

Sunstone Hotel Investors, Inc.
Form 10-Q
November 02, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016

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

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Sunstone Hotel Investors, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	20-1296886 (I.R.S. Employer Identification Number)
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120 Vantis, Suite 350 Aliso Viejo, California (Address of Principal Executive Offices)	92656 (Zip Code)
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Registrant's telephone number, including area code: (949) 330-4000

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

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

216,509,093 shares of Common Stock, \$0.01 par value, as of October 28, 2016

SUNSTONE HOTEL INVESTORS, INC.

QUARTERLY REPORT ON

FORM 10-Q

For the Quarterly Period Ended September 30, 2016

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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements

SUNSTONE HOTEL INVESTORS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	September 30, 2016 (unaudited)	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 367,117	\$ 499,067
Restricted cash	67,248	76,180
Accounts receivable, net	46,260	32,024
Inventories	1,365	1,395
Prepaid expenses	10,973	10,879
Total current assets	492,963	619,545
Investment in hotel properties, net	3,234,814	3,229,010
Deferred financing fees, net	2,593	4,310
Other assets, net	9,091	10,386
Total assets	\$ 3,739,461	\$ 3,863,251
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$ 37,020	\$ 30,193
Accrued payroll and employee benefits	22,486	28,023
Dividends and distributions payable	14,033	265,124
Other current liabilities	44,372	41,877
Current portion of notes payable, net	251,276	85,776
Total current liabilities	369,187	450,993
Notes payable, less current portion, net	748,767	1,010,819
Capital lease obligations, less current portion	15,574	15,575
Other liabilities	42,677	34,744
Total liabilities	1,176,205	1,512,131
Commitments and contingencies (Note 11)		
Equity:		
Stockholders' equity:		
Preferred stock, \$0.01 par value, 100,000,000 shares authorized:		
8.0% Series D Cumulative Redeemable Preferred Stock, zero shares issued and outstanding at September 30, 2016 and 4,600,000 shares issued	—	115,000

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and outstanding at December 31, 2015, stated at liquidation preference of \$25.00 per share		
6.95% Series E Cumulative Redeemable Preferred Stock, 4,600,000 shares issued and outstanding at September 30, 2016 and zero shares issued and outstanding at December 31, 2015, stated at liquidation preference of \$25.00 per share	115,000	—
6.45% Series F Cumulative Redeemable Preferred Stock, 3,000,000 shares issued and outstanding at September 30, 2016 and zero shares issued and outstanding at December 31, 2015, stated at liquidation preference of \$25.00 per share	75,000	—
Common stock, \$0.01 par value, 500,000,000 shares authorized, 216,509,093 shares issued and outstanding at September 30, 2016 and 207,604,391 shares issued and outstanding at December 31, 2015	2,165	2,076
Additional paid in capital	2,540,782	2,458,889
Retained earnings	753,725	652,704
Cumulative dividends and distributions	(973,105)	(927,868)
Total stockholders' equity	2,513,567	2,300,801
Noncontrolling interest in consolidated joint venture	49,689	50,319
Total equity	2,563,256	2,351,120
Total liabilities and equity	\$ 3,739,461	\$ 3,863,251

See accompanying notes to consolidated financial statements.

SUNSTONE HOTEL INVESTORS, INC.

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(In thousands, except per share data)

