DiamondRock Hospitality Co
Form 10-Q
August 08, 2014

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2014
OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission file number 001-32514
DIAMONDROCK HOSPITALITY COMPANY
(Exact Name of Registrant as Specified in Its Charter)

Maryland	20-1180098
(State of Incorporation)	(I.R.S. Employer Identification No.)
3 Bethesda Metro Center, Suite 1500, Bethesda, Maryland	20814
(Address of Principal Executive Offices)	(Zip Code)

(240) 744-1150
(Registrant’s telephone number, including area code)
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. þ Yes o 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). þ Yes o 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 definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o
	(Do not check if a smaller reporting company)		

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes þ No
The registrant had 195,698,858 shares of its $0.01 par value common stock outstanding as of August 8, 2014.

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PART I. FINANCIAL INFORMATION
Item I. Financial Statements

DIAMONDROCK HOSPITALITY COMPANY

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	June 30, 2014 (Unaudited)	December 31, 2013
ASSETS		
Property and equipment, at cost	$3,159,166	$3,168,088
Less: accumulated depreciation	(623,339)	(600,555)
	2,535,827	2,567,533
Deferred financing costs, net	6,310	7,702
Restricted cash	95,672	89,106
Due from hotel managers	81,819	69,353
Note receivable	—	50,084
Favorable lease assets, net	34,576	39,936
Prepaid and other assets	83,618	79,474
Cash and cash equivalents	253,900	144,584
Total assets	$3,091,722	$3,047,772
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Mortgage debt	$1,084,412	$1,091,861
Senior unsecured credit facility	41,320	—
Total debt	1,125,732	1,091,861
Deferred income related to key money, net	23,162	23,707
Unfavorable contract liabilities, net	77,157	78,093
Due to hotel managers	51,531	54,225
Dividends declared and unpaid	20,395	16,981
Accounts payable and accrued expenses	96,626	102,214
Total liabilities	1,394,603	1,367,081
Stockholders' Equity:		
Preferred stock, $0.01 par value; 10,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, $0.01 par value; 400,000,000 shares authorized; 195,698,858 and 195,470,791 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively	1,957	1,955
Additional paid-in capital	1,980,498	1,979,613
Accumulated deficit	(285,336)	(300,877)
Total stockholders' equity	1,697,119	1,680,691
Total liabilities and stockholders' equity	$3,091,722	$3,047,772

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

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DIAMONDROCK HOSPITALITY COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Revenues:				
Rooms	$165,088	$150,059	$294,824	$270,439
Food and beverage	52,182	55,573	100,793	99,590
Other	12,664	12,382	24,401	23,847
Total revenues	229,934	218,014	420,018	393,876
Operating Expenses:				
Rooms	41,143	38,037	79,248	73,217
Food and beverage	34,693	36,974	69,193	69,816
Management fees	8,459	7,184	13,752	11,918
Other hotel expenses	72,393	72,543	144,869	140,200
Depreciation and amortization	25,126	26,607	50,249	52,858
Corporate and other expenses	4,690	5,301	9,878	13,146
Gain on insurance proceeds	(608)	—	(1,271)	—
Gain on litigation settlement, net	(10,999)	—	(10,999)	—
Total operating expenses, net	174,897	186,646	354,919	361,155
Operating profit	55,037	31,368	65,099	32,721
Other Expenses (Income):				
Interest income	(957)	(1,659)	(2,609)	(2,944)
Interest expense	14,600	14,456	29,125	28,040
Gain on sale of hotel property	(1,290)	—	(1,290)	—
Gain on prepayment of note receivable	(13,550)	—	(13,550)	—
Total other expenses (income), net	(1,197)	12,797	11,676	25,096
Income from continuing operations before income taxes	56,234	18,571	53,423	7,625
Income tax (expense) benefit	(4,318)	(4,451)	2,530	1,695
Income from continuing operations	51,916	14,120	55,953	9,320
Income from discontinued operations, net of taxes	—	952	—	1,625
Net income	$51,916	$15,072	$55,953	$10,945
Basic earnings per share:				
Continuing operations	$0.27	$0.07	$0.29	$0.05
Discontinued operations	—	0.01	—	0.01
Basic earnings per share	$0.27	$0.08	$0.29	$0.06

