

STRATEGIC HOTELS & RESORTS, INC
Form 10-Q
May 08, 2009
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2009

OR

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

For the Transition period from _____ to _____

Commission File No. 001-32223

STRATEGIC HOTELS & RESORTS, INC.

(Exact name of registrant as specified in its charter)

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Maryland
(State of Incorporation)

33-1082757
(I.R.S. Employer Identification No.)

200 West Madison Street, Suite 1700, Chicago, Illinois
(Address of Principal Executive Offices)

60606-3415
(Zip Code)

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

Former name, former address and former fiscal year, if changed since last report:

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 checkmark 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). [This requirement is not yet applicable to the registrant.] 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. (Check one):

Large accelerated filer 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 .

The number of shares of common stock (par value \$0.01 per share) of the registrant outstanding as of May 6, 2009 was 75,174,335.

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FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2009

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WHERE TO FIND MORE INFORMATION:

We maintain a website at www.strategichotels.com. Through our website, we make available, free of charge, our annual proxy statement, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission (SEC). The SEC maintains a website that contains these reports at www.sec.gov.

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

Table of Contents**Part I. Financial Information****Item 1. Financial Statements****STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES (SHR)****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS****(In Thousands, Except Share Data)**

	March 31, 2009	December 31, 2008
Assets		
Investment in hotel properties, net	\$ 2,358,243	\$ 2,383,860
Goodwill	118,002	120,329
Intangible assets, net of accumulated amortization of \$3,414 and \$3,096	31,445	32,277
Investment in joint ventures	81,584	82,122
Cash and cash equivalents	128,283	80,954
Restricted cash and cash equivalents	28,796	37,358
Accounts receivable, net of allowance for doubtful accounts of \$2,477 and \$2,203	64,180	70,945
Deferred financing costs, net of accumulated amortization of \$6,981 and \$6,655	16,566	10,375
Deferred tax assets	36,246	38,260
Other assets	46,987	52,687
Total assets	\$ 2,910,332	\$ 2,909,167
Liabilities and Shareholders' Equity		
Liabilities:		
Mortgages and other debt payable	\$ 1,292,896	\$ 1,301,535
Exchangeable senior notes, net of discount	166,198	165,155
Bank credit facility	296,000	206,000
Accounts payable and accrued expenses	240,991	281,918
Deferred tax liabilities	31,232	34,236
Deferred gain on sale of hotels	97,800	104,251
Total liabilities	2,125,117	2,093,095
Noncontrolling interests in SHR's operating partnership	5,096	5,330
Equity:		
SHR's shareholders' equity:		
8.50% Series A Cumulative Redeemable Preferred Stock (par value \$0.01 per share; 4,488,750 shares issued and outstanding; liquidation preference \$25.00 per share)	108,206	108,206
8.25% Series B Cumulative Redeemable Preferred Stock (par value \$0.01 per share; 4,600,000 shares issued and outstanding; liquidation preference \$25.00 per share)	110,775	110,775
8.25% Series C Cumulative Redeemable Preferred Stock (par value \$0.01 per share; 5,750,000 shares issued and outstanding; liquidation preference \$25.00 per share)	138,940	138,940
Common shares (par value \$0.01 per share; 150,000,000 common shares authorized; 74,971,069 and 74,410,012 common shares issued and outstanding)	750	744
Additional paid-in capital	1,233,077	1,228,774
Accumulated deficit	(745,732)	(710,263)
Accumulated other comprehensive loss	(92,277)	(93,637)
Total SHR's shareholders' equity	753,739	783,539

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Noncontrolling interests in consolidated affiliates	26,380	27,203
Total equity	780,119	810,742
Total liabilities and equity	\$ 2,910,332	\$ 2,909,167

See accompanying notes to unaudited condensed consolidated financial statements.

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES (SHR)
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE LOSS

(In Thousands, Except Per Share Data)

	Three Months Ended March 31,	
	2009	2008
Revenues:		
Rooms	\$ 96,586	\$ 130,280
Food and beverage	57,106	79,124
Other hotel operating revenue	25,791	27,154
	179,483	236,558
Lease revenue	1,120	1,287
Total revenues	180,603	237,845
Operating Costs and Expenses:		
Rooms	27,289	33,125
Food and beverage	42,827	56,743
Other departmental expenses	55,238	62,562
Management fees	6,763	9,609
Other hotel expenses	13,782	16,042
Lease expense	3,966	4,327
Depreciation and amortization	34,103	27,603
Impairment losses and other charges	459	
Corporate expenses	10,424	7,430
Total operating costs and expenses	194,851	217,441
Operating (loss) income	(14,248)	20,404
Interest expense	(23,966)	(22,842)
Interest income	414	595
Loss on early extinguishment of debt	(883)	
Equity in earnings (losses) of joint ventures	139	(779)
Foreign currency exchange gain (loss)	2,015	(3,209)
Other expenses, net	(39)	(262)
Loss before income taxes, loss on sale of noncontrolling interests in hotel properties and discontinued operations	(36,568)	(6,093)
Income tax expense	(100)	(212)
Loss before loss on sale of noncontrolling interests in hotel properties and discontinued operations	(36,668)	(6,305)
Loss on sale of noncontrolling interests in hotel properties		(5)
Loss from continuing operations	(36,668)	(6,310)
Income from discontinued operations, net of tax		5,200
Net Loss	(36,668)	(1,110)
(Loss) gain on currency translation adjustments	(6,659)	24,833

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Gain (loss) on mark to market of derivatives	8,019	(41,044)
Comprehensive Loss	(35,308)	(17,321)
Comprehensive loss attributable to the noncontrolling interests in SHR s operating partnership	429	210
Comprehensive loss attributable to the noncontrolling interests in consolidated affiliates	753	897
Comprehensive Loss Attributable to SHR	\$ (34,126)	\$ (16,214)
Net Loss	\$ (36,668)	\$ (1,110)
Net loss attributable to the noncontrolling interests in SHR s operating partnership	446	2
Net loss attributable to the noncontrolling interests in consolidated affiliates	753	897
Net Loss Attributable to SHR	(35,469)	(211)
Preferred shareholder dividends	(7,721)	(7,721)
Net Loss Attributable to SHR Common Shareholders	\$ (43,190)	\$ (7,932)
Basic and Diluted Loss Per Share:		
Loss from continuing operations attributable to SHR common shareholders	\$ (0.57)	\$ (0.18)
Income from discontinued operations attributable to SHR common shareholders		0.07
Net loss attributable to SHR common shareholders	\$ (0.57)	\$ (0.11)
Weighted average common shares outstanding	75,166	74,950

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES (SHR)****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In Thousands)**