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015
REVENUES				
Room	\$ 217,672	\$ 233,787	\$ 629,145	\$ 666,756
Food and beverage	68,899	68,371	221,431	219,820
Other operating	16,733	22,437	49,180	61,671
Total revenues	303,304	324,595	899,756	948,247
OPERATING EXPENSES				
Room	54,624	58,332	160,185	169,742
Food and beverage	49,174	50,381	154,042	153,412
Other operating	4,328	5,605	12,516	16,073
Advertising and promotion	15,015	15,325	45,285	46,252
Repairs and maintenance	10,876	11,859	33,139	34,798
Utilities	8,252	9,374	23,114	26,736
Franchise costs	9,408	10,591	27,402	30,009
Property tax, ground lease and insurance	20,944	25,649	61,941	72,413
Property general and administrative	35,003	37,828	107,698	109,384
Corporate overhead	6,392	6,046	19,918	27,222
Depreciation and amortization	40,442	41,331	121,169	122,911
Total operating expenses	254,458	272,321	766,409	808,952
Operating income	48,846	52,274	133,347	139,295
Interest and other income	283	576	1,127	3,350
Interest expense	(11,136)	(16,405)	(47,018)	(51,020)
Loss on extinguishment of debt	—	—	(259)	(2)
Gain on sale of assets	—	11,682	18,223	11,682
Income before income taxes and discontinued operations	37,993	48,127	105,420	103,305
Income tax benefit (provision)	1,434	(938)	959	(1,256)
Income from continuing operations	39,427	47,189	106,379	102,049
Income from discontinued operations, net of tax	—	15,895	—	15,895
NET INCOME	39,427	63,084	106,379	117,944
Income from consolidated joint ventures attributable to noncontrolling interests	(2,053)	(1,982)	(5,358)	(6,643)
Preferred stock dividends and redemption charge	(3,207)	(2,300)	(12,756)	(6,900)
INCOME ATTRIBUTABLE TO COMMON STOCKHOLDERS	\$ 34,167	\$ 58,802	\$ 88,265	\$ 104,401
COMPREHENSIVE INCOME	\$ 39,427	\$ 63,084	\$ 106,379	\$ 117,944
COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON	\$ 34,167	\$ 58,802	\$ 88,265	\$ 104,401

STOCKHOLDERS

Basic and diluted per share amounts:

Income from continuing operations attributable to common stockholders	\$	0.16	\$	0.20	\$	0.41	\$	0.42
Income from discontinued operations, net of tax		—		0.08		—		0.08
Basic and diluted income attributable to common stockholders per common share	\$	0.16	\$	0.28	\$	0.41	\$	0.50
Basic and diluted weighted average common shares outstanding		215,413		207,604		214,565		207,264
Distributions declared per common share	\$	0.05	\$	0.05	\$	0.15	\$	0.15

See accompanying notes to consolidated financial statements.

SUNSTONE HOTEL INVESTORS, INC.

UNAUDITED CONSOLIDATED STATEMENT OF EQUITY

(In thousands, except share data)

Stock	Series E		Series F		Common Stock			Additional Paid in Capital	Retained Earnings	Cumulative Dividends and Distributions
	Amount	Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount			
	\$ 115,000	—	\$ —	—	\$ —	207,604,391	\$ 2,076	\$ 2,458,889	\$ 652,704	\$ (927,000)
	(115,000)	—	—	—	—	—	—	4,052	—	(4,052)
	—	4,600,000	115,000	3,000,000	75,000	—	—	(6,640)	—	—
	—	—	—	—	—	1,482,621	15	5,732	—	—
	—	—	—	—	—	7,422,081	74	78,749	—	—
	—	—	—	—	—	—	—	—	—	(32,400)
	—	—	—	—	—	—	—	—	—	(2,420)
	—	—	—	—	—	—	—	—	—	(4,460)
	—	—	—	—	—	—	—	—	—	(1,810)

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—	—	—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—	101,021	—
\$ —	4,600,000	\$ 115,000	3,000,000	\$ 75,000	216,509,093	\$ 2,165	\$ 2,540,782	\$ 753,725	\$ (973,

See accompanying notes to consolidated financial statements.

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SUNSTONE HOTEL INVESTORS, INC.

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 106,379	\$ 117,944
Adjustments to reconcile net income to net cash provided by operating activities:		
Bad debt expense	493	115
Gain on sale of assets, net	(18,226)	(27,708)
Loss on extinguishment of debt	259	2
Gain on redemption of note receivable	—	(939)
Loss on derivatives, net	7,810	12
Depreciation	118,764	119,811
Amortization of franchise fees and other intangibles	2,936	6,048
Amortization of deferred financing fees	1,648	2,472
Amortization of deferred stock compensation	5,616	8,106
Changes in operating assets and liabilities:		
Restricted cash	17,846	550
Accounts receivable	(14,747)	(13,892)
Inventories	26	76
Prepaid expenses and other assets	(72)	1,403
Accounts payable and other liabilities	3,002	14,075
Accrued payroll and employee benefits	(3,215)	970
Net cash provided by operating activities	228,519	229,045
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of assets	41,202	42,432
Proceeds from redemption of note receivable	—	1,125
Restricted cash — replacement reserve	(8,914)	(10,017)
Acquisition of air rights lease	(2,447)	—
Renovations and additions to hotel properties	(139,846)	(106,575)
Payment for interest rate derivative	—	(13)
Net cash used in investing activities	(110,005)	(73,048)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from preferred stock offerings	190,000	—
Payment of preferred stock offering costs	(6,640)	—
Redemption of preferred stock	(115,000)	—
Repurchase of common stock for employee withholding obligations	(2,641)	(9,264)
Proceeds from note payable and credit facility	100,000	38,000
Payments on notes payable and credit facility	(196,504)	(154,129)
Payments for costs related to extinguishment of notes payable	(153)	(2)
Payments of deferred financing costs	(85)	(4,908)
Dividends and distributions paid	(213,453)	(64,814)
Distributions to noncontrolling interests	(5,988)	(6,786)