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

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DIAMONDROCK HOSPITALITY COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30,	
	2014	2013
Cash flows from operating activities:		
Net income	$55,953	$10,945
Adjustments to reconcile net income to net cash provided by operating activities:		
Real estate depreciation	50,249	54,026
Corporate asset depreciation as corporate expenses	53	49
Gain on sale of hotel property	(1,290)	—
Gain on prepayment of note receivable	(13,550)	—
Non-cash ground rent	3,292	3,410
Non-cash financing costs, debt premium and interest rate cap as interest	1,410	1,349
Amortization of note receivable discount as interest income	(1,075)	(1,205)
Amortization of favorable and unfavorable contracts, net	(705)	(709)
Amortization of deferred income	(545)	(532)
Stock-based compensation	2,687	3,241
Changes in assets and liabilities:		
Prepaid expenses and other assets	(1,975)	(4,575)
Restricted cash	(9,156)	1,358
Due to/from hotel managers	(14,585)	(12,968)
Accounts payable and accrued expenses	(5,001)	(1,375)
Net cash provided by operating activities	65,762	53,014
Cash flows from investing activities:		
Hotel capital expenditures	(40,415)	(42,590)
Net proceeds from sale of property	23,650	—
Note receivable principal repayments	64,500	6,574
Change in restricted cash	2,576	(13,342)
Receipt of deferred key money	—	338
Net cash provided by (used in) investing activities	50,311	(49,020)
Cash flows from financing activities:		
Scheduled mortgage debt principal payments	(7,268)	(6,476)
Proceeds from mortgage debt	—	102,000
Draws on senior unsecured credit facility	41,320	25,000
Repayments of senior unsecured credit facility	—	(45,000)
Payment of financing costs	(192)	(535)
Deposit on new mortgage loan	(1,820)	—
Payment of cash dividends	(36,899)	(32,403)
Repurchase of common stock and other	(1,898)	(1,952)
Net cash (used in) provided by financing activities	(6,757)	40,634
Net increase in cash and cash equivalents	109,316	44,628
Cash and cash equivalents, beginning of period	144,584	9,623

Cash and cash equivalents, end of period	$253,900	$54,251
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$27,416	$26,313
Cash paid for income taxes	$220	$645
Capitalized interest	$687	$687
Cash received from litigation settlement	$14,000	$—
Non-cash Financing Activities:		
Unpaid dividends	$20,395	$16,919

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

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DIAMONDROCK HOSPITALITY COMPANY

Notes to the Condensed Consolidated Financial Statements
(Unaudited)

1. Organization

DiamondRock Hospitality Company (the "Company" or "we") is a lodging-focused real estate company that owns a portfolio of premium hotels and resorts. Our hotels are concentrated in key gateway cities and in destination resort locations and most are operated under a brand owned by one of the leading global lodging brand companies (Marriott International, Inc. ("Marriott"), Starwood Hotels & Resorts Worldwide, Inc. ("Starwood"), or Hilton Worldwide ("Hilton")). We are an owner, as opposed to an operator, of the hotels in our portfolio. As an owner, we receive all of the operating profits or losses generated by our hotels after we pay fees to the hotel managers, which are based on the revenues and profitability of the hotels.

As of June 30, 2014, we owned 25 hotels with 10,735 guest rooms, located in the following markets: Atlanta, Georgia; Boston, Massachusetts (2); Burlington, Vermont; Charleston, South Carolina; Chicago, Illinois (2); Denver, Colorado (2); Fort Worth, Texas; Los Angeles, California; Minneapolis, Minnesota; New York, New York (4); Orlando, Florida; Salt Lake City, Utah; San Diego, California; San Francisco, California; Sonoma, California; Washington D.C. (2); St. Thomas, U.S. Virgin Islands; and Vail, Colorado. We also have the right to acquire, upon completion later in 2014, a 282-room hotel under development in New York City.

We conduct our business through a traditional umbrella partnership REIT, or UPREIT, in which our hotel properties are owned by our operating partnership, DiamondRock Hospitality Limited Partnership, or subsidiaries of our operating partnership. The Company is the sole general partner of our operating partnership and currently owns, either directly or indirectly, all of the limited partnership units of our operating partnership.

2. Summary of Significant Accounting Policies

Basis of Presentation

We have condensed or omitted certain information and footnote disclosures normally included in financial statements presented in accordance with U.S. generally accepted accounting principles, or U.S. GAAP, in the accompanying unaudited condensed consolidated financial statements. We believe the disclosures made are adequate to prevent the information presented from being misleading. However, the unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto as of and for the year ended December 31, 2013, included in our Annual Report on Form 10-K filed on February 25, 2014.

In our opinion, the accompanying unaudited condensed consolidated financial statements reflect all adjustments necessary to present fairly our financial position as of June 30, 2014 and the results of our operations for the three and six months ended June 30, 2014 and 2013 and our cash flows for the six months ended June 30, 2014 and 2013. Interim results are not necessarily indicative of full-year performance because of the impact of seasonal and short-term variations.