	Three Months Ended March 31,	
	2009	2008
Operating Activities:		
Net loss	\$ (36,668)	\$ (1,110)
Adjustments to reconcile net loss to net cash provided by operating activities (including discontinued operations):		
Deferred income tax benefit	(757)	(2,375)
Depreciation and amortization	34,103	28,293
Amortization of deferred financing costs, discount and interest rate swap costs	3,242	2,238
Non-cash impairment losses and other charges	459	
Loss on early extinguishment of debt	883	
Equity in (earnings) losses of joint ventures	(139)	779
Share-based compensation	4,710	1,374
Gain on sale of assets	(2)	(607)
Loss on sale of noncontrolling interests in hotel properties		5
Foreign currency exchange (gain) loss	(2,015)	3,209
Recognition of deferred and other gains, net	(1,151)	(1,322)
Decrease (increase) in accounts receivable	6,765	(7,723)
Decrease in other assets	1,674	2,924
Decrease in accounts payable and accrued expenses	(10,350)	(6,458)
Net cash provided by operating activities	754	19,227
Investing Activities:		
Proceeds from sales of assets	49	551
Proceeds from promissory note		6,000
Acquisition of interest in joint ventures		(1,226)
Cash received from joint venture	214	
Decrease in security deposits related to sale-leasebacks	2,874	1,751
Capital expenditures	(27,422)	(50,846)
Decrease (increase) in restricted cash and cash equivalents	8,562	(2,711)
Other investing activities	359	(193)
Net cash used in investing activities	(15,364)	(46,674)
Financing Activities:		
Borrowings under bank credit facility	90,000	68,000
Payments on bank credit facility		(22,000)
Financing costs	(8,307)	
Distributions to common shareholders		(17,926)
Distributions to preferred shareholders		(7,721)
Distributions to holders of noncontrolling interests in SHR's operating partnership		(235)
Interest rate swap costs	(17,825)	
Other financing activities	(227)	(81)
Net cash provided by financing activities	63,641	20,037
Effect of exchange rate changes on cash	(1,702)	3,239

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Net change in cash and cash equivalents	47,329	(4,171)
Cash and cash equivalents, beginning of period	80,954	111,494
Cash and cash equivalents, end of period	\$ 128,283	\$ 107,323

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES (SHR)****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS** Continued

(In Thousands)

	Three Months Ended March 31,	
	2009	2008
Supplemental Schedule of Non-Cash Investing and Financing Activities:		
(Gain) loss on mark to market of derivative instruments (see notes 2 and 10)	\$ (8,019)	\$ 41,044
Distributions declared and payable to common shareholders (see note 9)	\$	\$ 18,004
Distributions payable to holders of noncontrolling interests in SHR's operating partnership (see note 9)	\$	\$ 236
Capital expenditures recorded as liabilities	\$ (5,347)	\$ 7,308
Cash Paid For:		
Interest, net of interest capitalized	\$ 20,418	\$ 19,741
Income taxes, net of refunds	\$ 1,212	\$ 5,926

See accompanying notes to unaudited condensed consolidated financial statements.

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. GENERAL

Strategic Hotels & Resorts, Inc. (SHR and, together with its subsidiaries, the Company) was incorporated in January 2004 to acquire and asset-manage upper upscale and luxury hotels that are subject to long-term management contracts. As of March 31, 2009, the Company's portfolio included 19 full-service hotel interests located in urban and resort markets in: the United States; Paris, France; Mexico City and Punta Mita, Nayarit, Mexico; Hamburg, Germany; London, England; and Prague, Czech Republic. The Company operates in one reportable business segment, hotel ownership.

SHR operates as a self-administered and self-managed real estate investment trust (REIT), which means that it is managed by its board of directors and executive officers. A REIT is a legal entity that holds real estate interests and, through payments of dividends to stockholders, is permitted to reduce or avoid federal income taxes at the corporate level. For SHR to continue to qualify as a REIT, it cannot operate hotels; instead it employs internationally known hotel management companies to operate its hotels under management contracts. SHR conducts its operations through its direct and indirect subsidiaries, including its operating partnership, Strategic Hotel Funding, L.L.C. (SH Funding), which currently holds substantially all of the Company's assets. SHR is the sole managing member of SH Funding and holds approximately 99% of its membership units as of March 31, 2009. SHR manages all business aspects of SH Funding, including the sale and purchase of hotels, the investment in these hotels and the financing of SH Funding and its assets.

As of March 31, 2009, SH Funding owned or leased the following 19 hotels:

- | | |
|--|--|
| 1. Fairmont Chicago | 11. Loews Santa Monica Beach Hotel |
| 2. Fairmont Scottsdale Princess ⁽¹⁾ | 12. Marriott Champs Elysees Paris (Paris Marriott) ⁽⁴⁾ |
| 3. Four Seasons Mexico City | 13. Marriott Hamburg ⁽⁴⁾ |
| 4. Four Seasons Punta Mita Resort | 14. Marriott Lincolnshire ⁽⁵⁾ |
| 5. Four Seasons Washington, D.C. | 15. Marriott London Grosvenor Square ⁽⁵⁾ |
| 6. Hotel del Coronado ⁽²⁾ | 16. Renaissance Paris Hotel Le Parc Trocadero (Renaissance Paris) ⁽⁶⁾ |
| 7. Hyatt Regency La Jolla ⁽³⁾ | 17. Ritz-Carlton Half Moon Bay |
| 8. InterContinental Chicago ⁽³⁾ | 18. Ritz-Carlton Laguna Niguel |
| 9. InterContinental Miami | 19. Westin St. Francis |
| 10. InterContinental Prague | |

⁽¹⁾ The Company has a ground lease interest in one land parcel at this property.

⁽²⁾ This property is owned by an unconsolidated affiliate in which the Company indirectly holds a 45% interest.

⁽³⁾ These properties are owned by consolidated affiliates in which the Company indirectly holds 51% interests.

⁽⁴⁾ The Company has leasehold interests in these properties.

⁽⁵⁾ These properties are subject to ground lease arrangements.

⁽⁶⁾ This hotel, formerly known as Hotel Le Parc, was rebranded on April 1, 2008.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation:

The accompanying unaudited condensed consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and in conformity with the rules and regulations of the SEC applicable to interim financial information. As such, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted in accordance with the rules and regulations of the SEC. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring accruals, necessary

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to present fairly the financial position of the Company and its results of operations and cash flows for the interim periods presented. The Company believes the disclosures made are adequate to prevent the information presented from being misleading. However, the

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements included in SHR's Annual Report on Form 10-K for the year ended December 31, 2008. The accompanying unaudited condensed consolidated financial statements include the accounts of SHR, its subsidiaries and other entities in which the Company has a controlling interest.

If the Company determines that it is the holder of a variable interest in a variable interest entity (VIE) within the meaning of the Financial Accounting Standards Board (FASB) revision to Interpretation No. 46, Consolidation of Variable Interest Entities and that its variable interest will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both, then the Company will consolidate the entity. For entities that are not considered VIEs, the Company consolidates those entities it controls. It accounts for those entities over which it has a significant influence but does not control using the equity method of accounting. At March 31, 2009, SH Funding owned the following interests in joint ventures, which are accounted for using the equity method of accounting: a 50% interest in BuyEfficient, L.L.C. (BuyEfficient); a 45% interest in the joint ventures that own the Hotel del Coronado and an associated condominium-hotel development adjacent to the Hotel del Coronado; and a 31% interest in the joint venture that owns the Four Seasons Residence Club Punta Mita (RCPM)(see note 6). At March 31, 2009, SH Funding also owned 51% controlling interests in each of the entities that own the InterContinental Chicago and the Hyatt Regency La Jolla hotels and a 69% controlling interest in Luxury Leisure Properties International, L.L.C. (LLPI), which are consolidated in the accompanying financial statements.