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Net cash used in financing activities	(250,464)	(201,903)
Net decrease in cash and cash equivalents	(131,950)	(45,906)
Cash and cash equivalents, beginning of period	499,067	222,096
Cash and cash equivalents, end of period	\$ 367,117	\$ 176,190
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid for interest	\$ 37,545	\$ 47,319
Cash paid (refunds received) for income taxes, net	\$ 1,103	\$ (99)
NONCASH INVESTING ACTIVITY		
Increase in accounts payable related to renovations and additions to hotel properties and other assets	\$ 7,165	\$ 2,779
Amortization of deferred stock compensation — construction activities	\$ 450	\$ 442
NONCASH FINANCING ACTIVITY		
Preferred stock redemption charge	\$ 4,052	\$ —
Issuance of common stock distributions	\$ 78,823	\$ 37,349
Dividends and distributions payable	\$ 14,033	\$ 12,730
See accompanying notes to consolidated financial statements.		

SUNSTONE HOTEL INVESTORS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Description of Business

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

As a REIT, certain tax laws limit the amount of “non-qualifying” income the Company can earn, including income derived directly from the operation of hotels. The Company leases all of its hotels to its TRS Lessee, which in turn enters into long-term management agreements with third parties to manage the operations of the Company’s hotels, in transactions that are intended to generate qualifying income. As of September 30, 2016, the Company had interests in 28 hotels (the “28 hotels”) held for investment, and the Company’s third-party managers included the following:

	Number of Hotels
Subsidiaries of Marriott International, Inc. or Marriott Hotel Services, Inc. (collectively, “Marriott”)	11
Interstate Hotels & Resorts, Inc.	5
Highgate Hotels L.P. and an affiliate	3
Crestline Hotels & Resorts	2
Hilton Worldwide	2
Hyatt Corporation	2
Davidson Hotels & Resorts	1
Fairmont Hotels & Resorts (U.S.)	1
HEI Hotels & Resorts	1
Total hotels held for investment	28

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements as of September 30, 2016 and December 31, 2015, and for the three and nine months ended September 30, 2016 and 2015, include the accounts of the Company, the Operating Partnership, the TRS Lessee and their subsidiaries. All significant intercompany balances and transactions have been eliminated. If the Company determines that it has an interest in a variable interest entity within the meaning of the Consolidation Topic of the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”), the Company will consolidate the entity when it is determined to be the primary beneficiary of the entity. Based on its review, the Company determined that all of its subsidiaries were properly consolidated as of September 30, 2016 and December 31, 2015, and for the three and nine months ended September 30, 2016 and 2015.

The accompanying interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) and in conformity with the rules and regulations of the Securities and Exchange Commission. In the Company’s opinion, the interim financial statements presented herein reflect all adjustments, consisting solely of normal and recurring adjustments, which are necessary to fairly present the interim financial statements. These financial statements should be read in conjunction with the financial statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2015, filed with the Securities and Exchange Commission on February 23, 2016.

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

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

Use of Estimates

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

Earnings Per Share

The Company applies the two-class method when computing its earnings per share. As required by the Earnings Per Share Topic of the FASB ASC, the net income per share for each class of stock (common stock and convertible preferred stock) is calculated assuming all 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.

The Company follows the requirements of the Earnings Per Share Topic of the FASB ASC. Unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are considered participating securities and shall be included in the computation of earnings per share pursuant to the two-class method.