Our financial statements include all of the accounts of the Company and its subsidiaries in accordance with U.S. GAAP. All intercompany accounts and transactions have been eliminated in consolidation. If the Company determines that it has an interest in a variable interest entity within the meaning of the FASB ASC 810, Consolidation,

the Company will consolidate the entity when it is determined to be the primary beneficiary of the entity.

Property and Equipment

Investments in hotel properties, land, land improvements, building and furniture, fixtures and equipment and identifiable intangible assets are recorded at fair value upon acquisition. Property and equipment purchased after the hotel acquisition date is recorded at cost. Replacements and improvements are capitalized, while repairs and maintenance are expensed as incurred. Upon the sale or retirement of a fixed asset, the cost and related accumulated depreciation is removed from the Company's accounts and any resulting gain or loss is included in the statements of operations.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 15 to 40 years for buildings, land improvements, and building improvements and 1 to 10 years for furniture, fixtures and equipment. Leasehold improvements are amortized over the shorter of the lease term or the useful lives of the related assets.

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We review our investments in hotel properties for impairment whenever events or changes in circumstances indicate that the carrying value of the hotel properties may not be recoverable. Events or circumstances that may cause a review include, but are not limited to, adverse changes in the demand for lodging at the properties due to declining national or local economic conditions and/or new hotel construction in markets where the hotels are located. When such conditions exist, management performs an analysis to determine if the estimated undiscounted future cash flows from operations and the proceeds from the ultimate disposition of a hotel, less costs to sell, exceed its carrying value. If the estimated undiscounted future cash flows are less than the carrying amount of the asset, an adjustment to reduce the carrying amount to the related hotel's estimated fair market value is recorded and an impairment loss is recognized.

We will classify a hotel as held for sale in the period that we have made the decision to dispose of the hotel, a binding agreement to purchase the property has been signed under which the buyer has committed a significant amount of nonrefundable cash and no significant financing or other contingencies exist which could cause the transaction to not be completed in a timely manner. If these criteria are met, we will record an impairment loss if the fair value less costs to sell is lower than the carrying amount of the hotel and related assets and will cease recording depreciation expense. We will classify the assets and related liabilities as held for sale on the balance sheet.

Note Receivable

Notes receivable are carried at cost, net of any premiums or discounts which are recognized as an adjustment of yield over the remaining life of the note using the effective interest rate method. Notes receivable are evaluated for collectability and if collectability of the original amounts due is in doubt, the value is adjusted for impairment. Our impairment analysis considers the anticipated cash receipts as well as the underlying value of the collateral. If collectability is in doubt, the note is placed in non-accrual status. No interest is recorded on such notes until the timing and amounts of cash receipts can be reasonably estimated. We record cash payments received on non-accrual notes receivable as a reduction in basis. We continually assess the current facts and circumstances to determine whether we can reasonably estimate cash flows. If we can reasonably estimate the timing and amount of cash flows to be collected, then income recognition becomes possible.

Revenue Recognition

Revenues from operations of the hotels are recognized when the services are provided. Revenues consist of room sales, golf sales, food and beverage sales, and other hotel department revenues, such as telephone, parking, gift shop sales and resort fees.

Earnings (Loss) Per Share

Basic earnings (loss) per share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the period plus other potentially dilutive securities such as equity awards or shares issuable in the event of conversion of operating partnership units. No adjustment is made for shares that are anti-dilutive during a period.

Comprehensive Income (Loss)

We do not have any items of comprehensive income (loss) other than net income (loss). If we do incur any additional items of comprehensive income (loss), such that a statement of comprehensive income would be necessary, such statement will be reported as one statement with the condensed consolidated statement of operations.

Stock-based Compensation

We account for stock-based employee compensation using the fair value based method of accounting. We record the cost of stock-based awards based on the grant-date fair value of the award. That cost is recognized over the period during which an employee is required to provide service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render the requisite service.

Income Taxes

We account for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect

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for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in earnings in the period when the new rate is enacted.

We have elected to be treated as a REIT under the provisions of the Internal Revenue Code of 1986, as amended, which requires that we distribute at least 90% of our taxable income annually to our stockholders and comply with certain other requirements. In addition to paying federal and state taxes on any retained income, we may be subject to taxes on “built-in gains” on sales of certain assets. Our taxable REIT subsidiaries will generally be subject to federal, state, local, and/or foreign income taxes.

