
Minority interest			1,761
Gains on sale of hotel properties, other real estate and 50% interest in subsidiary	(66,019)	(9,048)	(2,431)
Loss on early extinguishment of debt	818	9,976	
Depreciation	117,544	101,486	73,029
Amortization of deferred franchise fees and other intangibles	5,701	351	129
Amortization of deferred financing costs	1,923	4,834	3,996
Amortization of loan premiums	(709)	(2,486)	(609)
Amortization of deferred stock compensation	5,168	3,677	1,992
Impairment loss Goodwill and discontinued operations		4,920	
Equity in (earnings) losses of unconsolidated joint ventures	3,588	(140)	
Changes in operating assets and liabilities:			
Restricted cash	11,234	(9,290)	1,398
Accounts receivable	3,707	647	(14,695)
Due from affiliates	451	611	(1,847)
Inventories	(104)	(260)	(307)
Prepaid expenses and other assets	(6,748)	(32)	(628)
Accounts payable and other liabilities	6,643	3,244	14,412
Accrued payroll and employee benefits	6,137	3,378	3,146
Due to Interstate SHP	(1,556)	(2,902)	4,099
Discontinued operations		77	(77)
Net cash provided by operating activities	213,979	163,076	113,403
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from sale of hotel properties, other real estate and 50% interest in subsidiary	185,728	157,718	31,412
Restricted cash replacement reserve	5,993	(2,074)	(26,793)
Proceeds received from sale of note receivable	29,047		
Cash received from(contributed to) unconsolidated joint ventures	426	(68,574)	
Acquisitions of hotel properties	(403,249)	(448,373)	(907,342)
Additions to hotel properties and other real estate	(135,231)	(139,364)	(71,555)
Net cash used in investing activities	(317,286)	(500,667)	(974,278)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from preferred stock offering		55,000	220,250
Payment of preferred stock offering costs		(842)	(3,929)
Proceeds from common stock offering	110,895	158,400	320,979
Payment of common stock offering costs	(467)	(693)	(8,739)
Payment for repurchases of outstanding common stock	(86,423)		
Proceeds from notes payable	426,000	440,542	701,207
Payments on notes payable	(204,494)	(212,868)	(295,633)
Payments of deferred financing costs	(7,506)	(3,726)	(4,847)

Dividends and distributions paid		(96,315)		(86,731)		(56,841)
Net cash provided by financing activities		141,690		349,082		872,447
Net increase in cash and cash equivalents		38,383		11,491		11,572
Cash and cash equivalents, beginning of year		29,029		17,538		5,966
Cash and cash equivalents, end of year	$	67,412	$	29,029	$	17,538
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION						
Cash paid for interest	$	94,648	$	92,824	$	56,265
NONCASH INVESTING ACTIVITY						
Sale of 50% interest in subsidiary						
Assets	$	1,235	$		$	
Liabilities	$	908	$		$	
NONCASH FINANCING ACTIVITY						
Assumption of debt in connection with acquisitions of hotel properties	$		$	81,000	$	63,143
Receipt of note receivable	$		$	5,600	$	
Dividends and distributions payable	$	25,995	$	23,826	$	19,831

See accompanying notes to consolidated financial statements.

SUNSTONE HOTEL INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Description of Business

Sunstone Hotel Investors, Inc. (the Company) was incorporated in Maryland on June 28, 2004 in anticipation of an initial public offering of common stock, which was consummated on October 26, 2004. The Company, through its 100% controlling interest in Sunstone Hotel Partnership, LLC (the Operating Partnership), of which the Company is the sole managing member, and the subsidiaries of the Operating Partnership, including Sunstone Hotel TRS Lessee, Inc. (the TRS Lessee) and its subsidiaries, is currently engaged in acquiring, owning, asset managing, renovating and selling hotel properties. The Company operates as a real estate investment trust (REIT) for federal income tax purposes.

As a REIT, certain tax laws limit the amount of non-qualifying income the Company can earn, including income derived directly from the operation of hotels. As a result, the Company leases all of its hotel properties to its TRS Lessee, which in turn has entered into long-term management agreements with third parties to manage the operations of the Company s hotels. As of December 31, 2007, the Company owned 45 hotels, and its third-party managers included Sunstone Hotel Properties, Inc., a division of Interstate Hotels & Resorts, Inc. (Interstate SHP), the manager of 26 of the Company s hotels; Marriott (as defined below), manager of 13 of the Company s hotels; and Hyatt Corporation (Hyatt), Fairmont Hotels & Resorts (Fairmont), Hilton Hotels Corporation (Hilton) and Starwood Hotels & Resorts Worldwide, Inc. (Starwood), collectively manager of six of the Company s hotels. In addition to its leased hotels, the Company has a 38% equity interest in a joint venture that owns the Doubletree Times Square, located in New York City, New York.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements as of December 31, 2007 and 2006, and for the years ended December 31, 2007, 2006 and 2005, include the accounts of the Company, the Operating Partnership, the TRS Lessee and their subsidiaries. All significant intercompany balances and transactions have been eliminated.

Minority interest for the year ended December 31, 2005 represents the allocation of earnings to outside equity interests of the Operating Partnership.

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

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Reporting Periods

The results the Company reports in its consolidated income statements are based on results reported to the Company by its hotel managers. These hotel managers use different reporting periods. Subsidiaries of Marriott International, Inc., or Marriott Hotel Services, Inc. (collectively, Marriott), use a fiscal year ending on the Friday closest to December 31, and report twelve weeks of operations each for the first three quarters of the year and sixteen or seventeen weeks of operations for the fourth quarter of the year. The Company s other hotel managers report operations on a standard monthly calendar. The Company has elected to adopt quarterly close periods of March 31, June 30 and September 30, and an annual year end of December 31. As a result, the Company s results of operations for the Marriott-managed hotels for the year ended December 31, 2007 include results from December 30 through March 23 for the first quarter, March 24 through June 15 for the second quarter, June 16 through September 7 for the third quarter, and September 8 through December 28 for the fourth quarter. The Company s 2006 results of operations for the Marriott-managed hotels include results from December 31 through March 24 for the first quarter, March 25 through June 16 for the second quarter, June 17 through September 8 for the third quarter, and September 9 through December 29 for the fourth quarter. The Company s 2005 results of operations for the Marriott-managed hotels include results from January 1 through March 25 for the first quarter, March 26 through June 17 for the second quarter, June 18 through September 9 for the third quarter, and September 10 through December 30 for the fourth quarter.

Cash and Cash Equivalents

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

The Company maintains cash and cash equivalents and certain other financial instruments with various financial institutions. These financial institutions are located throughout the country and the Company s policy is designed to limit exposure to any one institution. The Company performs periodic evaluations of the relative credit standing of those financial institutions that are considered in the Company s investment strategy. At December 31, 2007 and 2006, the Company had amounts in banks that were in excess of federally insured amounts.

Restricted Cash

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

Accounts Receivable

Accounts receivable primarily represents receivables from hotel guests who occupy hotel rooms and utilize hotel services. Accounts receivable also includes receivables from customers who utilize the Company s laundry facilities in Salt Lake City, Utah, and Rochester, Minnesota. The Company maintains an allowance for doubtful accounts sufficient to cover potential credit losses. The Company s accounts receivable at December 31, 2007 and 2006 includes an allowance for doubtful accounts of $0.4 million and $0.6 million, respectively. At December 31, 2007 and 2006, the Company had approximately $5.0 million and $4.0 million, respectively, in accounts receivable with one customer who is operating under a contract with the United States government. The Company has specifically reserved a portion of these particular receivables in the amount of $14,000 and $50,000, respectively.

Inventories

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

Investments In Hotel Properties, Other Real Estate and Franchise Fees

Hotel properties and other real estate assets are recorded at cost, less accumulated depreciation. Hotel properties and other completed real estate investments are depreciated using the straight-line method over estimated useful lives ranging from five to 35 years for buildings and improvements and three to 12 years for furniture, fixtures and equipment. Intangible assets are amortized using the straight-line method over their estimated useful life or over the length of the related agreement, whichever is shorter. Initial franchise fees are recorded at cost and amortized using the straight-line method over the lives of the franchise agreements ranging from six to 20 years. All other franchise fees that are based on the Company s results of operations are expensed as incurred.