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

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

Three Months Ended Three Months Ended Nine Months Ended Nine Months Ended

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	September 30, 2016 (unaudited)	September 30, 2015 (unaudited)	September 30, 2016 (unaudited)	September 30, 2015 (unaudited)
Numerator:				
Net income	\$ 39,427	\$ 63,084	\$ 106,379	\$ 117,944
Income from consolidated joint ventures attributable to noncontrolling interests	(2,053)	(1,982)	(5,358)	(6,643)
Preferred stock dividends and redemption charge	(3,207)	(2,300)	(12,756)	(6,900)
Dividends paid on unvested restricted stock compensation	(55)	(49)	(173)	(162)
Undistributed income allocated to unvested restricted stock compensation	(123)	(161)	(293)	(270)
Numerator for basic and diluted income attributable to common stockholders	\$ 33,989	\$ 58,592	\$ 87,799	\$ 103,969
Denominator:				
Weighted average basic and diluted common shares outstanding	215,413	207,604	214,565	207,264
Basic and diluted income attributable to common stockholders per common share	\$ 0.16	\$ 0.28	\$ 0.41	\$ 0.50

The Company's unvested restricted shares associated with its long-term incentive plan and shares associated with common stock options have been excluded from the above calculation of earnings per share for both the three and nine months ended September 30, 2016 and 2015, as their inclusion would have been anti-dilutive.

New Accounting Standards and Accounting Changes

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" ("ASU No. 2014-09"). The core principle of ASU No. 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity will need to apply a five-step model: (1) identify the contract(s) with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when (or as) the entity satisfies a

performance obligation. ASU No. 2014-09 was originally to be effective during the first quarter of 2017; however, the FASB issued a one-year deferral in July 2015 so that it now becomes effective during the first quarter of 2018. ASU No. 2014-09 will require either a full retrospective approach or a modified retrospective approach, with early adoption permitted as of the original effective date. The Company is currently evaluating the impact that ASU No. 2014-09 will have on its consolidated financial statements, and has not yet selected a transition method.

In June 2014, the FASB issued Accounting Standards Update No. 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period" ("ASU No. 2014-12"), which requires a reporting entity to treat a performance target that affects vesting and that could be achieved after the requisite service period as a performance condition. ASU 2014-12 became effective during the first quarter of 2016, requiring either a prospective or a modified retrospective approach. The Company's adoption of ASU No. 2014-12 did not have an effect on its consolidated financial statements, and will not have an effect in the future unless the Company issues grants that fall within its scope.

In February 2015, the FASB issued Accounting Standards Update No. 2015-02, "Consolidation (Topic 810): Amendments to the Consolidation Analysis" ("ASU No. 2015-02"), which eliminates the option allowing entities with interests in certain investment funds to follow previous consolidation guidance and makes other changes to both the variable interest model and the voting model. While ASU No. 2015-02 is aimed at asset managers, it will affect all reporting entities involved with limited partnerships or similar entities. In some cases consolidation conclusions will change. In other cases, reporting entities will need to provide additional disclosures about entities that currently aren't considered VIEs but will be considered VIEs under the new guidance when they have a variable interest in those VIEs. Regardless of whether conclusions change or additional disclosure requirements are triggered, reporting entities will need to re-evaluate limited partnerships or similar entities for consolidation and revise their documentation. ASU No. 2015-02 changes (1) the identification of variable interests (fees paid to a decision maker or service provider), (2) the VIE characteristics for a limited partnership or similar entity and (3) the primary beneficiary determination. ASU No. 2015-02 became effective during the first quarter of 2016, requiring a modified retrospective approach. The Company's adoption of ASU No. 2015-02 did not have a material effect on its consolidated financial statements.

In September 2015, the FASB issued Accounting Standards Update No. 2015-16, "Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments" ("ASU No. 2015-16"), which eliminates the requirement for an acquirer in a business combination to account for measurement-period adjustments retrospectively. In a business combination, if the initial accounting is incomplete as of the end of the reporting period in which the acquisition occurs, the acquirer records provisional amounts based on information available at the acquisition date. The acquirer then adjusts these amounts as it obtains more information about facts and circumstances that existed as of the acquisition date. This period is called the measurement period. It ends when the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or when it determines that it cannot obtain more information. The measurement period cannot exceed one year from the date of the acquisition. Under the previous guidance, an acquirer must recognize adjustments to provisional amounts during the measurement period retrospectively (i.e., as if the accounting for the business combination had been completed at the acquisition date). That is, the acquirer was required to revise comparative information on the income statement and balance sheet for any prior periods affected. Under ASU No. 2015-16, an acquirer will now recognize measurement-period adjustments during the period in which it determines the amount of the adjustment. The acquirer still must disclose the amounts and reasons for adjustments to the provisional amounts. The acquirer also must disclose, by line item, the amount of the adjustment reflected in the current-period income statement that would have been recognized in previous periods if the adjustment to provisional amounts had been