In order for the income from our hotel property investments to constitute “rents from real properties” for purposes of the gross income tests required for REIT qualification, the income we earn cannot be derived from the operation of any of our hotels. Therefore, we lease each of our hotel properties to a wholly-owned subsidiary of Bloodstone TRS, Inc., our taxable REIT subsidiary, or TRS, except for the Frenchman’s Reef & Morning Star Marriott Beach Resort, which is owned by a Virgin Islands corporation, which we have elected to be treated as a TRS.

We had no accruals for tax uncertainties as of June 30, 2014 and December 31, 2013.

Fair Value Measurements

In evaluating fair value, U.S. GAAP outlines a valuation framework and creates a fair value hierarchy that distinguishes between market assumptions based on market data (observable inputs) and a reporting entity’s own assumptions about market data (unobservable inputs). The hierarchy ranks the quality and reliability of inputs used to determine fair value, which are then classified and disclosed in one of the three categories. The three levels are as follows:

•Level 1 - Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities
•Level 2 - Inputs include quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets in markets that are not active and model-derived valuations whose inputs are observable
•Level 3 - Model-derived valuations with unobservable inputs

Intangible Assets and Liabilities

Intangible assets and liabilities are recorded on non-market contracts assumed as part of the acquisition of certain hotels. We review the terms of agreements assumed in conjunction with the purchase of a hotel to determine if the terms are favorable or unfavorable compared to an estimated market agreement at the acquisition date. Favorable lease assets or unfavorable contract liabilities are recorded at the acquisition date and amortized using the straight-line method over the term of the agreement. We do not amortize intangible assets with indefinite useful lives, but we review these assets for impairment annually or at interim periods if events or circumstances indicate that the asset may be impaired.

Straight-Line Rental Income and Expense

We record rental income and expense on a straight-line basis for leases that provide for minimum rental payments that increase in pre-established amounts over the remaining term of the lease.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of our note receivable and cash and cash equivalents. We perform periodic evaluations of the underlying hotel property securing the note receivable. See further discussion in Note 5. We maintain cash and cash equivalents with various financial institutions. We perform periodic evaluations of the relative credit standing of these financial institutions and limit the amount of credit exposure with any one institution.

Use of Estimates

The preparation of the financial statements in conformity with U.S. 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 from those estimates.

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Risks and Uncertainties

The state of the overall economy can significantly impact hotel operational performance and thus, impact our financial position. Should any of our hotels experience a significant decline in operational performance, it may affect our ability to make distributions to our stockholders and service debt or meet other financial obligations.

Recently Issued Accounting Pronouncements

In April 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, which amends U.S. GAAP to require reporting of discontinued operations only if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. This ASU is effective for the first annual reporting period beginning on or after December 15, 2014 with early adoption permitted. We have adopted this ASU effective January 1, 2014, Under this ASU, we anticipate the majority of our hotel sales will not be classified as discontinued operations. Hotel sales that have already been reported within discontinued operations in previously issued financial statements will continue to be reported under the previous guidance.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. This pronouncement will be effective for the first annual reporting period beginning after December 15, 2016. Early application is not permitted. The ASU permits the use of either the retrospective or cumulative effect transition method. We are evaluating the effect that the ASU will have on our consolidated financial statements and related disclosures. We have not yet selected a transition method or determined the effect of the ASU on our future financial reporting.

3. Property and Equipment

Property and equipment as of June 30, 2014 and December 31, 2013 consists of the following (in thousands):

	June 30, 2014	December 31, 2013
Land	$385,456	$394,957
Land improvements	7,994	7,994
Buildings	2,312,806	2,321,666
Furniture, fixtures and equipment	442,224	421,230
CIP	10,686	22,241
	3,159,166	3,168,088
Less: accumulated depreciation	(623,339)	(600,555)
	$2,535,827	$2,567,533

As of June 30, 2014, we had accrued capital expenditures of $5.0 million. As of December 31, 2013, we had accrued capital expenditures of $8.6 million.

4. Favorable Lease Assets

In connection with the acquisition of certain hotels, we have recognized intangible assets for favorable ground leases and tenant leases. Our favorable lease assets, net of accumulated amortization of $2.7 million and $6.8 million as of June 30, 2014 and December 31, 2013, respectively, consist of the following (in thousands):

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	June 30, 2014	December 31, 2013
Westin Boston Waterfront Hotel Ground Lease	$18,401	$18,510
Westin Boston Waterfront Hotel Lease Right	9,045	9,045
Hilton Minneapolis Ground Lease	5,798	5,835
Oak Brook Hills Resort Ground Lease	—	5,058
Lexington Hotel New York Tenant Leases	1,103	1,176
Hilton Boston Downtown Tenant Leases	229	312
	$34,576	$39,936

Favorable lease assets are recorded at the acquisition date and are generally amortized using the straight-line method over the remaining non-cancelable term of the lease agreement. Amortization expense for the three and six months ended June 30, 2014 was approximately $0.2 million and $0.4 million, respectively.