All significant intercompany transactions and balances have been eliminated in consolidation. Certain amounts included in the financial statements for prior periods have been reclassified to conform to the current financial statement 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 periods. Actual results could differ from those estimates.

Restricted Cash and Cash Equivalents:

At March 31, 2009 and December 31, 2008, restricted cash and cash equivalents included \$26,575,000 and \$32,104,000, respectively, that will be used for property and equipment replacement in accordance with hotel management or lease agreements (FF&E Reserves). At March 31, 2009 and December 31, 2008, restricted cash and cash equivalents also included reserves of \$2,221,000 and \$5,254,000, respectively, required by loan and other agreements.

Income Taxes:

SHR has elected to be taxed as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the Code). As a REIT, SHR generally will not be subject to U.S. federal income tax if it distributes 100% of its annual taxable income to its shareholders. As a REIT, SHR is subject to a number of organizational and operational requirements. If it fails to qualify as a REIT in any taxable year, SHR will be subject to U.S. federal income tax (including any applicable alternative minimum tax) on its taxable income at regular corporate tax rates. Even if it qualifies for taxation as a REIT, it may be subject to foreign, state and local income taxes and to U.S. federal income tax and excise tax on its undistributed income. In addition, taxable income from SHR's taxable REIT subsidiaries is subject to federal, foreign, state and local income taxes. Also, the foreign countries where the Company has operations do not recognize REITs under their respective tax laws. Accordingly, the Company is subject to tax in those jurisdictions.

Deferred tax assets and liabilities are established for temporary differences between the financial reporting basis and the tax basis of assets and liabilities at the enacted tax rates expected to be in effect when the temporary differences reverse. A valuation allowance for deferred tax assets is provided if the Company

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believes all or some portion of the deferred tax asset may not be realized. Any increase or decrease in the valuation allowance that results from a change in circumstances that causes a change in the estimated realizability of the related deferred tax asset is included in income.

For the three months ended March 31, 2009 and 2008, income tax (expense) related to continuing operations is summarized as follows (in thousands):

	Three Months Ended March 31,	
	2009	2008
Current tax (expense):		
Europe	\$ (239)	\$ (884)
Mexico	(591)	(1,758)
United States	(27)	(35)
	(857)	(2,677)
Deferred tax benefit (expense):		
Europe	136	151
Mexico	(910)	(358)
United States	1,531	2,672
	757	2,465
Total income tax (expense)	\$ (100)	\$ (212)

Per Share Data:

In accordance with Statement of Financial Accounting Standards (SFAS) No. 128, Earnings Per Share, basic loss per share is computed by dividing the net loss attributable to SHR common shareholders by the weighted average common shares outstanding during each period. Diluted loss per share is computed by dividing the net loss attributable to SHR common shareholders as adjusted for the impact of dilutive securities, if any, by the weighted average common shares outstanding plus potentially dilutive securities. Dilutive securities may include restricted stock units (RSUs), stock options (Options), exchangeable debt securities and noncontrolling interests that have an option to exchange their interests to shares. No effect is shown for securities that are anti-dilutive. In accordance with FASB Staff Position Emerging Issues Task Force No. 03-6-1,

Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities (FSP EITF 03-6-1), the Company considers unvested RSUs participating securities. These unvested RSUs did not impact basic earnings per share for the three months ended March 31, 2009 and 2008. The following table sets forth the components of the calculation of loss from continuing operations attributable to SHR common shareholders for the three months ended March 31, 2009 and 2008 (in thousands):

	Three Months Ended March 31,	
	2009	2008
Numerator:		
Loss from continuing operations attributable to SHR	\$ (35,469)	\$ (5,345)
Preferred shareholder dividends	(7,721)	(7,721)

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Loss from continuing operations attributable to SHR common shareholders	\$ (43,190)	\$ (13,066)
Denominator:		
Weighted average common shares basic and diluted	75,166	74,950

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Securities that could potentially dilute basic loss per share in the future that are not included in the computation of diluted loss per share because they are anti-dilutive at March 31, 2009 and 2008 are as follows (in thousands):

	Computation For Three Months Ended March 31,	
	2009	2008
Noncontrolling interests	976	976
Options and RSUs	1,449	1,515

In addition, the diluted loss per share computation will not give effect to the dilution from the exchange of SH Funding's 3.50% Exchangeable Senior Notes due 2012 (the Exchangeable Notes) (see note 8) until the average share price of SHR's common stock exceeds the initial exchange price of approximately \$27.70.

Accumulated Other Comprehensive Loss:

The Company's accumulated other comprehensive loss (OCL) results from mark to market of certain derivative financial instruments and unrealized gains or losses on foreign currency translation adjustments (CTA). The following table provides the components of accumulated other comprehensive loss (in thousands):

	Derivative and Other Adjustments	CTA	Accumulated OCL
Balance at January 1, 2009	\$ (98,594)	\$ 4,957	\$ (93,637)
Mark to market of derivative instruments	7,960		7,960
Reclassification to equity in earnings (losses) of joint ventures	59		59
CTA activity		(6,659)	(6,659)
Balance at March 31, 2009	\$ (90,575)	\$ (1,702)	\$ (92,277)

Fair Value of Financial and Nonfinancial Instruments:

SFAS No. 157, Fair Value Measurements (SFAS 157) emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, SFAS 157 establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset or liability (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, which are typically based on an entity's own assumptions, as there is little, if any, related market activity. In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair

value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

Table of Contents**STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****New Accounting Pronouncements:**

In April 2009, the FASB issued FASB Staff Position (FSP) FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. This FSP relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet at fair value. Prior to issuing this FSP, fair values for these assets and liabilities were only disclosed once a year. The FSP now requires these disclosures on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value. This FSP is effective for interim reporting periods ending after June 15, 2009.

In April 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4). FSP FAS 157-4 relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms what SFAS 157 states is the objective of fair value measurement to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. Specifically, it reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. FSP 157-4 is effective for interim and annual reporting periods ending after June 15, 2009. The Company does not expect the adoption of this FSP to have a material impact on its consolidated financial statements.

On January 1, 2009, the Company adopted the provisions of FSP APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (FSP APB 14-1) that requires the liability and equity components of convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) to be separately accounted for in a manner that reflects the issuer's nonconvertible debt borrowing rate. FSP APB 14-1 requires that the initial debt proceeds from the sale of the Exchangeable Notes be allocated between a liability component and an equity component. The resulting debt discount is amortized over the debt instrument's expected life as additional interest expense. The Company applied this change in accounting principle retrospectively to all prior periods presented herein in accordance with SFAS 154, *Accounting Changes and Error Corrections*. The adjustment had no effect on net cash flows from operations.