The Company follows the requirements of Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS No. 144). FAS No. 144 requires impairment losses to be recorded on long-lived assets to be held and used by the Company when indicators of impairment are present and the future undiscounted cash flows estimated to be generated by those assets are less than the assets carrying amount. When an impairment loss is required for assets to be held and used by the Company, the related assets are adjusted to their estimated fair values. When an impairment loss is required for assets held for sale, the related assets are adjusted to their estimated fair values, less costs to sell. Operating results of any long-lived assets with their own identifiable cash flows that are disposed of or held for sale are removed from income from continuing operations and reported as discontinued operations. Depreciation ceases when a property is held for sale. The operating results for any such assets for any prior periods presented must also be reclassified as discontinued operations. Based on the Company s review, management believes that there were no other impairments on its long-lived assets held for use and that the carrying values of its hotel properties and other real estate are recoverable at December 31, 2007.

Fair value represents the amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than a forced or liquidation sale. The estimation process involved in determining if assets have been impaired and in the determination of fair value is inherently uncertain because it requires estimates of current market yields as well as future events and conditions. Such future events and conditions include economic and market conditions, as well as the availability of suitable financing. The realization of the Company s investment in hotel properties and other real estate is dependent upon future uncertain events and conditions and, accordingly, the actual timing and amounts realized by the Company may be materially different from their estimated fair values.

Deferred Financing Costs

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

Upon repayment of the underlying debt, any related unamortized deferred financing cost is charged to interest expense. During 2007 and 2006, approximately $7.5 million and $3.7 million, respectively, were incurred and paid, related to new debt and debt refinancings. Such costs are being amortized over the related terms of the loans.

Interest expense related to the amortization of deferred financing costs was $1.9 million, $4.8 million, and $4.0 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Goodwill

The Company follows the requirements of Statement No. 142, *Goodwill and Other Intangible Assets* (FAS No. 142). Under FAS No. 142, goodwill and intangible assets deemed to have indefinite lives are subject to annual impairment tests. As a result, the carrying value of goodwill allocated to the hotel properties and other real estate is reviewed at least annually and when facts and circumstances suggest that it may be impaired. Such review entails comparing the carrying value of the individual hotel property (the reporting unit) including the allocated goodwill to the fair value determined for that hotel property. If the aggregate carrying value of the hotel property exceeds the fair value, the goodwill of the hotel property is impaired to the extent of the difference between the fair value and the aggregate carrying value, not to exceed the carrying amount of the allocated goodwill. In conjunction with the sale of seven hotel properties during the second and fourth quarters of 2007 and 14 hotel properties during the third and fourth quarters of 2006, the Company wrote off the goodwill associated with these properties totaling $6.0 million against gain on sale of hotels in 2007 and $4.9 million to impairment loss in 2006. The amounts are included in income/(loss) from discontinued operations. The fair values of the reporting units were determined using factors such as net operating cash flows, terminal capitalization rates and replacement costs. Based on the Company s review at December 31, 2007 and December 31, 2006, management believes that there were no additional impairments on its goodwill.

Property and Equipment

Property and equipment is stated on the cost basis and includes computer equipment and other corporate office equipment and furniture. Property and equipment is depreciated on a straight-line basis over the estimated useful lives ranging from three to 12 years. The cost basis of property and equipment amounted to $7.1 million and $7.5 million at December 31, 2007 and 2006, respectively. Accumulated depreciation amounted to $5.7 million at both December 31, 2007 and 2006. Property and equipment net of related accumulated depreciation is included in other assets.

Investment in Unconsolidated Joint Ventures

In December 2007, the Company entered into a joint venture agreement with Strategic Hotels & Resorts, Inc. (Strategic) to own and operate BuyEfficient, LLC, an electronic purchasing platform that allows members to procure food, operating supplies, furniture, fixtures and equipment. Under the terms of the agreement, Strategic acquired a 50% interest in BuyEfficient, LLC from the Company. In December 2006 the Company entered into a joint venture agreement to obtain a 38% interest in the Doubletree Guest Suites Hotel in New York City, New York. The Company accounts for both of these ownership interests using the equity method. The Company s accounting policies are consistent with those of the unconsolidated joint ventures

Fair Value of Financial Instruments

As of December 31, 2007 and 2006, the carrying amount of certain financial instruments, including cash and cash equivalents, accounts receivable, accounts payable, and accrued expenses were representative of their fair values due to the short-term maturity of these instruments. As of December 31, 2007, all of the Company s outstanding debt has fixed interest rates. The Company s fixed-rate mortgage debt is at commensurate terms with similar debt instruments based on risk, collateral, and other characteristics, except for two mortgage loans assumed in 2005, one of which was defeased in 2007 and

the other of which was refinanced in 2006. During 2006, the Company adjusted the carrying value of the loan repaid in 2007 by $0.7 million. This adjustment is included in Other Liabilities. Management believes the carrying value of the mortgage and other debt is a reasonable estimation of its fair value as of December 31, 2007 and 2006.

Revenue Recognition

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

Other operating revenues consist of revenues derived from incidental hotel services such as concessions, movie rentals, retail sales, fitness services, internet access, telephone, sublease revenues relating to the restaurants and retail shops. Additionally, as part of the Company s purchase of the Hyatt Regency Century Plaza, the Company entered into a 30-year term agreement with Hyatt whereby Hyatt provided the Company with a limited performance guaranty that ensured, subject to certain limitations, a return on equity to the Company. Under the terms of this agreement, were net cash flow generated by the hotel to be insufficient to cover the Company s debt service related to this hotel, plus a 10% return on the Company s equity investment in the hotel, Hyatt was obligated to pay the Company the difference, up to $27.0 million over the term of the agreement. The Company recognized into revenue quarterly, the amount due from Hyatt under this agreement. The Company used a total of $2.8 million of the $27.0 million performance guaranty during 2007, $17.4 million during 2006, and $6.8 million during 2005 for a total of $27.0 million cumulatively. Also, as an adjunct to the Company s hotels located in Rochester, Minnesota and Salt Lake City, Utah, the Company operates commercial laundries at those locations providing laundry services to the Company s hotels and other third parties in the respective locations. Revenues from incidental hotel services, management agreements, and laundry services are recognized in the period the related services are provided or the revenue is earned. Prior to December 7, 2007, the Company wholly owned BuyEfficient, LLC, an online purchasing platform that offers volume discounts to third parties. Revenues generated by BuyEfficient, LLC prior to December 7, 2007 were included in the Company s other operating revenue, and consisted of transactions fees, development fees, and rebate sales as BuyEfficient, LLC charges the third party for the installation associated with configuring the third party s information technology system with the purchasing platform and access rights to the purchasing platform. Fees for the installation are typically based on time and materials and are recognized as the services are performed. Fees associated with access rights are based on a percentage of the price of goods purchased by the third party from the vendor and are recognized when earned. On December 7, 2007 the Company entered into a joint venture agreement with Strategic whereby Strategic acquired a 50% interest in BuyEfficient, LLC from the Company. In accordance with the equity method of accounting, the Company s share of BuyEfficient LLC s earnings is now shown in equity in earnings (losses) of unconsolidated joint ventures.

Advertising and Promotion Costs

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

Income Taxes

For the years ended December 31, 2007, 2006 and 2005, the Company elected to be treated as a REIT pursuant to the Internal Revenue Code, as amended (the Code). Management believes that the Company has qualified and intends to continue to qualify as a REIT. Therefore, the Company is permitted to deduct distributions paid to our stockholders, eliminating the federal taxation of income represented by such distributions at the company level. REITs are subject to a number of organizational and operational requirements. If the Company fails to qualify as a REIT in any taxable year, the Company will be subject to federal income tax (including any applicable alternative minimum tax) on taxable income at regular corporate tax rates.

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

Minority Interest

Prior to November 2005, minority interests of the Company represented the limited partnership interests in the Operating Partnership. The carrying value of the minority interest increased by the minority interests share of earnings and decreased by cash distributions and the purchase of limited partnership interests. During November 2005, the membership

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

Dividends

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

Earnings Per Share

The Company applies the two-class method as required by the Financial Accounting Standards Board (FASB) Emerging Issues Task Force Issue No. 03-6, *Participating Securities and the Two-Class Method under FASB Statement No. 128, Earnings per Share* (EITF No. 03-6). EITF No. 03-6 requires the net income per share for each class of stock (common stock and convertible preferred stock) to be calculated assuming 100% of the Company s net income is distributed as dividends to each class of stock based on their contractual rights. To the extent the Company has undistributed earnings in any calendar quarter, the Company will follow the two-class method of computing earnings per share.