recognized as of the acquisition date. Alternatively, an acquirer may present those amounts separately on the face of the income statement. ASU No. 2015-16 became effective during the first quarter of 2016, requiring a prospective approach. The Company's adoption of ASU No. 2015-16 will have an effect on its consolidated financial statements and related disclosures when and if the Company has a business combination that requires a significant measurement-period adjustment.

In January 2016, the FASB issued Accounting Standards Update No. 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU No. 2016-01"), which makes targeted amendments to guidance on classifying and measuring financial instruments. ASU No. 2016-01 provides disclosure relief for public companies by eliminating the requirement to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments measured at amortized cost. ASU No. 2016-01 will become effective during the first quarter of 2018, with early adoption permitted. The Company chose to early adopt ASU 2016-01 effective January 1, 2016, and eliminated the disclosure in its consolidated financial statements of the methods and significant assumptions the Company used to calculate the fair value of its debt.

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, "Leases (Topic 842)" ("ASU No. 2016-02"), which will require lessees to put most leases on their balance sheets but recognize expenses in the income statement in a manner similar to today's accounting. The guidance also eliminates today's real estate-specific provisions and changes the guidance on sale-leaseback transactions, initial direct costs and lease executory costs for all entities. For lessors, the standard modifies the classification criteria and the accounting for sales-type and direct financing leases. All entities will classify leases to determine how to recognize lease-related revenue and expense. Classification will continue to affect amounts that lessors record on the balance sheet. ASU No. 2016-02 will become effective during the first quarter of 2019, and will require a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. The Company is currently

evaluating the impact that ASU No. 2016-02 will have on its consolidated financial statements, and, other than the inclusion of operating leases on the Company’s balance sheet, such effects have not yet been determined.

In March 2016, the FASB issued Accounting Standards Update No. 2016-08, “Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)” (“ASU No. 2016-08”), which clarifies the principal versus agent guidance in ASU 2014-09. In particular, ASU No. 2016-08 clarifies how an entity should identify the unit of accounting for the principal versus agent evaluation and how it should apply the control principle to certain types of arrangements, such as service transactions by explaining what a principal controls before the specified good or service is transferred to the customer. In addition, ASU No. 2016-08 reframes the indicators to focus on evidence that an entity is acting as a principal rather than as an agent. ASU No. 2016-08 will become effective, along with ASU No. 2014-09, during the first quarter of 2018. Similar to ASU No. 2014-09, ASU 2016-08 will require either a full retrospective approach or a modified retrospective approach, with early adoption permitted as of the original effective date. The Company is currently evaluating the impact that ASU No. 2016-08 will have on its consolidated financial statements.

In March 2016, the FASB issued Accounting Standards Update No. 2016-09, “Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting” (“ASU No. 2016-09”), which changes certain aspects of accounting for share-based payments to employees. The new guidance will require all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also will allow an employer to repurchase more of an employee’s shares for tax withholding purposes without triggering liability accounting and to make a policy election to account for forfeitures as they occur. ASU No. 2016-09 will become effective during the first quarter of 2017, with early adoption permitted, and will require a modified retrospective approach. As noted below, the Company chose to early adopt ASU No. 2016-09 effective January 1, 2016.

Upon adoption of ASU No. 2016-09, the Company elected to account for forfeitures as they occur. In addition, pursuant to employee statutory withholding obligations, the Company may repurchase more of an employee’s shares for tax withholding purposes up to the maximum statutory tax rate in the employee’s applicable jurisdictions.