For the three months ended March 31, 2009, this change in accounting principle resulted in an increase of \$974,000 to interest expense and net loss and an increase of \$(0.01) to basic and diluted loss per share. The following table summarizes the effect of the accounting change on the Company's prior period consolidated financial statements (in thousands, except per share data):

	Originally Reported	Effect of Change	As Adjusted
<i>Statement of Operations for the three months ended March 31, 2008:</i>			
Interest expense	\$ (21,927)	\$ (915)	\$ (22,842)
Net income (loss) attributable to SHR	704	(915)	(211)
Per common share:			
Basic earnings (loss)	(0.09)	(0.02)	(0.11)
Diluted earnings (loss)	(0.09)	(0.02)	(0.11)
<i>Balance Sheet as of December 31, 2008:</i>			
Deferred financing costs	10,668	(293)	10,375
Exchangeable senior notes, net of discount	179,415	(14,260)	165,155
Additional paid-in capital	1,208,221	20,553	1,228,774
Accumulated deficit	(703,677)	(6,586)	(710,263)

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In June 2008, the FASB ratified EITF Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock* (EITF 07-5). EITF 07-5 provides a two-step approach to determine whether a financial instrument or an embedded feature is indexed to an issuer's own stock and exempt from the application of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The transition under EITF 07-5 requires a cumulative adjustment to the opening balance of retained earnings in the year in which the EITF becomes effective. The Company adopted EITF 07-5 on January 1, 2009 and determined that this EITF did not have a material impact on its consolidated financial statements.

In June 2008, the FASB issued FSP EITF 03-6-1. FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting. FSP EITF 03-6-1 indicates that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities that should be included in earnings per share calculations under the two-class method, as described in SFAS No. 128 *Earnings Per Share* (SFAS 128). The Company adopted this statement on January 1, 2009 and determined that this FSP did not have a material impact on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 is intended to improve financial reporting about derivative instruments by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company adopted this statement on January 1, 2009 and complied with the expanded disclosure requirements, as applicable (see note 10).

In February 2008, the FASB issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157* (FSP FAS 157-2), which deferred the effective date for non-financial assets and liabilities, except those items recognized or disclosed at fair value on an annual or more frequently recurring basis, until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. The Company adopted SFAS 157 with respect to its non-financial assets and liabilities and determined that the statement did not have a material impact on its financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* an amendment of Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (SFAS 160). The statement requires that noncontrolling interests, previously reported as minority interests, be reported as a separate component of stockholders' equity, a change that affects the Company's financial statement presentation of minority interests in its consolidated subsidiaries. SFAS 160 specifies that consolidated net income attributable to the parent and to the noncontrolling interests be clearly identified and presented separately on the face of the consolidated statements of operations. The statement also establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary and specifies that these transactions be recorded as equity transactions as long as the ownership change does not result in deconsolidation. This standard also expands disclosures in the financial statements to include a reconciliation of the beginning and ending balances of the equity attributable to the parent and the noncontrolling owners and a schedule showing the effects of changes in a parent's ownership interest in a subsidiary on the equity attributable to the parent. The Company adopted SFAS 160 on January 1, 2009 (see note 9). SFAS 160 is applied prospectively in 2009, except for the presentation and disclosure requirements which are applied retrospectively. The retrospective presentation and disclosure requirements had no effect on previously reported net loss attributable to SHR common shareholders or earnings per share. The prospective accounting requirements are dependent on future transactions involving noncontrolling interests.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (revised-2007) (SFAS 141(R)). SFAS 141(R) broadens the guidance of SFAS 141, extending its applicability to all transactions and other events in which one entity obtains controls over one or more other businesses. SFAS 141(R) also establishes requirements for how the acquirer recognizes the fair value of the assets acquired, liabilities assumed, and noncontrolling interests in the acquiree as a result of business combinations; and requires the acquisition related costs to be expensed rather than included as part of the basis of the acquisition. SFAS 141(R) expands required disclosures to improve the ability to evaluate the nature and financial effects of business

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combinations. SFAS 141(R) is effective for all business combinations for which the acquisition date is on or after fiscal years beginning on or after December 15, 2008. The Company adopted this statement on January 1, 2009 and the statement will impact the Company's accounting for future acquisitions and related transaction costs.

3. INVESTMENT IN HOTEL PROPERTIES, NET

The following summarizes the Company's investment in hotel properties as of March 31, 2009 and December 31, 2008, excluding unconsolidated joint ventures (in thousands):

	2009	2008
Land	\$ 394,073	\$ 397,429
Land held for development	120,732	120,367
Leasehold interest	11,633	11,633
Buildings	1,643,588	1,652,641
Building and leasehold improvements	91,230	81,821
Site improvements	53,480	53,510
Furniture, fixtures and equipment	427,609	412,840
Improvements in progress	64,036	70,229
Total investment in hotel properties	2,806,381	2,800,470
Less accumulated depreciation	(448,138)	(416,610)
Total investment in hotel properties, net	\$ 2,358,243	\$ 2,383,860
Consolidated hotel properties	18	18
Consolidated hotel rooms	7,601	7,590

The table below demonstrates the geographic distribution of the Company's portfolio based on its unde depreciated carrying amount as of March 31, 2009 and December 31, 2008, excluding unconsolidated joint ventures:

	2009	2008
Northern California	18.9%	18.7%
Southern California	18.6	18.6
Chicago, IL	16.4	16.4
Scottsdale, AZ	11.9	11.8
Washington, D.C.	6.4	6.4
Miami, FL	5.0	5.0
United States	77.2	76.9
Mexico	9.7	9.6
Prague, Czech Republic	5.4	5.7
London, England	4.2	4.2
Paris, France	3.5	3.6
Total	100.0%	100.0%

4. IMPAIRMENT AND OTHER CHARGES

Impairment Losses

During 2008, management concluded that indicators of potential impairment were present and that evaluations of carrying values of goodwill, intangible assets, and other long-lived assets was therefore required. Management reached the conclusion that impairment tests were required to be performed based on its assessment of the conditions that have contributed to SHR's low stock price and reduced market capitalization relative to the book value of its equity, including generally weak economic conditions, macroeconomic factors impacting industry business conditions, recent and forecasted operating performance, and continued tightening of the credit markets, along with other factors. In 2008, the Company recorded non-cash impairment charges

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to reduce goodwill and intangible assets. For the three months ended March 31, 2009, the Company did not record any non-cash impairment charges. Continued deterioration in economic and market conditions present a potential for additional impairment charges on the Company's hotel properties subsequent to March 31, 2009.

Other Charges

The Company plans to exit the LLPI venture and is currently negotiating the terms thereof. For the three months ended March 31, 2009, the Company recorded a charge of \$206,000 to write off its investment in LLPI.

In addition, the Company recorded a charge of approximately \$253,000 to write off costs related to capital projects that management decided to abandon during the three months ended March 31, 2009.

5. DISCONTINUED OPERATIONS

The results of operations of hotels sold are classified as discontinued operations and segregated in the consolidated statements of operations for all periods presented. On July 2, 2008, the Company sold the Hyatt Regency Phoenix hotel for net sales proceeds of \$89,581,000.

On December 28, 2007, the Company sold the Hyatt Regency New Orleans hotel for a gross sales price of \$32,000,000, of which \$23,000,000 was received in cash at closing and \$9,000,000 was received in the form of a promissory note from the purchaser. The promissory note provides for payment in two tranches, a \$6,000,000 tranche which bore interest at 10.0% and was due on March 31, 2008, and a \$3,000,000 tranche which is non-interest bearing and is due on or before December 27, 2013. The Company recorded this note at its estimated present value of \$7,789,000. After payment of commissions and other selling costs, the net sales proceeds to the Company were \$28,047,000, resulting in a gain on sale of \$2,279,000. The Company initially deferred recognition of the gain and recorded it as an offset to the promissory note. On March 31, 2008, the Company received the \$6,000,000 promissory note tranche plus interest and recognized \$416,000 of the gain, which is recorded in discontinued operations for the three months ended March 31, 2008. The Company will recognize the remainder of the gain when remaining cash payments are received from the buyer.