Basic income available to common stockholders per share is computed based on the weighted average number of shares of common stock outstanding during each period. Diluted income available to common stockholders per share of common stock is computed based on the weighted average number of shares of common stock outstanding during each period, plus convertible redeemable preferred stock and unvested restricted stock awards considered outstanding during the period, in accordance with Statement of Financial Accounting Standards No. 128, *Earnings per Share.*

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

	Year Ended December 31, 2007	Year Ended December 31, 2006	Year Ended December 31, 2005
Numerator:			
Net income	$ 125,663	$ 53,237	$ 30,205
Less preferred dividends and accretion	(20,795)	(19,616)	(10,973)
Less undistributed income allocated to Series C Preferred Stock	(1,583)		
Numerator for basic and diluted earnings available to common stockholders	$ 103,285	$ 33,621	$ 19,232
Denominator:			
Weighted average basic common shares outstanding	58,998	57,247	40,655
Unvested restricted stock awards	141	162	106
Weighted average diluted common shares outstanding	59,139	57,409	40,761
Basic earnings available to common stockholders per common share	$ 1.75	$ 0.59	$ 0.47
Diluted earnings available to common stockholders per common share	$ 1.75	$ 0.59	$ 0.47

Shares of the Company s Series C preferred stock have not been included in the above calculation of earnings per share for the years ended December 31, 2007, 2006 and 2005 as their effect would have been anti-dilutive.

During the third quarter of 2007, the Company revised its methodology for computation of diluted earnings per share by applying the treasury stock method to unvested restricted stock awards. In prior periods, the Company included the entire weighted average number of unvested restricted stock awards in diluted shares outstanding. This revision had no effect on basic or diluted earnings per share as reported by the Company for the year ended December 31, 2005. For the year ended December 31, 2006, the change resulted in a $0.01 increase in diluted income available to common stockholders per common share. As a result of this revision, the unvested restricted stock awards for purposes of calculating diluted earnings per share have been decreased by 282,000 shares and 198,000 shares for the years ended December 31, 2006 and

2005, respectively. There was no change in the number of shares for purposes of basic earnings per share.

Segment Reporting

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

Recent Accounting Pronouncements

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* . The provisions of FIN 48 became effective for the Company s fiscal year beginning January 1, 2007. Based on the Company s evaluation, the Company has concluded that there are no significant uncertain tax positions requiring recognition in its financial statements. The Company s evaluation was performed for the tax years ended December 31, 2004, 2005 and 2006. These are the tax years which remained subject to examination by major tax jurisdictions as of December 31, 2007. The Company may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to our financial results. In the event the Company receives an assessment for interest and/or penalties, it will be classified in the financial statements as tax expense.

In September 2006, the FASB issued Statement No. 157 (FAS 157), *Fair Value Measurements* (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157* (the FSP). The FSP amends FAS 157 to delay the effective date of FAS 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (that is, at least annually). For items within its scope, the FSP defers the effective date of FAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company does not believe adoption will have a material effect on its financial condition, results of operations and cash flow.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159). FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. FAS 159 is effective as of the beginning of an entity s first fiscal year that begins after November, 15, 2007. The Company is currently evaluating the effect, if any, the adoption of FAS 159 will have on its financial condition, results of operations and cash flow.

In December 2007, the FASB issued revised Statement No. 141 *Business Combinations* (FAS 141R). FAS 141R will change the accounting for business combinations. Under FAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. FAS 141R will change the accounting treatment and disclosure for certain specific items in a business combination. FAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. FAS 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.

In December 2007, the FASB issued Statement No. 160 *Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51* (FAS 160). FAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. FAS 160 is effective for fiscal years beginning on or after December 15, 2008. The Company does not currently expect the adoption of FAS 160 to have a material impact on its consolidated financial position, results of operations and cash flows.

3. Investment in Hotel Properties

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

	December 31,	
	2007	**2006**
Land	$ 439,387	$ 384,242
Buildings and improvements	2,370,563	2,067,930
Fixtures, furniture and equipment	295,111	264,870
Intangibles	42,863	35,736
Franchise fees	1,396	1,382
Construction in process	24,426	30,808

	3,173,746	2,784,968
Accumulated depreciation and amortization	(386,925)	(307,454)
	$ 2,786,821	$ 2,477,514

In January 2007, the Company purchased the 499-room LAX Renaissance located in Los Angeles, California for $65.2 million and retained Marriott as manager. This hotel s results of operations from the acquisition date of January 4, 2007 through Marriott s fourth quarter ended December 28, 2007, have been included in the Company s income statements.

In March 2007, the Company purchased the 402-room Marriott Long Wharf located in Boston, Massachusetts for $228.5 million and retained Marriott as manager. This hotel s results of operations from the acquisition date of March 23, 2007 through Marriott s fourth quarter ended December 28, 2007, have been included in the Company s income statements.

In April 2007, the Company paid an additional $0.8 million as part of a purchase price true-up for the Marriott Del Mar located in San Diego, California, originally purchased by the Company in January 2006. In December 2007, the Company accrued an additional $0.1 million to be paid in January 2008.

In May 2007, the Company purchased the 464-room Marriott Boston Quincy Hotel located in Quincy, Massachusetts for a purchase price of $117.0 million and retained Marriott as manager. This hotel s results of operations from the acquisition date of May 1, 2007 through Marriott s fourth quarter ended December 28, 2007, have been included in the Company s income statements.

On January 10, 2006, the Company purchased the 284-room Marriott Del Mar located in San Diego, California for $69.1 million and named Marriott as manager. This hotel s results of operations from the acquisition date of January 10, 2006 through Marriott s fourth quarter ended December 29, 2006, have been included in the Company s income statements.

On March 17, 2006, the Company purchased the 444-room Hilton Times Square located in New York City for $241.5 million and named the Interstate SHP as manager. In addition, concurrently with the acquisition, the Company exercised an option and made an additional $15.0 million payment to convert the property to a franchise. This hotel s results of operations from the acquisition date of March 17, 2006 through the fourth quarter ended December 31, 2007 have been included in the Company s income statements.

On May 17, 2006, the Company purchased the 335-room Embassy Suites La Jolla located in San Diego, California for $100.7 million and named Hilton Hotels Corporation as manager. This hotel s results of operations from the acquisition date of May 17, 2006 through the fourth quarter ended December 31, 2007, have been included in the Company s income statements.

On June 26, 2006, the Company purchased the 259-room W San Diego located in San Diego, California for $95.9 million and named Starwood Hotels & Resorts Worldwide, Inc. as manager. This hotel s results of operations from the acquisition date of June 26, 2006 through the fourth quarter ended December 31, 2006, have been included in the Company s income statements.

Acquired properties are included in the Company s results of operations from the date of acquisition. The following unaudited pro forma results of operations reflect the Company s results as if the acquisitions had occurred on the first day of each fiscal year presented. In the Company s opinion, all significant adjustments necessary to reflect the effects of the acquisitions have been made (in thousands, except per share data):

	Year Ended December 31, 2007	**Year Ended December 31, 2006**	**Year Ended December 31, 2005**
Revenues	$ 1,073,229	$ 977,426	$ 918,254
Income available to common stockholders from continuing operations	$ 37,951	$ 9,161	$ 2,438
Income per diluted share available to common stockholders from continuing operations	$ 0.64	$ 0.16	$ 0.06

4. Discontinued Operations

As part of a strategic plan to dispose of non-core hotel assets, the Company sold seven hotel properties during 2007, 15 hotel properties during 2006, and three hotel properties during 2005. Seven properties were sold during 2007 for net proceeds of $179.3 million and a net gain of $59.9 million. Fifteen properties were sold during 2006 for net proceeds of $163.3 million, including the receipt of a $5.6 million note receivable. One of the properties sold during 2006 was classified as held for sale on the Company s consolidated balance sheet as of December 31, 2005. This property was subsequently sold in March 2006. The Company recognized a net gain on sale of assets of $9.0 million, and also recognized a $4.9 million goodwill impairment loss in the year ended December 31, 2006. Three properties and two parcels of land were sold during 2005 for net proceeds of $31.4 million and a net gain on sale of $2.3 million. These 25 hotel properties met the held for sale and discontinued operations criteria in accordance with FAS No. 144.