We own a favorable lease asset related to the right to acquire a leasehold interest in a parcel of land adjacent to the Westin Boston Waterfront Hotel for the development of a 320 to 350 room hotel (the “lease right”). The option expires in 2016. We do not amortize the lease right but review the asset for impairment annually or at interim periods if events or circumstances indicate that the asset may be impaired. No impairment loss was recorded for the three or six months ended June 30, 2014 or 2013.

The fair value of the lease right is a Level 3 measurement under the fair value hierarchy (see Note 2) and is derived from a discounted cash flow model using the favorable difference between the estimated participating rents or actual rents in accordance with the lease terms and the estimated market rents. The discount rate is estimated using a risk adjusted rate of return, the estimated participating rents are estimated based on a hypothetical hotel comparable to our Westin Boston Waterfront Hotel, and market rents are based on comparable long-term ground leases in the City of Boston.

In connection with the sale of the Oak Brook Hills Resort on April 14, 2014, we wrote off the favorable ground lease asset, which is included in the gain on sale of hotel property on the accompanying condensed consolidated statements of operations for the three and six months ended June 30, 2014.

5. Note Receivable

On May 21, 2014, we received $58.5 million in the prepayment of the senior mortgage loan secured by the 443-room Allerton Hotel in Chicago, Illinois (the "Allerton Loan"). As a result of the prepayment, we recorded a gain of $13.6 million. The Allerton Loan had an original principal balance of $66.0 million, which had a four-year term (plus a one-year extension option) and bore annual interest at a fixed rate of 5.5%. Principal payments were based on a 30-year amortization schedule, but were only due to the extent there was available cash flow from operations.

We recorded the following amounts of interest income on the Allerton Loan (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Contractual interest income	$456	$906	$1,317	$1,642
Amortization of discount	379	672	1,075	1,205
Total interest income	$835	$1,578	$2,392	$2,847

6. Capital Stock

Common Shares

We are authorized to issue up to 400 million shares of common stock, $0.01 par value per share. Each outstanding share of common stock entitles the holder to one vote on all matters submitted to a vote of stockholders. Holders of our common stock are entitled to receive dividends out of assets legally available for the payment of dividends when authorized by our board of directors.

We have paid the following dividends to holders of our common stock during 2014 as follows:

Payment Date	Record Date	Dividend per Share
January 10, 2014	December 31, 2013	$0.0850
April 10, 2014	March 31, 2014	$0.1025
July 10, 2014	June 30, 2014	$0.1025

Preferred Shares

We are authorized to issue up to 10 million shares of preferred stock, $0.01 par value per share. Our board of directors is required to set for each class or series of preferred stock the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications, and terms or conditions of redemption. As of June 30, 2014 and December 31, 2013, there were no shares of preferred stock outstanding.

Operating Partnership Units

Holders of operating partnership units would have certain redemption rights, which would enable them to cause our operating partnership to redeem their units in exchange for cash per unit equal to the market price of our common stock, at the time of redemption, or, at our option for shares of our common stock on a one-for-one basis. The number of shares issuable upon exercise of the redemption rights will be adjusted upon the occurrence of stock splits, mergers, consolidations or similar pro-rata share transactions, which otherwise would have the effect of diluting the ownership interests of the limited partners or our stockholders. As of June 30, 2014 and December 31, 2013, there were no operating partnership units held by unaffiliated third parties.

7. Stock Incentive Plans

We are authorized to issue up to 8 million shares of our common stock under our 2004 Stock Option and Incentive Plan, as amended (the “Incentive Plan”), of which we have issued or committed to issue 3,691,272 shares as of June 30, 2014. In addition to these shares, additional shares of common stock could be issued in connection with the market stock unit awards and performance stock unit awards as further described below. On May 15, 2014, we issued (i) 19,671 shares of common stock and (ii) 19,671 deferred stock units to our board of directors having an aggregate value of $465,000, based on the closing stock price for our common stock on such day.