The following is a summary of income from discontinued operations for the three months ended March 31, 2009 and 2008 (in thousands):

	Three Months Ended	
	March 31,	
	2009	2008
Hotel operating revenues	\$	\$ 14,223
Operating costs and expenses		8,478
Depreciation and amortization		690
Total operating costs and expenses		9,168
Operating income		5,055
Other expenses, net		(181)
Income tax expense		(90)
Gain on sale of assets		416
Income from discontinued operations	\$	\$ 5,200

Table of Contents**STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. INVESTMENT IN JOINT VENTURES**

Investment in joint ventures as of March 31, 2009 and December 31, 2008 included the following (in thousands):

	2009	2008
Hotel del Coronado and North Beach Ventures (a)	\$ 71,336	\$ 71,467
RCPM (b)	3,599	3,397
BuyEfficient (c)	6,649	6,653
LLPI (d)		605
Total investment in joint ventures	\$ 81,584	\$ 82,122

- (a) The Company owns 45% joint venture ownership interests in SHC KSL Partners, LP (Hotel Venture), the existing owner of the Hotel del Coronado, and in HdC North Beach Development, LLLP (North Beach Venture), the owner of an adjacent residential condominium-hotel development. The Hotel Venture and North Beach Venture are collectively referred to as the Partnerships. The Company earns asset management, development and financing fees under agreements with the Partnerships. The Company recognizes income of 55% of these fees, representing the percentage of the Partnerships not owned by the Company. These fees amounted to \$145,000 and \$293,000 for the three months ended March 31, 2009 and 2008, respectively, and are included in other expenses, net on the consolidated statements of operations.
- (b) The Company owns a 31% interest in and acts as asset manager for a joint venture, with two unaffiliated parties, that is developing the RCPM, a luxury vacation home product that is being sold in fractional ownership interests on the property adjacent to the Company's Four Seasons Punta Mita Resort in Mexico. The Company earns asset management fees and recognizes income of 69% of these fees, representing the percentage not owned by the Company. These fees amounted to \$34,000 and \$7,000 for the three months ended March 31, 2009 and 2008, respectively, and are included in other expenses, net on the consolidated statements of operations.
- (c) On December 7, 2007, the Company acquired a 50% interest in BuyEfficient for \$6,346,000. BuyEfficient is an electronic purchasing platform that allows members to procure food, operating supplies, furniture, fixtures and equipment.
- (d) On February 12, 2008, the Company invested \$1,200,000 in LLPI, a newly-formed venture with the objectives of purchasing, developing and arranging for the operations of luxury resort and tourist-oriented destination properties in multiple locations throughout North America, Central America and Europe. One of the founders and officers of LLPI is the son-in-law of our President and Chief Executive Officer. As of December 31, 2008, the Company had a 40% interest in this venture. In January 2009, the members of LLPI approved a restructuring of the venture. This restructuring increased the Company's ownership percentage from 40.0% to 68.6% and eliminated its obligation to fund an additional \$800,000 capital commitment. Effective January 2009, the Company no longer accounts for this investment using the equity method of accounting. The Company plans to exit the LLPI venture and is currently negotiating the terms thereof. For the three months ended March 31, 2009, the Company recorded a charge of \$206,000 to write off its investment in LLPI.

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The following is summarized financial information for the Company's joint ventures as of March 31, 2009 and December 31, 2008 and for the three months ended March 31, 2009 and 2008 (in thousands):

	March 31, 2009	December 31, 2008
Assets		
Investment in hotel properties, net	\$ 322,721	\$ 325,845
Goodwill	23,401	23,401
Intangible assets, net	49,000	49,000
Cash and cash equivalents	64,618	58,367
Restricted cash and cash equivalents	360	1,160
Other assets	24,840	25,861
Total assets	\$ 484,940	\$ 483,634
Liabilities and Partners' Deficit		
Mortgage and other debt payable	\$ 635,717	\$ 632,276
Other liabilities	34,849	35,848
Partners' deficit	(185,626)	(184,490)
Total liabilities and partners' deficit	\$ 484,940	\$ 483,634

	Three Months Ended March 31,	
	2009	2008
Revenues		
Hotel operating revenue	\$ 28,192	\$ 34,879
Residential sales	3,095	709
Other	1,288	873
Total revenues	32,575	36,461
Expenses		
Residential costs of sales	1,614	278
Hotel operating expenses	19,687	23,311
Depreciation and amortization	4,110	3,972
Other operating expenses	1,906	1,878
Total operating expenses	27,317	29,439
Operating income	5,258	7,022
Interest expense, net	(4,741)	(9,859)
Other (expenses) income, net	(382)	351

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Net income (loss)	\$ 135	\$ (2,486)
Equity in earnings (losses) in joint ventures		
Net income (loss)	\$ 135	\$ (2,486)
Joint venture partners' share of (income) loss of joint ventures	(179)	1,367
Adjustments for basis differences, taxes and intercompany eliminations	183	340
Total equity in earnings (losses) of joint ventures	\$ 139	\$ (779)

7. OPERATING LEASE AGREEMENTS

In February 2004, the Company sold its interest in the Marriott Hamburg to a third party, Union Investment Real Estate AG (UIRE), formerly Deutsche Immobilien Fonds Aktiengesellschaft. UIRE subsequently leased the hotel back to the Company. The sale and leaseback transaction was originally recorded as a finance obligation due to a collateralized guarantee issued as part of the sale. In June 2004, the collateralized

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guarantee was cancelled and the Company recorded a sale of the Marriott Hamburg and the leaseback was reflected as an operating lease. A deferred gain of \$5,619,000 was recorded in conjunction with the sale. The deferred gain is being recognized as a reduction of lease expense over the life of the lease. For the three months ended March 31, 2009 and 2008, the Company recognized \$51,000 and \$59,000 of the deferred gain, respectively. As of March 31, 2009 and December 31, 2008, the deferred gain on the sale of the Marriott Hamburg recorded on the accompanying consolidated balance sheets amounted to \$4,265,000 and \$4,457,000, respectively. The lease's initial term runs through June 14, 2030 and is subject to extension. The Company makes monthly minimum rent payments aggregating 3,540,000 (\$4,703,000 based on the foreign exchange rate as of March 31, 2009) annually (increasing by an index formula) and pays additional rent based upon the performance of the hotel, which are recorded as lease expense in the Company's consolidated statements of operations. The Company funded a euro-denominated security deposit with UIRE initially representing approximately 18 months of the minimum rent. This amount at March 31, 2009 and December 31, 2008 was \$6,643,000 and \$6,984,000, respectively, and is included in other assets on the Company's consolidated balance sheets. The Company subleases its interest in the Marriott Hamburg to a third party. The Company has reflected the sublease arrangement as an operating lease and records lease revenue. The Company's annual base rent received from the sublease arrangement can increase or decrease based on changes in a cost of living index defined in the sublease agreement. The Company may also receive additional rent based on the hotel's performance.