The following sets forth the discontinued operations for the years ended December 31, 2007, 2006 and 2005, related to hotel properties that have been sold (in thousands):

	Year Ended December 31, 2007	Year Ended December 31, 2006	Year Ended December 31, 2005
Operating revenues	$ 32,554	$ 99,622	$ 120,773
Operating expenses	(22,575)	(71,189)	(88,202)
Interest expense	(2,977)	(5,503)	(11,135)
Depreciation and amortization	(3,390)	(11,445)	(14,668)
Goodwill and asset impairment loss		(4,920)	
Gain on sale of hotels	59,893	9,048	2,339
Income from discontinued operations	$ 63,505	$ 15,613	$ 9,107

5. Other Real Estate

Other real estate consisted of the following (in thousands):

	December 31, 2007	December 31, 2006
Land	$ 3,824	$ 3,824
Buildings and improvements	9,565	9,070
Fixtures, furniture and equipment	5,131	4,465
Construction in progress	10	89
	18,530	17,448
Accumulated depreciation	(4,514)	(3,708)
	14,016	13,740
Land held for investment	510	933
	$ 14,526	$ 14,673

In May 2007, the Company sold a vacant parcel of land for net proceeds of $429,000, resulting in a net loss of $23,000.

During the first quarter of 2006, the Company purchased land and an office building adjacent to one of its hotels in Troy, Michigan for $4.4 million.

6. Investment in Unconsolidated Joint Ventures

On December 7, 2007 the Company entered into a joint venture agreement with Strategic to own and operate BuyEfficient, LLC, an electronic purchasing platform that allows members to procure food, operating supplies, furniture, fixtures and equipment. Under the terms of the agreement, Strategic acquired a 50% interest in BuyEfficient, LLC from the Company for a gross sales price of $6.3 million. As part of this transaction, the Company reclassed its remaining 50% share in BuyEfficient, LLC to investment in unconsolidated joint ventures and recognized a gain on sale of $6.1 million.

On December 28, 2006 the Company entered into a joint venture agreement with Whitehall Street Global Real Estate Limited Partnership 2005 (Whitehall) and Highgate Holdings (Highgate) to acquire the 460-room Doubletree Guest Suites Hotel in New York City, New York. The $68.5 million investment was funded entirely from cash on hand and was comprised of two parts: (i) a $28.5 million mezzanine loan, which bore an interest rate of 8.5% on a face value of $30 million and (ii) a $40 million equity investment representing a 38% ownership interest in the joint venture. In April 2007, the Company sold the $28.5 million mezzanine loan for net proceeds of $29.0 million. Annual dividends on the equity investment are senior to the returns on equity to both Whitehall and Highgate and begin at 8.0% and grow to 9.25% over a nine-year period. In addition, the equity is entitled to receive a pro-rata share of any excess equity distributions to the joint venture.

7. Other Assets

Other assets consist of the following (in thousands):

	December 31, 2007	December 31, 2006
Property and equipment, net	$ 1,360	$ 1,730
Pre-acquisition costs	549	8,985
Other receivables	12,228	8,485
Other	2,937	2,771
	$ 17,074	$ 21,971

During the third quarter of 2006, the buyer of 13 of the Company s hotels issued a $5.6 million promissory note to the Company. The note includes an interest rate of 8.0% per year on the unpaid principal balance, and is due in October 2011.

8. Due to Interstate SHP and Other Current Liabilities

Due to Interstate SHP

Interstate SHP manages 26 of the Company s 45 hotels as of December 31, 2007. The following amounts make up the net liability owed to Interstate SHP (in thousands):

	December 31, 2007	December 31, 2006
Accrued payroll and employee benefits	$ 10,574	$ 10,088
Worker s compensation	4,822	6,683
Accrued pension liability	242	500
Management and accounting fees payable	738	738
Other		9
Accumulated other comprehensive loss and reimbursements from Interstate SHP	(1,325)	(1,411)
	$ 15,051	$ 16,607

Other Current Liabilities

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

	December 31, 2007	December 31, 2006
Property, sales, and use taxes payable	$ 12,637	$ 11,039
Accrued interest mortgage	13,400	7,421
Advanced deposits	5,591	6,542
Worker s compensation	103	86
Other	8,086	7,266

	$ 39,817	$ 32,354

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9. Notes Payable

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

	2007	2006
Notes payable requiring payments of interest and principal, with fixed rates ranging from 4.98% to 9.88%; maturing at dates ranging from December 2010 through May 2021. The notes are collateralized by first deeds of trust on 34 hotel properties and one laundry facility.	$ 1,472,151	$ 1,499,828
Exchangeable senior notes with a fixed interest rate of 4.60%, maturing in July 2027. The notes are guaranteed by the Company and certain of its subsidiaries.	250,000	
	1,722,151	1,499,828
Less: current portion	(9,815)	(23,231)
	$ 1,712,336	$ 1,476,597

The Company was not in default on any of its loan covenants at December 31, 2007 and 2006.

During the first quarter of 2007, the Company drew down $138.0 million of its $200.0 million credit facility (the credit facility) in connection with the acquisitions of the LAX Renaissance, Los Angeles, California and the Marriott Long Wharf, Boston, Massachusetts, and for other working capital requirements. During the second quarter of 2007, the Company drew down an additional $27.0 million of the credit facility in connection with the acquisition of the Marriott Boston Quincy, Quincy, Massachusetts, and for other working capital requirements. During the fourth quarter, the Company drew down an additional $10.0 million of the credit facility to fund working capital requirements. The Company repaid $24.0 million of the credit facility in April 2007, $141.0 million in June, and the remaining $10.0 million balance in November 2007. As of December 31, 2007, the Company had no outstanding indebtedness under its credit facility, and had $10.8 million in outstanding irrevocable letters of credit backed by the credit facility, leaving, as of that date, $189.2 million available under the credit facility.

In March 2007, the Company obtained a $176.0 million mortgage loan with a maturity date of April 2017 and a fixed interest rate of 5.58% in connection with the acquisition of the Marriott Long Wharf, Boston, Massachusetts.

In April 2007, the Company amended one of its mortgage loans to eliminate amortization and to provide for partial collateral releases, provided the Company continues to meet certain loan covenants, from May 2007 until the maturity date of May 2011, at which time the outstanding loan balance of $248.2 million will be due and payable.

In May 2007, the Company amended its credit facility initially entered into in July 2006 (as described below). The interest rate on the amended credit facility continues to be based on grid pricing, with the interest rate spread to LIBOR changing based on the Company s overall leverage ratio. The pricing grid sets forth in four tiers the applicable interest rate spread at leverage ratios for the Company as follows: tier 1 up to and including 50%, tier 2 greater than 50% and less than or equal to 55%, tier 3 greater than 55% and less than or equal to 60%, and tier 4 greater than 60%. The applicable interest rate spreads for each of the various tiers contained in the amended credit facility are 90 basis points, 105 basis points, 125 basis points and 150 basis points for tiers 1 to 4, respectively, which are 25 to 35 basis points lower than the applicable spreads contained in credit facility prior to its amendment. In addition, the Company extended the initial maturity date on the credit facility from 2010 to 2011.

In June 2007, the Operating Partnership issued an aggregate $250.0 million of exchangeable senior notes with a maturity date of July 2027 and an interest rate of 4.60%. Interest on the notes is payable semi-annually in arrears on January 15 and July 15 of each year, beginning January 15, 2008. The notes, subject to specified events and other conditions, are exchangeable into, at the Company s option, cash, the Company s common stock, or a combination of cash and the Company s common stock. The initial exchange rate for each $1,000 principal amount of notes is 28.9855 shares of the Company s common stock, representing an exchange price of approximately $34.50 per common share. The initial exchange rate is subject to adjustment under certain circumstances. The Operating Partnership does not have the right to redeem the notes, except to preserve the Company s REIT status, before January 20, 2013, and may redeem the notes, in whole or in part, thereafter at a redemption price equal to 100% of the principal amount of the notes to be redeemed, plus any accrued and unpaid interest. Upon specified change in control events as well as on specified dates, holders of the notes may require the Operating Partnership to repurchase their notes, in whole or in part, for cash equal to 100% of the principal amount of the notes to be repurchased, plus any accrued and unpaid interest. The notes are the senior unsecured obligations of the Operating Partnership. The Company and all of its subsidiaries that are guarantors under the Company s credit facility have guaranteed the Operating Partnership s obligations under the notes. The notes do not qualify as a derivative or an equity instrument.