In accordance with the transition provisions of the new guidance, the Company adjusted items on its consolidated balance sheet, consolidated statement of equity and consolidated statement of cash flows. The following financial statement line items have been adjusted on the Company’s consolidated balance sheet and consolidated statement of equity for the year ended December 31, 2015 in order to reverse the effects of forfeitures recognized in prior years, and on the consolidated statement of cash flows for the nine months ended September 30, 2015 to reclassify the repurchase of employee common stock for employee withholding obligations from an operating activity to a financing activity (in thousands):

As Originally	Effect of Change in Accounting Principle	As Adjusted
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	Reported	(unaudited)	(unaudited)
Consolidated Balance Sheet and Consolidated Statement of Equity as of December 31, 2015 (audited):			
Additional paid in capital	\$ 2,458,735	\$ 154	\$ 2,458,889
Retained earnings	\$ 652,858	\$ (154)	\$ 652,704
Consolidated Statement of Cash Flows for the nine months ended September 30, 2015 (unaudited):			
Amortization of deferred stock compensation	\$ 5,505	\$ 2,601	8,106
Accrued payroll and employee benefits	\$ (5,693)	\$ 6,663	\$ 970
Net cash provided by operating activities	\$ 219,781	\$ 9,264	\$ 229,045
Repurchase of common stock for employee withholding obligations	\$ —	\$ (9,264)	\$ (9,264)
Net cash used in financing activities	\$ (192,639)	\$ (9,264)	\$ (201,903)

In May 2016, the FASB issued Accounting Standards Update No. 2016-12, “Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients” (“ASU No. 2016-12”), which amends the FASB’s new revenue recognition guidance on transition, collectability, noncash consideration and the presentation of sales and other similar taxes. The amendments clarify that, for a contract to be considered completed at transition, all (or substantially all) of the revenue must have been recognized under legacy GAAP. This clarification is important because entities that use the modified retrospective transition approach need to apply the standard only to contracts that are not complete as of the date of initial application, and entities that use the full retrospective approach may apply certain practical expedients to completed contracts. In addition, ASU No. 2016-12 clarifies that an entity should consider the probability of collecting substantially all of the consideration to which it will be entitled in exchange for goods and services expected to be transferred to the customer rather than the total amount promised for all the goods or services in the contract. ASU No. 2016-12 also clarifies that an entity may consider its ability to manage its exposure to credit risk as part of the collectability assessment, as well as that the fair value of noncash consideration should be measured at contract inception when determining the transaction price. Finally, ASU No. 2016-12 allows an entity to make an accounting policy election to exclude from the transaction price certain types of taxes collected from a customer if it discloses that policy. ASU No. 2016-12 will become

effective, along with ASU No. 2014-09, during the first quarter of 2018. Similar to ASU No. 2014-09, ASU 2016-12 will require either a full retrospective approach or a modified retrospective approach, with early adoption permitted as of the original effective date. The Company is currently evaluating the impact that ASU No. 2016-12 will have on its consolidated financial statements.

In June 2016, the FASB issued Accounting Standards Update No. 2016-13, “Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments” (“ASU No. 2016-13”), which will replace today’s “incurred loss” approach with an “expected loss” model for instruments measured at amortized cost. For trade and other receivables, held-to-maturity debt securities, loans and other instruments, entities will be required to use a new forward looking “expected loss” model that generally will result in the earlier recognition of allowances for losses. In addition, entities will have to disclose significantly more information, including information they use to track credit quality by year of origination for most financing receivables. ASU No. 2016-13 is effective during the first quarter of 2020. ASU No. 2016-13 will require a modified retrospective approach, with early adoption permitted during the first quarter of 2019. The Company is currently evaluating the impact that ASU No. 2016-13 will have on its consolidated financial statements.

In September 2016, the FASB issued Accounting Standards Update No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force)” (“ASU No. 2016-15”), which clarifies how entities should classify certain cash receipts and cash payments on the statement of cash flows. ASU No. 2016-15 addresses certain issues where diversity in practice was identified. It amends existing guidance, which is principles based and often requires judgment to determine the appropriate classification of cash flows as operating, investing or financing activities. In addition, ASU No. 2016-15 clarifies how the predominance principle should be applied when cash receipts and cash payments have aspects of more than one class of cash flows. ASU No. 2016-15 is effective during the first quarter of 2018, and will generally require a retrospective approach. Early adoption is permitted. The Company does not believe that the adoption of ASU No. 2016-15 will have a material effect on its consolidated financial statements.