In July 2003, the Company sold its interest in the Paris Marriott to UIRE. UIRE subsequently leased the hotel back to the Company. The sale and leaseback transaction was originally recorded as a finance obligation due to a collateralized guarantee issued as part of the sale. In June 2004, the collateralized guarantee was cancelled and the Company recorded a sale of the Paris Marriott and the leaseback was reflected as an operating lease. A deferred gain of \$103,590,000 was recorded in conjunction with the sale. The deferred gain is being recognized as a reduction of lease expense over the life of the lease. The Company recognized \$1,100,000 and \$1,263,000 of the deferred gain for the three months ended March 31, 2009 and 2008, respectively. As of March 31, 2009 and December 31, 2008, the deferred gain on the sale of the Paris Marriott recorded on the accompanying consolidated balance sheets amounted to \$93,535,000 and \$99,794,000, respectively. The lease's initial term runs through December 31, 2029. The Company makes monthly minimum rent payments aggregating 12,144,000 (\$16,135,000 based on the foreign exchange rate as of March 31, 2009) annually (increasing by an index formula) and pays additional rent based upon the performance of the hotel, which are recorded as lease expense in the accompanying consolidated statements of operations. The Company funded a euro-denominated security deposit with UIRE initially representing approximately 16 months of the minimum rent. This amount at March 31, 2009 and December 31, 2008 was \$11,822,000 and \$15,507,000, respectively, and is included in other assets on the accompanying consolidated balance sheets.

8. INDEBTEDNESS**Mortgages and Other Debt Payable:**

Certain subsidiaries of SHR are the borrowers under various financing arrangements. These subsidiaries are separate legal entities and their respective assets and credit are not available to satisfy the debt of SHR or any of its other subsidiaries.

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Mortgages and other debt payable at March 31, 2009 and December 31, 2008 consisted of the following (in thousands):

Debt	Spread (a) (basis points)	Maturity	Balance Outstanding at	
			March 31, 2009	December 31, 2008
Mortgage loans				
Westin St. Francis (c)	70	August 2009(b)	\$ 220,000	\$ 220,000
Fairmont Scottsdale Princess	56	September 2009(b)	180,000	180,000
InterContinental Chicago	106	October 2009(b)	121,000	121,000
InterContinental Miami	73	October 2009(b)	90,000	90,000
Loews Santa Monica Beach Hotel	63	March 2010(b)	118,250	118,250
Ritz-Carlton Half Moon Bay	67	March 2010(b)	76,500	76,500
InterContinental Prague (d)	120	March 2012	138,174	145,277
Fairmont Chicago (c)	70	April 2012	123,750	123,750
Hyatt Regency La Jolla	100	September 2012	97,500	97,500
Marriott London Grosvenor Square (e)	110	October 2013	110,831	112,731
Total mortgage loans			1,276,005	1,285,008
Other debt (f)			16,891	16,527
Total mortgages and other debt payable			\$ 1,292,896	\$ 1,301,535

- (a) Interest is paid monthly at the applicable spread over LIBOR (0.50% at March 31, 2009) for all loans except for those secured by the InterContinental Prague and the Marriott London Grosvenor Square. Interest on the InterContinental Prague loan is paid quarterly at the applicable spread over three-month EURIBOR (1.51% at March 31, 2009). Interest on the Marriott London Grosvenor Square loan is paid quarterly at the applicable spread over three-month GBP LIBOR (1.65% at March 31, 2009).
- (b) These loans have two one-year extensions remaining at the option of the Company or its consolidated affiliates. The Company exercised its first option to extend the maturity date of the InterContinental Chicago, InterContinental Miami, Fairmont Scottsdale Princess, Westin St. Francis, Loews Santa Monica Beach Hotel and Ritz-Carlton Half Moon Bay mortgage loans by an additional year. The maturity dates exclude the two remaining one-year extension options.
- (c) These mortgage loans require that the Company maintain a minimum tangible net worth requirement. At December 31, 2008, due to the impairment of goodwill, the Company did not meet the minimum tangible net worth covenant as it was defined. On March 25, 2009, the Company entered into second amendments to its mortgage loans to modify the tangible net worth covenant to be consistent with the amended covenant in the bank credit facility as described below, which is calculated without regard to goodwill. The Company met the requirements of this modified tangible net worth calculation as of March 31, 2009 and December 31, 2008.
- (d) Under this loan, the lender has the right but not the requirement to request that the loan be repaid to maintain no greater than a 70% loan to value as determined by an appraisal commissioned by the lender. The lender has recently commissioned such an appraisal which is in the process of being completed. An appraisal was commissioned by the Company as a supporting document to the amendment process on the

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bank credit facility. That appraisal suggests the loan may not meet the 70% loan to value requirement, and, if the lender elects to seek a reduction in the loan amount, the Company would then have 30 days to repay approximately €30.0 million in loan principal in order to avoid an event of default. Failure of the Company then complying with the lender's request would cause an event of default and the loan would be subject to acceleration and potentially foreclosure. In addition, this loan also contains a covenant that requires a 1.4 times interest coverage ratio. While this covenant was met for the quarter ended March 31, 2009, the Company anticipates that it may breach this covenant in the second quarter of 2009. Upon falling below this threshold, there is a six month cure period to remedy this breach before it becomes an event of default. The Company is in discussions with the lender regarding these potential future events of default. As of March 31, 2009, the InterContinental Prague had a net investment in hotel property of \$112,029,000 and goodwill of \$31,651,000. Management has assessed that in amending the bank credit facility, in the worst case, a failure to maintain the financial covenants in the Prague loan and foreclosure by the lender would not have a material impact to the Company's liquidity. A default under and acceleration of this loan, or any other property located in Europe, would not constitute an event of default under the amended bank credit facility.

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

- (e) This loan agreement requires maintenance of financial covenants, all of which the Company was in compliance with at March 31, 2009.
- (f) In connection with the acquisition of a 60-acre oceanfront land parcel in Punta Mita, Nayarit, Mexico, the Company executed two \$17,500,000 non-interest bearing promissory notes. The Company recorded these notes at their present value based on an imputed interest rate of 9.5% and will amortize the resulting discount over the life of the promissory notes. On September 30, 2008, the Company paid the first of the \$17,500,000 non-interest bearing promissory notes. The second note is due August 31, 2009.

Exchangeable Notes:

On April 4, 2007, SH Funding issued \$150,000,000 in aggregate principal amount of Exchangeable Notes and on April 25, 2007 issued an additional \$30,000,000 of Exchangeable Notes in connection with the exercise by the initial purchasers of their over-allotment option. The 3.50% Exchangeable Notes were issued at 99.5% of par value. The Company received proceeds of \$175,593,000, net of underwriting fees and expenses and original issue discount. On January 1, 2009, the Company adopted the provisions of FSP APB 14-1 and retrospectively recorded an additional discount on the Exchangeable Notes of \$20,978,000 as of the issuance date (see note 2). The Exchangeable Notes pay interest in cash semi-annually in arrears on April 1 and October 1 of each year beginning October 1, 2007 and mature on April 1, 2012, unless previously redeemed by the Company, repurchased by the Company or exchanged in accordance with their terms prior to such date.