In June 2007, the Company repaid a $175.0 million mortgage loan with a maturity date of December 2014. In connection with the repayment, the Company incurred prepayment penalties of $0.4 million.

In August 2007, the Company repaid a $13.1 million mortgage loan with a maturity date of September 2007.

In December 2007, the Company defeased an $8.7 million mortgage loan with an effective maturity date of August 2009, incurring a loss on early extinguishment of debt of $0.8 million related to the cost associated with the defeasance of the debt.

In January 2006, the Company obtained a $48.0 million fixed rate mortgage loan with a maturity date of January 2016 and a fixed interest rate of 5.69% in connection with the acquisition of the Marriott Del Mar, San Diego, California.

In February 2006, the Company refinanced two of its hotel properties, replacing a $36.9 million mortgage at a fixed interest rate of 8.25% scheduled to mature in 2008, with an 11-year $75.0 million mortgage at a fixed interest rate of 5.58%. Additionally, the Company replaced a $35.8 million mortgage at a fixed rate of 8.25% scheduled to mature in 2008, with a ten-year $34.0 million mortgage at a fixed rate of 5.66%. In connection with these transactions, the Company expensed $7.4 million for loss on early extinguishment of debt related to the cost associated with the defeasance of the previous debt.

In March 2006, the Company assumed an $81.0 million fixed rate mortgage loan with a maturity date of December 2010 and an interest rate of 5.92% in connection with the acquisition of the Hilton Times Square located in New York City.

In April 2006, the Company refinanced one of its hotel properties by defeasing the existing $52.9 million loan at a fixed interest rate of 7.50% scheduled to mature in 2008 with a portion of the proceeds from a new loan of $135.0 million at a fixed rate of 5.95% scheduled to mature in 2021. In connection with this transaction, the Company expensed $2.6 million for loss on early extinguishment of debt related to the cost associated with the defeasance of the previous debt.

In May 2006, the Company obtained a $70.0 million fixed rate mortgage loan with a maturity date of June 2019 and a fixed interest rate of 6.60% in connection with the acquisition of the Embassy Suites, La Jolla, California.

In June 2006, the Company obtained a $65.0 million fixed rate mortgage loan with a maturity date of January 2018 and an interest rate of 6.14% in connection with the acquisition of the W Hotel, San Diego, California.

In July 2006, the Company closed a $200.0 million unsecured credit facility (the new credit facility). This facility replaced the Company s $150.0 million secured credit facility. Amounts outstanding under the new credit facility bear interest at LIBOR plus the applicable margin for eurodollar rate advances or the Citibank, N.A. prime lending rate plus the applicable margin for base rate advances. The applicable margin ranges were initially set from 1.25% to 1.75% in the case of eurodollar rate advances and 0.25% to 0.75% in the case of base rate advances, depending upon the ratio of the Borrower s Total Debt to EBITDA , although these were reduced pursuant to an amendment as described above. The maturity date of this facility is July 2010. In addition, the applicable margin will increase by 2.0% upon the occurrence and during the continuance of an event of default. Subject to certain conditions, the new credit facility may be extended for one year and increased to $300.0 million. The new credit facility is unsecured and advances are not subject to any borrowing base requirement. The Company is required to maintain a pool of specified unencumbered assets (the unencumbered pool assets). Assets may be removed from or added to the unencumbered pool assets, subject to the satisfaction of certain conditions. The new credit facility contains customary financial covenants, including certain leverage and coverage ratios and a minimum tangible net worth. In connection with this refinancing, the Company expensed $1.3 million of deferred financing costs.

In August 2006, the Company exercised its right under the earn-out agreement for the loan on the Renaissance Orlando to draw an additional $13.0 million of debt under the agreement. The terms under the revised mortgage loan remain the same, with interest only payments at a rate of 5.30% payable until July 2008, and a maturity date in July 2016.

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

	Year Ended December 31, 2007	Year Ended December 31, 2006	Year Ended December 31, 2005
Continuing operations:			
Interest expense	$ 96,280	$ 78,681	$ 45,748
Deferred financing fees	1,859	4,298	3,134
Prepayment penalties	415		2,665

Write-off loan premium		(465)		(1,903)		
Costs associated with early extinguishments of debt		818		9,976		
	$	98,907	$	91,052	$	51,547
Discontinued operations:						
Interest expense	$	2,913	$	4,970	$	10,096
Deferred financing fees		64		533		861
Costs associated with early extinguishment of debt						178
	$	2,977	$	5,503	$	11,135

Aggregate future principal maturities of notes payable at December 31, 2007, are as follows (in thousands):

2008	$ 9,815
2009	13,382
2010	95,983
2011	265,939
2012	76,839
Thereafter	1,260,193
	$ 1,722,151

10. Income Taxes

The Company has elected to be taxed as a REIT under the Code. As a REIT the Company generally will not be subject to corporate level federal income taxes on net income it distributes to its stockholders. The Company may be subject to certain state and local taxes on its income and property and to federal income and excise taxes on its undistributed taxable income. Taxable income from non-REIT activities managed through taxable REIT subsidiaries is subject to federal, state and local taxes.

The Company leases its hotels to wholly owned TRS s that are subject to federal and state income taxes. The Company accounts for income taxes in accordance with the provisions of FAS 109, *Accounting for Income Taxes* . Under FAS 109, the Company accounts for income taxes using the asset and liability method, under which deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between GAAP carrying amounts and their respective tax bases.

The income tax benefit (provision) included in the consolidated financial statements is as follows (in thousands):

	Year Ended December 31, 2007	Year Ended December 31, 2006	Year Ended December 31, 2005
Current:			
Federal	$	$	$
State			
Deferred:			
Federal	2,032	5,695	8,619
State	525	1,438	2,204
	2,557	7,133	10,823
Valuation allowance	(2,557)	(7,133)	(10,823)
Provision for income taxes	$	$	$

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

	December 31, 2007	December 31, 2006
NOL carryover	$ 20,874	$ 19,387
Other reserves	4,657	3,833
State taxes and other	816	533
Current deferred tax asset before valuation allowance	26,347	23,753
Depreciation	(84)	(47)
	(84)	(47)
Net deferred tax asset	26,263	23,706
Valuation allowance	(26,263)	(23,706)
	$	$

The Company has provided a valuation allowance against its deferred tax asset at December 31, 2007 and 2006. The valuation allowance is due to the uncertainty of realizing the Company s historical operating losses. Accordingly, no provision or benefit for income taxes is reflected in the accompanying consolidated income statements.

At December 31, 2007 and 2006, net operating loss carryforwards for federal income tax purposes is approximately $53.0 million and $49.0 million, respectively. These losses, which begin to expire in 2019, are available to offset future income through 2026.