Noncontrolling Interests

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

At both September 30, 2016 and December 31, 2015, the noncontrolling interest reported in the Company’s financial statements included Hilton Worldwide’s 25.0% ownership in the Hilton San Diego Bayfront. During both the three and

nine months ended September 30, 2015, noncontrolling interests recorded in the Company's financial statements also included preferred investors that owned a \$0.1 million preferred equity interest in a subsidiary captive REIT that owned the Doubletree Guest Suites Times Square. The Company sold its interests in the Doubletree Guest Suites Times Square in December 2015.

Segment Reporting

The Company considers each of its hotels to be an operating segment, none of which meets the threshold for a reportable segment in accordance with the Segment Reporting Topic of the FASB ASC. Currently, the Company operates in one segment, hotel ownership.

3. Investment in Hotel Properties

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

	September 30, 2016 (unaudited)	December 31, 2015
Land	\$ 542,660	\$ 542,660
Buildings and improvements	3,168,291	3,109,562
Furniture, fixtures and equipment	510,347	480,832
Intangibles	47,090	45,249
Franchise fees	1,021	1,082
Construction in process	116,782	97,974
Investment in hotel properties, gross	4,386,191	4,277,359
Accumulated depreciation and amortization	(1,151,377)	(1,048,349)
Investment in hotel properties, net	\$ 3,234,814	\$ 3,229,010

In June 2016, the Company purchased the air rights lease associated with its Renaissance Harborplace for \$2.4 million, including closing costs. The air rights lease, which has an indefinite useful life, and therefore, is not amortized, is included with intangibles in the Company's investment in hotel properties on its consolidated balance sheet. This non-amortizable asset will be reviewed annually for impairment and more frequently if events or circumstances indicate that the asset may be impaired. If the non-amortizable intangible asset is subsequently determined to have a finite useful life, the intangible asset will be written down to the lower of its fair value or carrying amount, and then amortized prospectively, based on the remaining useful life of the intangible asset.

4. Disposals

In May 2016, the Company sold the 203-room Sheraton Cerritos located in Cerritos, California for net proceeds of \$41.2 million. The Company recognized a net gain on the sale of \$18.2 million. The sale did not represent a strategic shift that had a major impact on the Company's business plan or its primary markets, and therefore, did not qualify as a discontinued operation.

The following table provides summary results of operations for the Sheraton Cerritos that was sold during 2016, as well as for the Doubletree Guest Suites Times Square and an electronic purchasing platform ("BuyEfficient") that were sold during 2015, all of which are included in continuing operations (in thousands):

	Three Months Ended September 30, 2016 (unaudited)	Three Months Ended September 30, 2015 (unaudited)	Nine Months Ended September 30, 2016 (unaudited)	Nine Months Ended September 30, 2015 (unaudited)
Revenues	\$ —	\$ 24,629	\$ 4,846	\$ 64,962
Income before income taxes	\$ —	\$ 1,751	\$ 876	\$ 2,468
Gain on sale of assets	\$ —	\$ 11,682	\$ 18,223	\$ 11,682

5. Fair Value Measurements and Interest Rate Derivatives

Fair Value of Financial Instruments

As of September 30, 2016 and December 31, 2015, the carrying amount of certain financial instruments, including cash and cash equivalents, restricted cash, accounts receivable, accounts payable and accrued expenses were representative of their fair values due to the short-term maturity of these instruments.

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

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Inputs reflect quoted prices for identical assets or liabilities in markets that are not active; quoted prices for similar assets or liabilities in active markets; inputs other than quoted prices that are observable for the asset or the liability; or inputs that are derived principally from or corroborated by observable market data by correlation or other means.

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Level 3 Unobservable inputs reflecting the Company's own assumptions incorporated in valuation techniques used to determine fair value. These assumptions are required to be consistent with market participant assumptions that are reasonably available.

On an annual basis and periodically when indicators of impairment exist, the Company analyzes the carrying values of its hotel properties and other assets using Level 3 measurements, including a discounted cash flow analysis to estimate the fair value of its hotel properties and other assets taking into account each property's expected cash flow from operations, holding period and estimated proceeds from the disposition of the property. The factors addressed in determining estimated proceeds from disposition include anticipated operating cash flow in the year of disposition and terminal capitalization rate. The Company did not identify any properties or other assets with indicators of impairment during either the three or nine months ended September 30, 2016 and 2015.