Restricted Stock Awards

Restricted stock awards issued to our officers and employees generally vest over a 3-year period from the date of the grant based on continued employment. We measure compensation expense for the restricted stock awards based upon the fair market value of our common stock at the date of grant. Compensation expense is recognized on a straight-line basis over the vesting period and is included in corporate expenses in the accompanying condensed consolidated statements of operations. A summary of our restricted stock awards from January 1, 2014 to June 30, 2014 is as follows:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested balance at January 1, 2014	583,021	$9.80
Granted	246,621	12.37
Vested	(270,440)	10.10

Unvested balance at June 30, 2014	559,202	$10.79

The remaining share awards are expected to vest as follows: 280,532 during 2015, 184,993 during 2016, 87,331 during 2017, and 6,346 during 2018. As of June 30, 2014, the unrecognized compensation cost related to restricted stock awards was $5.1 million and the weighted-average period over which the unrecognized compensation expense will be recorded is approximately 26 months. We recorded $0.7 million of compensation expense related to restricted stock awards for each of the three months ended June 30, 2014 and June 30, 2013. We recorded $1.4 million and $2.0 million, respectively, of compensation expenses related to restricted stock awards for each of the six months ended June 30, 2014 and June 30, 2013. The compensation expense for the three and six months ended June 30, 2013 includes $0.7 million related to the accelerated vesting of awards in connection with the departure of our former Chief Operating Officer in 2013.

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Market Stock Units

From 2010 to 2012, we awarded our executive officers market stock units ("MSUs"). MSUs are restricted stock units that vest three years from the date of grant. As of June 30, 2014, there are 96,755 MSUs outstanding, which represent awards granted in 2012. The unrecognized compensation cost related to the MSUs was $0.2 million as of June 30, 2014 and is expected to be recognized on a straight-line basis over a weighted average period of 8 months. For the three months ended June 30, 2014 and June 30, 2013, we recorded approximately $0.1 million of compensation expense related to the MSUs. For the six months ended June 30, 2014 and June 30, 2013, we recorded approximately $0.2 million and $0.5 million, respectively, of compensation expense related to the MSUs.

Performance Stock Units

Beginning in 2013, we have awarded our executive officers performance stock units ("PSUs"). PSUs are restricted stock units that vest three years from the date of grant. Each executive officer is granted a target number of PSUs (the "PSU Target Award"). The actual number of shares of common stock issued to each executive officer is subject to the achievement of certain levels of total stockholder return relative to the total stockholder return of a peer group of publicly-traded lodging REITs over a three-year performance period. There will be no payout of shares of our common stock if our total stockholder return falls below the 30th percentile of the total stockholder returns of the peer group. The maximum number of shares of common stock issued to an executive officer is equal to 150% of the PSU Target Award and is earned if our total stockholder return is equal to or greater than the 75th percentile of the total stockholder returns of the peer group.

The fair values of the PSU awards are determined using a Monte Carlo simulation performed by a third-party valuation firm. The determination of the grant-date fair values of the awards included the following assumptions:

Award Grant Date	Volatility		Risk-Free Rate		Fair Value at Grant Date
March 3, 2013	39.2	%	0.36	%	$9.55
May 15, 2013	37.9	%	0.40	%	$10.41
March 3, 2014	33.5	%	0.66	%	$12.77
May 15, 2014	33.1	%	0.80	%	$9.88

The simulations also considered the share performance of the Company and the peer group. A summary of our PSUs from January 1, 2014 to June 30, 2014 is as follows:

	Number of Units	Weighted-Average Grant Date Fair Value
Unvested balance at January 1, 2014	223,176	$9.66
Granted	200,685	12.33
Additional units from dividends	5,095	11.67
Unvested balance at June 30, 2014	428,956	$10.93

As of June 30, 2014, the unrecognized compensation cost related to the PSUs was $3.4 million and is expected to be recognized on a straight-line basis over a weighted average period of 28 months. For the three months ended June 30, 2014 and June 30, 2013, we recorded approximately $0.4 million and $0.2 million, respectively, of compensation expense related to the PSUs. For the six months ended June 30, 2014 and June 30, 2013, we recorded approximately

$0.6 million and $0.2 million, respectively, of compensation expense related to the PSUs.

8. Earnings (Loss) Per Share

Basic earnings (loss) per share is calculated by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding. Diluted earnings (loss) per share is calculated by dividing net income (loss) available to common stockholders that has been adjusted for dilutive securities, by the weighted-average number of common shares outstanding including dilutive securities.