Characterization of Distributions:

For income tax purposes, distributions paid consist of ordinary income, capital gains, return of capital or a combination thereof. For the years ended December 31, 2007, 2006, and 2005, distributions paid per share were characterized as follows:

	2007		2006		2005	
	Amount	%	Amount	%	Amount	%
Common Stock:						
Ordinary income	$ 1.267	96.744%	$ 1.240	100.000%	$ 1.440	100.000%
Capital gain	0.043	3.256				
Return of capital						
Total	$ 1.310	100.000%	$ 1.240	100.000%	$ 1.440	100.000%
Preferred Stock Series A						
Ordinary income	$ 1.935	96.743%	$ 2.000	100.000%	$ 1.578	100.000%
Capital gain	0.065	3.257				
Return of capital						
Total	$ 2.000	100.000%	$ 2.000	100.000%	$ 1.578	100.000%
Preferred Stock Series C						
Ordinary income	$ 1.531	96.743%	$ 1.572	100.000%	$ 0.786	100.000%
Capital gain	0.052	3.257				
Return of capital						

Total	$ 1.583	100.000%	$ 1.572	100.000%	$ 0.786	100.000%

11. Series C Cumulative Convertible Redeemable Preferred Stock

In July 2005, the Company sold 4,102,564 shares of Series C Cumulative Convertible Redeemable Preferred Stock (Series C preferred stock) with a liquidation preference of $24.375 per share to Security Capital Preferred Growth, Incorporated, an investment vehicle advised by Security Capital Research & Management Incorporated, for gross proceeds of $99.0 million, or $24.13 per share, which included a 1% discount to the conversion price/liquidation preference. Other costs of the offering totaled $130,000. Net proceeds of $99.0 million were contributed to the Operating Partnership in exchange for preferred membership units with economic terms substantially identical to the Series C preferred stock. The net proceeds were used to partially finance the Company s acquisition of six Renaissance hotels. The Series C preferred stock is convertible into shares of the Company s common stock at the option of the holder on a one-for-one basis, subject to customary antidilution provisions, including stock splits, stock dividends, non-cash distributions and above-market issuer self-tender or exchange offers. On or after July 8, 2010, the Series C preferred stock will be redeemable at the Company s option, in whole or in part, at any time or from time to time, for cash at a redemption price of $24.375 per share, plus accrued and unpaid dividends up to and including the redemption date. The holders of the Series C preferred stock have the right to require the Company to redeem the Series C preferred stock in the event of any of the following: (1) a change in control of the Company, if certain conditions are not met; (2) a REIT termination event; or, (3) a termination of the Company s listing on either the New York Stock Exchange or NASDAQ. In general, holders of Series C preferred stock vote on an as-converted basis as a single class with holders of the Company s common stock. If the Company is in violation of certain financial ratios for four consecutive quarters, the holders have the right to elect one director to serve on the Company s board of directors. In addition, if the Company is in arrears on dividends on the Series C preferred stock for four or more quarters, the holders have the right to elect additional directors to serve on the Company s board of directors. Subject to a limited exception, holders of Series C preferred stock cannot elect more than an aggregate of two directors. The holders are eligible to receive a participating dividend should the Company s dividend on its common stock increase beyond $0.339 per share per quarter. The Series C preferred stock has no maturity date and, except as set forth above, the Company is not required to redeem the Series C preferred stock at any time.

The initial carrying value of the Series C preferred stock was recorded at its sales price less costs to issue on the date of issuance. This carrying value is periodically adjusted so that the carrying value will equal the redemption value on the redemption date, which is the earliest date available for the Company to redeem the Series C preferred stock. The carrying value will also be periodically adjusted for any accrued and unpaid dividends, if any. At December 31, 2007 and 2006, the Series C preferred stock carrying value consisted of the following (in thousands):

	December 31,	
	2007	**2006**
Initial fair value, sales price of $99.0 million	$ 99,000	$ 99,000
Redemption value accretion	496	296
	$ 99,496	$ 99,296

12. Stockholders Equity

Series A Cumulative Redeemable Preferred Stock

In March 2005, the Company sold an aggregate of 4,850,000 shares of 8.0% Series A and B Cumulative Redeemable Preferred Stock (Series A preferred stock and Series B preferred stock, respectively) with a liquidation preference of $25.00 per share for gross proceeds of $121.3 million. Underwriting and other costs of the offering totaled $3.8 million. Net proceeds of $117.5 million were contributed to the Operating Partnership in exchange for preferred membership units with economic terms substantially identical to the Series A and B preferred stock. Subsequent to this offering, the shares of Series B preferred stock were exchanged for an equivalent number of shares of Series A preferred stock. The net proceeds were used to reduce borrowings under the Company s credit facility and for acquisitions. On or after March 17, 2010, the Series A preferred stock will be redeemable at the Company s option, in whole or in part, at any time or from time to time, for cash at a redemption price of $25.00 per share, plus accrued and unpaid dividends up to and including the redemption date. Holders of Series A preferred stock generally have no voting rights. However, if the Company is in arrears on dividends on the Series A preferred stock for six or more quarterly periods, whether or not consecutive, holders of the Series A preferred stock will be entitled to vote at its next annual meeting and each subsequent annual meeting of stockholders for the election of two additional directors to serve on the Company s board of directors until all unpaid dividends and the dividend for the then-current period with respect to the Series A preferred stock have been paid or declared and a sum sufficient for the payment thereof set aside for payment. The Series A preferred stock has no maturity date and the Company is not required to redeem the Series A preferred stock at any time.

In April 2006, the Company sold an additional 2,200,000 shares of Series A preferred stock with a liquidation preference of $25.00 per share for gross proceeds of $55.0 million. The proceeds to the Company, net of offering costs, were $54.2 million, and were used together with proceeds of certain debt refinancings to repay the Company s term loan facility.

Common Stock

In February 2006, the Company completed a follow-on offering of 5,500,000 shares of common stock at a price per share of $28.80 (before underwriting discounts and offering costs), generating gross proceeds of $158.4 million. The proceeds to the Company, net of offering costs, were $158.1 million and were used to fund a portion of the acquisition price of the Hilton Times Square and for general corporate purposes.

In July 2006, the Company entered into a forward sale agreement (the Forward Sale Agreement) with an affiliate of Citigroup Global Markets Inc. as the forward counterparty, relating to 4,000,000 shares of the Company s common stock. In connection with the execution of the Forward Sale Agreement and at the Company s request, Citigroup Global Markets Inc., as agent for the forward counterparty, borrowed and sold in a public offering 4,000,000 shares of common stock. In April 2007, the Company settled the Forward Sale Agreement for net proceeds of $110.0 million, including $0.4 million in related expenses paid in 2006. The proceeds were used to fund a portion of the acquisition price of the Marriott Boston Quincy hotel. The Forward Sale Agreement was accounted for as an equity instrument and did not qualify as a derivative liability.

In June 2007, the Company s board of directors authorized the Company to repurchase up to $100.0 million of the Company s common stock prior to December 31, 2007. The Company repurchased 3,129,810 shares of its common stock at a cost of $86.4 million through December 31, 2007.

Operating Partnership Units

As of December 31, 2007, the Operating Partnership had 58,815,271 units outstanding, all of which are held by the Company.

13. Long-Term Incentive Plan

The Company has a Long-Term Incentive Plan (LTIP) which provides for the granting to directors, officers and eligible employees of incentive or nonqualified share options, restricted shares, deferred shares, share purchase rights and share appreciation rights in tandem with options, or any combination thereof. The Company has reserved 3,850,000 common shares for issuance under the LTIP.

Restricted shares and restricted share units granted pursuant to the LTIP generally vest over periods from three to five years from the date of grant. The value of shares granted has been calculated based on the share price on the date of grant and is being amortized as compensation expense in accordance with the Company s policy on a straight-line basis over the vesting periods for the entire award. For the years ended December 31, 2007, 2006 and 2005, the Company s expense related to these restricted shares and restricted share units was $7.6 million, $5.2 million, and $2.6 million, respectively.

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

	2007		2006		2005	
	Shares	**Weighted Average Price**	**Shares**	**Weighted Average Price**	**Shares**	**Weighted Average Price**
Outstanding at beginning of year	626,841	$ 22.55	454,413	$ 17.56	434,211	$ 17.00

Granted	464,081	28.65	333,665	28.76	76,458	20.92
Vested	(255,571)	23.82	(124,444)	19.44	(46,782)	17.95
Forfeited	(184,805)	22.82	(36,793)	27.84	(9,474)	17.00
Outstanding at end of year	650,546	26.33	626,841	22.55	454,413	17.56

At December 31, 2007, there were no options, deferred shares, share purchase rights, or share appreciation rights issued or outstanding under the LTIP.

14. Commitments and Contingencies

Management Agreements

Management agreements with the Company s third-party hotel managers require the Company to pay between 1% and 3.5% of total revenue of the managed hotels to the third-party managers each month as a basic management fee. Total basic management fees incurred by the Company during the years ended December 31, 2007, 2006 and 2005 were $28.0 million, $23.6 million and $15.4 million, respectively. Basic management fees included in property general and administrative expense were $27.4 million, $21.6 million and $13.4 million, respectively. Discontinued operations included $0.6 million, $2.0 million and $2.0 million, respectively, of basic management fees for 2007, 2006 and 2005.