On an annual basis and periodically when indicators of impairment exist, the Company also analyzes the carrying value of its goodwill using Level 3 measurements, including a discounted cash flow analysis to estimate the fair value of its reporting units. As of both September 30, 2016 and December 31, 2015, the Company's goodwill, which is included in other assets, net on the Company's consolidated balance sheets, consists of \$1.0 million associated with one of its hotels. The Company did not identify any indicator of goodwill impairment during either the three or nine months ended September 30, 2016 and 2015.

As of September 30, 2016 and December 31, 2015, the only financial instruments that the Company measures at fair value are its interest rate derivatives, along with a life insurance policy and a related retirement benefit agreement. In accordance with the Fair Value Measurement and Disclosure Topic of the FASB ASC, the Company estimates the fair value of its interest rate derivatives using Level 2 measurements based on quotes obtained from the counterparties, which are based upon the consideration that would be required to terminate the agreements. Both the life insurance policy and the related retirement benefit agreement, which are for a former Company associate, are valued using Level 2 measurements.

The following table presents the Company's assets measured at fair value on a recurring and non-recurring basis at September 30, 2016 and December 31, 2015 (in thousands):

	Total	Fair Value Measurements at Reporting Date		
		Level 1	Level 2	Level 3
September 30, 2016 (unaudited):				
Interest rate cap derivatives	\$ —	\$ —	\$ —	\$ —
Life insurance policy (1)	857	—	857	—
Total assets measured at fair value at September 30, 2016	\$ 857	\$ —	\$ 857	\$ —
December 31, 2015:				
Interest rate cap derivatives	\$ 1	\$ —	\$ 1	\$ —
Interest rate swap derivative	759	—	759	—
Life insurance policy (1)	964	—	964	—

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Total assets measured at fair value at December 31, 2015 \$ 1,724 \$ — \$ 1,724 \$ —

(1) Includes the split life insurance policy for one of the Company's former associates, which the Company values using Level 2 measurements. These amounts are included in other assets, net on the accompanying consolidated balance sheets, and will be used to reimburse the Company for payments made to the former associate from the related retirement benefit agreement, which is included in accrued payroll and employee benefits on the accompanying consolidated balance sheets.

The following table presents the Company's liabilities measured at fair value on a recurring and non-recurring basis at September 30, 2016 and December 31, 2015 (in thousands):

	Total	Fair Value Measurements at Reporting Date		
		Level 1	Level 2	Level 3
September 30, 2016 (unaudited):				
Interest rate swap derivative	\$ 7,487	\$ —	\$ 7,487	\$ —
Retirement benefit agreement (1)	857	—	857	—
Total liabilities measured at fair value at September 30, 2016	\$ 8,344	\$ —	\$ 8,344	\$ —
December 31, 2015:				
Interest rate swap derivative	\$ 437	\$ —	\$ 437	\$ —
Retirement benefit agreement (1)	964	—	964	—
Total liabilities measured at fair value at December 31, 2015	\$ 1,401	\$ —	\$ 1,401	\$ —

(1) Includes the retirement benefit agreement for one of the Company's former associates, which the Company values using Level 2 measurements. The agreement calls for the balance of the retirement benefit to be paid out to the former associate in

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ten annual installments, beginning in 2011. As such, the Company has paid the former associate a total of \$1.2 million through September 30, 2016, which was reimbursed to the Company using funds from the related split life insurance policy noted above. These amounts are included in accrued payroll and employee benefits on the accompanying consolidated balance sheets.

Interest Rate Derivatives

The Company's interest rate derivatives, which are not designated as effective cash flow hedges, consisted of the following at September 30, 2016 (unaudited) and December 31, 2015 (in thousands):

Hedged Debt	Type	Strike /		Effective Date	Maturity Date	Notional Amount	Estimated Fair Value	
		Capped Rate	Index				(Liability)	Asset
							September 30, 2016	December 31, 2015
Hilton San Diego	Cap	4.250%	1-Month LIBOR	April 15, 2015	May 1, 2017	\$ 111,69\$	—	\$ 1
Bayfront (1)	Cap	4.250%	1-Month LIBOR	October 29, 2015	September 2, 2022	\$ 85,000\$	(2,699)	\$ 759
\$85.0 million term loan (2)	Swap	3.391%	1-Month LIBOR	January 29, 2016	January 31, 2023	\$ 100,000\$	(4,788)	\$
\$100.0 million term loan (2)	Swap	3.653%	1-Month LIBOR	2016	2023	\$ 100,000\$	(4,788)	\$