The Exchangeable Notes can be exchanged for cash or shares of the Company's common stock or a combination thereof, at the Company's option, based on the applicable exchange rate prior to the close of business on the business day immediately preceding the stated maturity date at any time on or after November 1, 2011 and also under the following circumstances:

- (1) if during any calendar quarter beginning after June 30, 2007 (and only during such calendar quarter) the closing price per share of the Company's common stock for at least 20 trading days in 30 consecutive trading days of the previous quarter is more than 130% of the applicable exchange price per share;
- (2) if, for any five consecutive trading-day period, the trading price of the Exchangeable Notes on each trading day during such period is less than 95% of the product of the closing price per share of SHR's common stock multiplied by the exchange rate on such trading day;
- (3) if the Company calls the Exchangeable Notes for redemption;
- (4) as described in the indenture governing the Exchangeable Notes, if the Company makes specified distributions to holders of SHR's common stock or specified corporate transactions occur; or
- (5) if SHR's common stock ceases to be listed on a U.S. national or regional securities exchange.

The Exchangeable Notes may be exchanged based on an initial exchange rate of 36.1063 shares per \$1,000 principal amount of the Exchangeable Notes, which represented an initial exchange price of approximately \$27.70 per share and an exchange premium of approximately 20% based on a price of \$23.08 per share of SHR's common stock on March 29, 2007. Upon exchange, at the Company's election, a holder would receive an amount in cash equal to the lesser of (i) the principal amount of such holder's Exchangeable Notes, or (ii) the exchange value, as defined. If the exchange value exceeds \$1,000, the Company will also deliver, at its option, cash or SHR common stock or a combination of cash and SHR common stock for the exchange value in excess of \$1,000. If the Exchangeable Notes are exchanged in connection with events specified in the indenture governing the Exchangeable Notes, the Company may be required to provide a make-whole premium in the form of an increase in the exchange rate, subject to a stated maximum amount. In addition, in connection with designated events, the holders of the Exchangeable Notes may require the Company to purchase all or a portion of their Exchangeable Notes at a purchase price equal to 100% of the principal amount of the Exchangeable Notes, plus accrued and unpaid interest, if any.

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Exchangeable Notes are unsecured obligations that rank equally in right of payment with any other senior unsecured indebtedness the Company may incur and are effectively subordinated in right of payment to all of the Company's secured indebtedness and all liabilities and preferred equity of the Company's subsidiaries. The Company is not subject to any financial covenants under the indenture governing the Exchangeable Notes.

In connection with the issuance of the Exchangeable Notes, the Company purchased call options for \$9,900,000, which was recorded in additional paid-in capital, to purchase approximately 928,000 shares of SHR's common stock at a strike price of \$27.70 up to a cap price of \$32.31 per share (subject to adjustment in certain circumstances). The call options generally allow the Company to receive shares of SHR's common stock from counterparties equal to the number of shares of common stock to be issued to holders of the Exchangeable Notes upon exchange. The economic impact of these call option transactions is to mitigate the dilutive impact on the Company as if the exchange price were increased from \$27.70 to \$32.31 per common share, which represents an increase from the 20% premium to a 40% premium based on the March 29, 2007 closing price of \$23.08 per share. The call option transactions are expected to generally reduce the potential dilution upon exchange in the event the market value per share of SHR's common stock is greater than the strike price of the call option transaction. If however the market value per share of SHR's common stock exceeds the \$32.31 per common share, then the dilution mitigation under the call option transactions will be capped, which means there would be dilution from exchange of the Exchangeable Notes to the extent that the market value per share of SHR's common stock exceeds \$32.31. These call options will terminate April 1, 2012, subject to earlier exercise.

The Company also entered into a registration rights agreement in connection with the issuance of the Exchangeable Notes. As required under the registration rights agreement, the Company filed a shelf registration statement, which became effective August 23, 2007. The Company must use reasonable efforts to keep the shelf registration statement effective until the earlier of 1) the date one year following the last date on which the Exchangeable Notes have been exchanged and settlement has occurred or 2) the date on which there are no longer any Exchangeable Notes or restricted shares of SHR's common stock outstanding. If the Company fails to comply with certain of its obligations under the registration rights agreement, it will be required to pay additional interest on the Exchangeable Notes in an amount equal to an annual rate of 0.25% for the first 90 days following a registration default and 0.50% following the first 90 days through the day on which the registration default is cured or the date that registration statement is no longer required to be kept effective. If the Exchangeable Notes are exchanged into SHR common stock during a period of registration default, a holder will not be entitled to receive additional interest, but instead will receive an increase in the exchange rate of 3% for each \$1,000 principal amount of Exchangeable Notes. The maximum amount of consideration that the Company would be required to transfer if a registration default were to occur would be approximately \$2,592,000 in additional interest, or approximately 195,000 additional shares of SHR common stock, if the Exchangeable Notes were exchanged. After the filing of the annual report on Form 10-K for the year ended December 31, 2008, the Company's previous shelf registration statement was no longer effective. On March 26, 2009 a new registration statement was declared effective by the SEC. During the three months ended March 31, 2009, the Company recorded additional interest expense of \$11,000 under the registration rights agreement described above for the temporary unavailability of an effective registration statement with respect to SHR's common stock that may, under certain circumstances, be issued with respect to the Exchangeable Notes.

Bank Credit Facility:

In February 2009, SH Funding entered into the third amendment to the bank credit facility, which among other things provides the Company with additional flexibility with respect to its financial covenants and related financial calculations. In connection with this amendment, the Company wrote off \$883,000 of unamortized deferred financing costs. The following summarizes key financial terms and conditions of the amended bank credit facility:

The maximum facility size was reduced to \$400,000,000;

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest rate on the facility is LIBOR plus a margin of 3.75% and a commitment fee of 0.50% per annum based on the unused revolver balance;

Lenders received additional collateral in the form of mortgages over the five borrowing base properties, which mortgages supplement the existing pledges of the Company's interest in SH Funding and SH Funding's interest in certain subsidiaries and guarantees of the loan from the Company and certain of its subsidiaries, all of which continue to secure the bank credit facility;

Maximum availability is determined by the lesser of a 1.3 times debt service coverage on the borrowing base assets or a 50% advance rate against the appraised value of the borrowing base assets;

Minimum corporate fixed charge coverage of 1.0 times, which may be reduced at SH Funding's option to 0.9 times for up to four consecutive quarters with a quarterly fee of 0.25% paid on outstanding balances during each quarter that the coverage ratio is reduced;

Maximum corporate leverage of 80% as defined in the agreement;

Minimum tangible net worth of \$600,000,000, excluding goodwill and currency translation adjustments;

Default under and acceleration of any loan secured by property located in Europe, would not constitute an event of default;

Maturity date of March 9, 2011, with a one-year extension option conditioned upon compliance with a corporate fixed charge coverage ratio for the year ending December 31, 2010 of 1.15 times;

Restrictions on the Company and SH Funding's ability to pay dividends. Such restrictions include:

a prohibition on each of the Company and SH Funding's ability to pay any amount of preferred dividends in cash or in kind if SH Funding has elected to reduce its fixed charge coverage to 0.9 as discussed above;

prohibitions on the Company and SH Funding and their respective subsidiaries' ability to pay any dividends unless certain ratios and other conditions are met; and

prohibitions on the Company and SH Funding's ability to issue dividends in cash in or kind at any time an event of default shall have occurred.