In addition to basic management fees, provided certain operating thresholds are met, the Company may also be required to pay certain of its third-party managers an incentive management fee. Total incentive management fees incurred by the Company were $4.8 million, $3.9 million and $2.8 million, respectively, for the years ended December 31, 2007, 2006 and 2005, all of which were included in property general and administrative expense.

Franchise Agreements

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

Total franchise costs incurred by the Company during the years ended December 31, 2007, 2006 and 2005, were $39.5 million, $37.8 million, and $27.5 million, respectively. Of the total franchise costs, franchise royalties totaled $15.1 million, $16.4 million, and $15.0 million, respectively. The remaining franchise costs include advertising, reservation and priority club assessments. Franchise costs included in discontinued operations totaled $2.0 million, $7.1 million, and $8.8 million, respectively, for the years ended December 31, 2007, 2006 and 2005.

Renovation and Construction Commitments

At December 31, 2007 and 2006, the Company had various contracts outstanding with third parties in connection with the renovation of certain of its hotel properties. The remaining commitments under these contracts at December 31, 2007 and 2006 totaled $22.3 million and $26.2 million, respectively.

Operating Leases

At December 31, 2007, the Company was obligated under the terms of nine ground or air leases and a lease on the corporate facility, which mature from dates ranging from 2010 through 2096, excluding renewal options. Payments on one of the ground leases and the air lease require payments of $1.00 annually. Future minimum payments under the terms of the operating leases in effect at December 31, 2007 are as follows (in thousands):

2008	$ 4,905
2009	4,960
2010	4,604
2011	4,240
2012	4,279
Thereafter	291,695
	$ 314,683

Rent expense incurred pursuant to these ground lease agreements for the years ended December 31, 2007, 2006 and 2005, totaled $7.8 million, $7.7 million, and $4.8 million, respectively. Rent expense included in property tax, ground lease and insurance totaled $7.8 million, $7.2 million and $3.8 million for the years ended December 31, 2007, 2006 and 2005. Rent expense included in discontinued operations totaled zero, $0.5 million and $1.0 million for the years ended December 31 2007, 2006 and 2005, respectively.

Rent expense incurred pursuant to the lease on the corporate facility for the years ended December 31, 2007, 2006 and 2005 totaled $0.5 million, $0.4 million, and $0.1 million, respectively, and was included in general and administrative expenses in the accompanying income statements.

Employment Agreements

As of December 31, 2007, the Company has employment agreements with certain executive employees, which expire through February 2012. The terms of the agreements stipulate payments of base salaries and bonuses.

Approximate minimum future obligations under employment agreements are as follows as of December 31, 2007 (in thousands):

2008	$ 1,050
2009	600
2010	600
2011	600
2012	100
	$ 2,950

Litigation

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

Collective Bargaining Agreements

The Company is subject to exposure to collective bargaining agreements at certain hotels operated by our management companies. At December 31, 2007, approximately 15.0% of workers employed by our third-party operators are covered by such collective bargaining agreements.

Defined Benefit Retirement Plan Obligation

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

The benefits expected to be paid in each of the next five years, and in the aggregate for the five years thereafter as of December 31, 2007 are as follows (in thousands):

2008	$ 304,789
2009	330,472
2010	332,215
2011	356,537
2012	379,329
Thereafter	2,145,881
	$ 3,849,223

401(k) Savings and Retirement Plan

Beginning in 2005, the Company s employees may participate, subject to eligibility, in the Company s 401(k) Savings and Retirement Plan (the 401(k) Plan). Employees are eligible to participate in the 401(k) Plan after attaining 21 years of age and performing six months of service. Three percent of eligible employee annual base earnings is contributed by the Company as a Safe Harbor elective contribution. Safe Harbor contributions made by the Company for the years ended December 31, 2007, 2006 and 2005 were $237,000, $171,000 and $132,000, respectively.

The Company is also responsible for Interstate SHP s 401(k) Plan, and matches up to three percent of the Interstate SHP s employee contributions at 50%. Employees are eligible to participate in the Interstate SHP s 401(k) Plan after attaining 21 years of age and performing one year of service and working at least 1,000 hours. Matching contributions made by the Company for the years ended December 31, 2007, 2006 and 2005 totaled $1.1 million, $855,000, and $568,000, respectively.

Other

The Company has provided unsecured environmental indemnities to certain lenders. The Company has performed due diligence on the potential environmental risks including obtaining an independent environmental review from outside environmental consultants. These indemnities obligate the Company to reimburse the guaranteed parties for damages related to environmental matters. There is no term or damage limitation on these indemnities; however, if an environmental matter arises, the Company could have recourse against other previous owners.

At December 31, 2007 and 2006, the Company had $10.8 million and $11.6 million, respectively, of outstanding irrevocable letters of credit to guaranty the Company s financial obligations related to workers compensation insurance programs and certain notes payable. The beneficiary may draw upon these letters of credit in the event of a contractual default by the Company relating to each respective obligation. There have been no draws made through December 31, 2007.

15. Transactions With Affiliates

Other Reimbursements

From time to time, the Company pays for certain expenses such as payroll, insurance and other costs on behalf of certain affiliates. The affiliates generally reimburse such amounts on a monthly basis. At December 31, 2007 and 2006, amounts owed to the Company by its affiliates amounted to $0.9 million and $1.4 million, respectively, and are included in due from affiliates.

Transactions With Others

The Company purchases telecommunications equipment from Gemini Telemanagement Systems, or GTS, a telecommunications equipment provider based in Redwood City, California. The Company s Executive Chairman, Robert A. Alter, is a 5.2% stockholder in GTS, and his brother, Richard Alter, is the majority stockholder in GTS. The Company paid GTS $725,000, $253,000, and $393,000, respectively, for the years ended December 31, 2007, 2006 and 2005.

16. Quarterly Results (Unaudited)

The combined and consolidated quarterly results for the years ended December 31, 2007 and 2006, of the Company are as follows (in thousands):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues Continuing Operations				
2007	$ 227,413	$ 267,826	$ 263,101	$ 298,399
2006	186,021	218,269	213,479	237,486
Operating income Continuing Operations				
2007	26,683	43,208	40,556	44,945
2006	23,518	38,788	30,439	31,583
Net income				
2007	4,828	74,472	16,567	29,796
2006	17,825	22,052	1,536	11,824
Net income (loss) available to common stockholders per share basic				
2007	$ (0.01)	$ 1.10	$ 0.19	$ 0.42
2006	$ 0.25	$ 0.29	$ (0.06)	$ 0.11
Net income (loss) available to common stockholders per share diluted				
2007	$ (0.01)	$ 1.09	$ 0.19	$ 0.41
2006	$ 0.25	$ 0.29	$ (0.06)	$ 0.11

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

In December 2007 the Company entered into a joint venture agreement with Strategic to own and operate BuyEfficient, LLC, an electronic purchasing platform that allows members to procure food, operating supplies, furniture, fixtures and equipment. Under the terms of the agreement, Strategic acquired a 50% interest in BuyEfficient, LLC from the Company for a gross sales price of $6.3 million. As part of this transaction, the Company reclassed its remaining 50% share in BuyEfficient to investment in unconsolidated joint ventures and recognized a gain on sale of $6.1 million.

As part of a strategic plan to dispose of non-core hotel assets, the Company sold the Sheraton Salt Lake City during the fourth quarter of 2007 for net proceeds of $31.9 million and a net gain of $3.9 million.

SUNSTONE HOTEL INVESTORS, INC.