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The following is a reconciliation of the calculation of basic and diluted earnings (loss) per share (in thousands, except share and per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Numerator:				
Income from continuing operations	$51,916	$14,120	$55,953	$9,320
Income from discontinued operations	—	952	—	1,625
Net income	$51,916	$15,072	$55,953	$10,945
Denominator:				
Weighted-average number of common shares outstanding—basic	195,776,924	195,515,328	195,700,864	195,408,890
Effect of dilutive securities:				
Unvested restricted common stock	134,737	66,912	181,803	98,562
Shares related to unvested MSUs and PSUs	335,057	112,043	335,057	159,793
Weighted-average number of common shares outstanding—diluted	196,246,718	195,694,283	196,217,724	195,667,245
Basic earnings per share:				
Continuing operations	$0.27	$0.07	$0.29	$0.05
Discontinued operations	—	0.01	—	0.01
Total	$0.27	$0.08	$0.29	$0.06
Diluted earnings per share:				
Continuing operations	$0.26	$0.07	$0.29	$0.05
Discontinued operations	—	0.01	—	0.01
Total	$0.26	$0.08	$0.29	$0.06

We did not include 262,461 unexercised stock appreciation rights in our calculation of diluted earnings per share for all periods presented as they would be anti-dilutive.

9. Debt

The following table sets forth information regarding the Company’s debt as of June 30, 2014, in thousands:

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Property	Principal Balance	Interest Rate	Maturity Date
Courtyard Manhattan / Midtown East (1)	$41,315	8.81%	October 2014
Marriott Salt Lake City Downtown	62,179	4.25%	November 2020
Courtyard Manhattan / Fifth Avenue	49,282	6.48%	June 2016
Renaissance Worthington	53,334	5.40%	July 2015
Frenchman's Reef & Morning Star Marriott Beach Resort	57,136	5.44%	August 2015
Marriott Los Angeles Airport	82,600	5.30%	July 2015
Orlando Airport Marriott	56,353	5.68%	January 2016
Chicago Marriott Downtown Magnificent Mile	206,799	5.975%	April 2016
Hilton Minneapolis	93,980	5.464%	May 2021
JW Marriott Denver at Cherry Creek	39,226	6.47%	July 2015
Lexington Hotel New York	170,368	LIBOR + 3.00% (3.151% at June 30, 2014)	March 2015 (2)
Westin Washington D.C. City Center	71,533	3.99%	January 2023
The Lodge at Sonoma, a Renaissance Resort & Spa	30,377	3.96%	April 2023
Westin San Diego	69,568	3.94%	April 2023
Debt premium (3)	362		
Total mortgage debt	1,084,412		
Senior unsecured credit facility (5)	41,320	LIBOR + 1.90% (2.09% at June 30, 2014)	January 2017 (2)
Total debt	$1,125,732		
Weighted-Average Interest Rate		5.05%	

(1) We prepaid the mortgage loan in full on July 1, 2014.

(2) The loan may be extended for two additional one-year terms subject to the satisfaction of certain conditions and the payment of an extension fee.

(3) Recorded upon our assumption of the JW Marriott Denver at Cherry Creek mortgage debt in 2011.

(4) The credit facility may be extended for an additional year upon the payment of applicable fees and the satisfaction of certain customary conditions.

(5) Draw on the credit facility was used to fund the prepayment of the mortgage loan secured by the Courtyard Manhattan/Midtown East on July 1, 2014. As permitted under the credit facility, the mortgage was transferred to the credit facility until the closing of the new mortgage loan on July 18, 2014.

Mortgage Debt

We have incurred limited recourse, property specific mortgage debt secured by certain of our hotels. In the event of default, the lender may only foreclose on the secured assets; however, in the event of fraud, misapplication of funds or other customary recourse provisions, the lender may seek payment from us. As of June 30, 2014, 14 of our 25 hotels were secured by mortgage debt. Our mortgage debt contains certain property specific covenants and restrictions, including minimum debt service coverage ratios that trigger "cash trap" provisions as well as restrictions on incurring additional debt without lender consent.

The Lexington Hotel New York mortgage loan contains a quarterly financial covenant requiring a minimum debt service coverage ratio ("DSCR"), as defined in the loan agreement, of 1.1 times. As a result of the ongoing renovation of the hotel during most of 2013, the DSCR fell below the minimum requirement. Under the loan agreement, we have the ability to cure the default by depositing the amount of the DSCR shortfall into a reserve with the lender. If we did not fund the DSCR shortfall and cure the default, the loan would have become due and payable. As of June 30, 2014, the lender is holding $2.8 million in a reserve to cover the DSCR shortfall. The reserve will be released back to us when the DSCR is above 1.1 times, which we achieved as of June 30, 2014. In addition, the cash trap provision was triggered on the loan during 2013 and is still in effect.