Notwithstanding the dividend restrictions described above, for so long as the Company qualifies, or has taken all other actions necessary to qualify as a REIT, SH Funding may authorize, declare and pay quarterly cash dividends to the Company when and to the extent necessary for the Company to distribute cash dividends to its shareholders generally in an aggregate amount not to exceed the minimum amount necessary for

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the Company to maintain its tax status as a REIT, unless SH Funding receives notice of any monetary event of default or other material event of default.

Other terms and conditions exist including provisions to release assets from the borrowing base and limitations on the Company's ability to incur costs for discretionary capital programs. Under the agreement, SH Funding has a letter of credit sub-facility of \$75,000,000, which is secured by the amended \$400,000,000 bank credit facility. Letters of credit reduce the borrowing capacity under the facility.

The weighted average interest rate for the three months ended March 31, 2009 was 2.69%. As noted above, maximum availability is determined by the lesser of a 1.3 times debt service coverage on the borrowing base assets or a 50% advance rate against the appraised value of the borrowing base assets. Based upon the coverage appraisal value tests, the Company had \$400,000,000 available under the bank credit facility at March 31, 2009. At March 31, 2009, there was \$296,000,000 of borrowings outstanding under the bank credit facility and outstanding letters of credit of \$750,000 (see note 13). The agreement also requires maintenance of financial covenants, all of which SH Funding and SHR were in compliance with at March 31, 2009.

Table of Contents**STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Debt Maturity:**

The following table summarizes the aggregate maturities (assuming all extension options exercised, excluding the conditional option to extend the bank credit facility) as of March 31, 2009 for all mortgages and other debt payable, the Exchangeable Notes and the Company's bank credit facility (in thousands):

Years ended	Amounts
December 31,	
2009 (remainder)	\$ 16,891
2010	7,101
2011	914,101
2012	728,839
2013	101,964
Thereafter	
	1,768,896
Less discount on Exchangeable Notes	(13,802)
Total	\$ 1,755,094

Interest Expense:

Total interest expense in continuing and discontinued operations includes a reduction related to capitalized interest of \$612,000 and \$2,132,000 for the three months ended March 31, 2009 and 2008, respectively. Total interest expense in continuing and discontinued operations includes amortization of deferred financing costs of \$1,203,000 and \$1,255,000 for the three months ended March 31, 2009 and 2008, respectively. Total interest expense also includes amortization of the discount related to the Exchangeable Notes of \$1,043,000 and \$983,000 for the three months ended March 31, 2009 and 2008, respectively.

Liquidity and Operating Matters:

The lodging industry is faced with a weakening operating environment hampered by lagging consumer confidence and restrained corporate spending leading to softness in both transient and group demand. The Company does not expect to see the beginning of a recovery until current economic trends reverse and liquidity returns to the credit markets.

The Company's long-term liquidity requirements consist primarily of funds necessary to pay for scheduled debt maturities, renovations, expansions and other non-recurring capital expenditures that need to be made periodically to its properties and the costs associated with acquisitions of properties. In addition, the Company may use cash to buy back outstanding debt, common or preferred securities from time to time when market conditions are favorable through open market purchases, privately negotiated transactions, or a tender offer, although the terms of the amended bank credit facility prohibit the Company from buying back common or preferred shares unless certain conditions are met.

Historically, the Company has satisfied its long-term liquidity requirements through various sources of capital, including its existing working capital, cash provided by operations, sales of properties, long-term property mortgage indebtedness, bank credit facilities, issuance of senior unsecured debt instruments and through the issuance of additional equity securities. The recent crisis in the credit markets has resulted in a challenging credit environment and the Company's ability to raise capital through various debt markets is uncertain. The Company's ability to raise funds through the issuance of equity securities is dependent upon, among other things, general market conditions for both REITs in general and the Company specifically and market perceptions about the Company. The Company will continue to analyze which source of capital is

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most advantageous to it at any particular point in time, but equity and debt financing may not be consistently available to the Company on terms that are attractive or at all.

Table of Contents**STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

As of May 7, 2009, the Company is compliant with its financial and other restrictive covenants contained in its loan documents, including amendments made or agreed to between the parties as of that date. The Company's ability to borrow under the amended bank credit facility is subject to compliance with these financial and other covenants. Based upon the Company's current outlook for 2009, the Company expects to remain in compliance with the financial covenants set forth in the bank credit facility for the next 12 months. Compliance with these covenants in 2009 and future periods will depend substantially on the financial results of the Company's hotels. The amended bank credit facility provides increased operating cushion with respect to the financial covenants against a prolonged downturn. However, if current financial market conditions worsen and the Company's business deteriorates, it may breach one or more of its financial covenants. If the Company breaches its financial covenants, it would be in default under the related bank credit facility, which could allow the lenders to declare all amounts outstanding under the facility to become due and payable. Additionally, such an acceleration event would allow for acceleration of the interest rate swaps and Exchangeable Notes. If this happens, there would be a material adverse effect on the Company's financial position and results of operations.

As a result of the uncertainty surrounding how long the current economic downturn may continue, the Company has taken several steps to maximize its liquidity during this period. These steps include; a focus on reducing expenses at the hotel and corporate levels, cancelling or deferring planned capital projects, suspension of dividend payments, and amending the bank credit facility.

The Company believes that the measures described above should be sufficient to satisfy its liquidity needs for the next 12 months.

9. EQUITY AND DISTRIBUTION ACTIVITY**Common Shares:**

The following table presents the changes in the issued and outstanding shares of SHR common stock since December 31, 2008 (excluding 975,855 units of SH Funding outstanding at March 31, 2009 and December 31, 2008, which are exchangeable for shares of SHR common stock on a one-for-one basis, or the cash equivalent thereof, subject to certain restrictions and at the option of SH Funding) (in thousands):

Outstanding at December 31, 2008	74,410
Restricted stock units redeemed for shares of SHR common stock	561
Outstanding at March 31, 2009	74,971

As of March 31, 2009, no shares of SHR common stock have been repurchased under the \$50,000,000 share repurchase program.

Distributions:

On November 4, 2008, SHR's board of directors elected to suspend the quarterly dividend to holders of shares of SHR common stock.

Distributions are declared quarterly to holders of shares of SHR preferred stock. In February 2009, SHR's board of directors elected to suspend the quarterly dividend beginning with the first quarter of 2009 to holders of shares of 8.50% Series A Cumulative Preferred Stock, 8.25% Series B Cumulative Preferred Stock, and 8.25% Series C Cumulative Preferred Stock. Dividends on the preferred stock are cumulative. As of March 31, 2009, unpaid cumulative dividends on SHR preferred stock were \$7,721,000.

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The Company adopted SFAS 160 on January 1, 2009, which requires that noncontrolling interests, previously reported as minority interests, be reported as a separate component of stockholders' equity subject to the provisions of EITF Topic D-98, "Classification and Measurement of Redeemable Securities" (EITF Topic D-98). This standard also expands disclosures in the financial statements to include amounts attributable to the parent for income from continuing operations and discontinued operations and a reconciliation of the beginning and ending balances of the equity attributable to the parent and the noncontrolling owners as presented below (in thousands):

	Three Months Ended March 31,	
	2009	2008
Amounts attributable to SHR:		
Loss from continuing operations	\$ (35,469)	\$ (5,345)
Discontinued operations		5,134
Net loss	\$ (35,469)	\$ (211)

For the Three Months Ended March 31, 2009
SHR
Shareholders
Equity