SCHEDULE III REAL ESTATE AND ACCUMULATED DEPRECIATION

DECEMBER 31, 2007

(In Thousands)

		Initial costs		Cost Capitalized Subsequent to Acquisition		Gross Amount at December 31, 2007[1]					
	Encmbr.	**Land**	**Bldg. and Impr**	**Land**	**Bldg. and Impr.**	**Land**	**Bldg. and Impr.**	**Totals**	**Accum. Depr.**	**Date Acq./Constr.**	**Depr. Life**
Crowne Plaza Grand Rapids		$ 1,488	$ 15,698	$	$ 3,528	$ 1,488	$ 19,226	$ 20,714	$ 3,187	2002	5-35
Courtyard by Marriott Los Angeles			8,446		8,325		16,771	16,771	4,635	1999	5-35
Courtyard by Marriott San Diego	(a)	1,569	15,336		3,912	1,569	19,248	20,817	4,912	1999	5-35
Doubletree Minneapolis	(b)	1,150	9,953		3,494	1,150	13,447	14,597	2,269	2002	5-35
Embassy Suites Hotel Chicago	$ 75,000	79	46,886	6,348	7,998	6,427	54,884	61,311	9,513	2002	5-35
Embassy Suites La Jolla	70,000	27,900	70,450		5,718	27,900	76,168	104,068	4,254	2006	5-35
Fairmont Newport Beach			65,769		29,337		95,106	95,106	7,252	2005	5-35
Hilton Del Mar	(b)	4,106	22,353		5,332	4,106	27,685	31,791	4,793	2002	5-35
Hilton Huntington	(a)	6,730	41,198		8,933	6,730	50,131	56,861	8,235	2002	5-35
Hilton Times Square	81,000		221,488		4,519		226,007	226,007	14,592	2006	5-35
Holiday Inn San Diego (Harbor View)	(a)	875	15,648		7,715	875	23,363	24,238	6,505	1999	5-35
Holiday Inn Express San Diego (Old Town)	(a)	2,070	10,005		1,454	2,070	11,459	13,529	3,010	1999	5-35
Hyatt Atlanta		2,700	15,359		(2,763)	2,700	12,596	15,296	3,633	2000	5-35
Hyatt Regency Century Plaza		174,155	110,272		20,233	174,155	130,505	304,660	9,734	2005	5-35
Hyatt Regency Newport Beach			30,549		8,387		38,936	38,936	6,534	2002	5-35
Kahler Hotel Rochester	(b)	3,411	45,349		11,988	3,411	57,337	60,748	14,049	1999	5-35
Kahler Inn & Suites Rochester	(a)	1,666	21,582	(173)	1,575	1,493	23,157	24,650	6,320	1999	5-35
Marriott Boston Long Wharf	176,000	51,598	170,238		396	51,598	170,634	222,232	4,813	2007	5-35
Marriott Del Mar	48,000	5,125	58,548		1,314	5,125	59,862	64,987	4,198	2006	5-35

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(In Thousands)

		Initial costs		Cost Capitalized Subsequent to Acquisition		Gross Amount at December 31, 2007[1]					
	Encmbr.	**Land**	**Bldg. and Impr.**	**Land**	**Bldg. and Impr**	**Land**	**Bldg. and Impr.**	**Totals**	**Accum. Depr.**	**Date Acq./Constr.**	**Depr. Life**
Marriott Houston	(b)	4,167	19,155		4,322	4,167	23,477	27,644	3,796	2002	5-35
Marriott Napa Valley		5,845	21,975	3,000	28,825	8,845	50,800	59,645	11,868	1999	5-35
Marriott Ontario	(b)	5,057	18,481		4,711	5,057	23,192	28,249	3,772	2003	5-35
Marriott Park City	(b)	2,260	17,778		5,177	2,260	22,955	25,215	5,691	1999	5-35
Marriott Philadelphia	(b)	3,297	29,710		4,887	3,297	34,597	37,894	5,917	2002	5-35
Marriott Portland		5,341	20,705		3,068	5,341	23,773	29,114	5,640	2000	5-35
Marriott Provo	(a)	1,117	18,676		4,692	1,117	23,368	24,485	5,643	1999	5-35
Marriott Quincy		14,375	97,875		69	14,375	97,944	112,319	2,382	2007	5-35
Marriott Riverside		2,145	8,689		6,545	2,145	15,234	17,379	3,131	2000	5-35
Marriott Rochester	(a)	1,851	39,714		4,337	1,851	44,051	45,902	12,042	1999	5-35
Marriott Salt Lake City	(a)		19,918		3,696		23,614	23,614	5,927	1999	5-35
Marriott Troy	(b)	2,701	45,814		6,042	2,701	51,856	54,557	9,023	2002	5-35
Marriott Tysons Corner	(b)	3,897	43,528		9,308	3,897	52,836	56,733	8,848	2002	5-35
Renaissance Concourse	(a)		32,716		3,522		36,238	36,238	3,106	2005	5-35
Renaissance Harborplace	109,134	25,085	102,707		8,338	25,085	111,045	136,130	9,707	2005	5-35
Renaissance LAX		7,800	52,506		458	7,800	52,964	60,764	1,908	2007	5-35
Renaissance Long Beach	35,000	10,437	37,300		9,430	10,437	46,730	57,167	3,640	2005	5-35
Renaissance Orlando Resort at Sea World	88,000		119,733		18,461		138,194	138,194	11,451	2005	5-35
Renaissance Washington D.C.	135,000	14,563	132,800		6,246	14,563	139,046	153,609	11,907	2005	5-35
Renaissance Westchester	30,000	12,874	33,237		7,380	12,874	40,617	53,491	3,188	2005	5-35
Residence Inn Manhattan Beach	(a)	7,990	8,024		1,473	7,990	9,497	17,487	1,349	2003	5-35
Residence Inn Rochester		225	9,652	173	990	398	10,642	11,040	1,349	2004	5-35
Sheraton Cerritos			24,737		3,563		28,300	28,300	2,182	2005	5-35
Valley River Inn Eugene	(b)	1,806	14,113		2,083	1,806	16,196	18,002	2,764	2002	5-35
W Hotel San Diego	65,000	6,400	85,131		95	6,400	85,226	91,626	4,745	2006	5-35
Wyndham Houston	34,000	6,184	35,628		6,021	6,184	41,649	47,833	6,999	2002	5-35
Total	$ 946,134	$ 430,039	$ 2,085,429	$ 9,348	$ 285,134	$ 439,387	$ 2,370,563	$ 2,809,950	$ 270,413		

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SCHEDULE III REAL ESTATE AND ACCUMULATED DEPRECIATION

DECEMBER 31, 2007

(In Thousands)

		Initial costs		Cost Capitalized Subsequent to Acquisition		Gross Amount at December 31, 2007[1]						
	Encmbr.	**Land**	**Bldg. and Impr.**	**Land**	**Bldg. and Impr**	**Land**	**Bldg. and Impr.**	**Totals**	**Accum. Depr.**	**Date of Constr.**	**Date Acq.**	**Depr. Life**
Investments in Other Real Estate												
TCS Rochester	$ 4,812	$ 1,600	$	$	$ 7,425	$ 1,600	$ 7,425	$ 9,025	$ 1,376	N/A	1999	5-35
Office Building Troy		2,224	2,140			2,224	2,140	4,364	154	N/A	2006	5-35
Land held for future development or sale		4,500		(3,990)		510		510		N/A	1999	5-35
	$ 4,812	$ 8,324	$ 2,140	$ (3,990)	$ 7,425	$ 4,334	$ 9,565	$ 13,899	$ 1,530			

(1) The aggregate cost of properties for federal income tax purposes is approximately $3.1 billion at December 31, 2007.

	Hotel Properties 2007	2006	2005	Other Real Estate Investments 2007	2006	2005
(1) Reconciliation of land and buildings and improvements:						
Balance at the beginning of the year	$ 2,452,172	$ 2,052,675	$ 1,157,110	$ 13,826	$ 6,518	$ 6,286
Additions during year:						
Acquisitions	395,401	474,906	895,608		4,360	
Improvements	96,839	89,126	28,252	525	2,948	232
Impairment loss						
Disposals during the year	(134,462)	(164,535)	(28,295)	(452)		
Balance at the end of the year	$ 2,809,950	$ 2,452,172	$ 2,052,675	$ 13,899	$ 13,826	$ 6,518
(2) Reconciliation of accumulated depreciation:						
Balance at the beginning of the year	$ 216,240	$ 177,677	$ 134,159	$ 1,206	$ 977	$ 824
Depreciation for the year	83,241	70,383	47,993	324	229	153
Retirement	(29,068)	(31,820)	(4,475)			
Balance at the end of the year	$ 270,413	$ 216,240	$ 177,677	$ 1,530	$ 1,206	$ 977

(a) Property is pledged as collateral by the note payable secured by deed of trust dated October 26, 2004 with a current balance at December 31, 2007 of $248,164,000.

(b) Property is pledged as collateral by the note payable secured by deed of trust dated April 29, 2005 with a current balance at December 31, 2007 of $273,041,000.