As of June 30, 2014, we are in compliance with the other financial covenants of our mortgage debt.

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On July 1, 2014, we prepaid the $41.3 million mortgage loan secured by the Courtyard Manhattan/Midtown East. We funded the mortgage loan using a $41.3 million draw on our senior unsecured credit facility. The mortgage was transferred to our senior unsecured credit facility until July 18, 2014, when we entered into a new $86 million mortgage loan secured by the Courtyard Manhattan/Midtown East. The new loan has a term of ten years and bears interest at a fixed rate of 4.40%. In connection with the new mortgage loan, we repaid the $41.3 million outstanding on our senior unsecured credit facility. The new loan is interest-only for the first two years after which principal will amortize over 30 years.

Senior Unsecured Credit Facility

We are party to a $200 million unsecured credit facility, which expires in January 2017. The maturity date of the facility may be extended for an additional year upon the payment of applicable fees and the satisfaction of certain other customary conditions. We also have the right to increase the amount of the facility up to $400 million with lender approval. Interest is paid on the periodic advances under the facility at varying rates, based upon LIBOR, plus an agreed upon additional margin amount. The applicable margin is based upon the Company’s ratio of net indebtedness to EBITDA, as follows:

Ratio of Net Indebtedness to EBITDA	Applicable Margin	
Less than 4.00 to 1.00	1.75	%
Greater than or equal to 4.00 to 1.00 but less than 5.00 to 1.00	1.90	%
Greater than or equal to 5.00 to 1.00 but less than 5.50 to 1.00	2.10	%
Greater than or equal to 5.50 to 1.00 but less than 6.00 to 1.00	2.20	%
Greater than or equal to 6.00 to 1.00 but less than 6.50 to 1.00	2.50	%
Greater than or equal to 6.50 to 1.00	2.75	%

In addition to the interest payable on amounts outstanding under the facility, we are required to pay an amount equal to 0.35% of the unused portion of the facility if the unused portion of the facility is greater than 50% or 0.25% if the unused portion of the facility is less than or equal to 50%.

The facility contains various corporate financial covenants. A summary of the most restrictive covenants is as follows:

	Covenant	Actual at June 30, 2014
Maximum leverage ratio (1)	60%	46.0%
Minimum fixed charge coverage ratio (2)	1.50x	2.52x
Minimum tangible net worth (3)	$1.857 billion	$2.321 billion
Secured recourse indebtedness	Less than 45% of Total Asset Value	40.7%

(1) Leverage ratio is total indebtedness, as defined in the credit agreement which includes our commitment on the Times Square development hotel, divided by total asset value, defined in the credit agreement as a) total cash and cash equivalents plus b) the value of our owned hotels based on hotel net operating income divided by a defined capitalization rate, and (c) the book value of the Allerton Loan.

(2) Fixed charge coverage ratio is Adjusted EBITDA, defined in the credit agreement as EBITDA less FF&E reserves, for the most recently ending 12 months, to fixed charges, which is defined in the credit agreement as interest expense, all regularly scheduled principal payments and payments on capitalized lease obligations, for the same

most recently ending 12-month period.

(3) Tangible net worth, as defined in the credit agreement, is (i) total gross book value of all assets, exclusive of depreciation and amortization, less intangible assets, total indebtedness, and all other liabilities, plus (ii) 75% of net proceeds from future equity issuances.

The facility requires us to maintain a specific pool of unencumbered borrowing base properties. The unencumbered borrowing base assets must include a minimum of five properties with an unencumbered borrowing base value, as defined in the credit agreement, of not less than $250 million. As of June 30, 2014, the unencumbered borrowing base included five properties with a borrowing base value of $323 million.

As of June 30, 2014, we had $41.3 million of borrowings outstanding under the facility and the Company's ratio of net indebtedness to EBITDA was 3.97x. Accordingly, interest on our borrowings under the facility will be based on LIBOR plus 175 basis points for the next quarter. The borrowings outstanding under the facility were repaid on July 18, 2014. We incurred interest and unused credit facility fees on the facility of $0.2 million for the three months ended June 30, 2014 and 2013. We incurred

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interest and unused credit facility fees on the facility of $0.4 million and $0.5 million for the six months ended June 30, 2014 and 2013, respectively.

10. Dispositions

Effective January 1, 2014, we adopted ASU No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, which amends U.S. GAAP to require reporting of discontinued operations only if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. As a result, the operations of hotels sold subsequent to December 31, 2013 are expected to be reported in continuing operations.

On April 14, 2014, we sold the 386-room Oak Brook Hills Resort to an unaffiliated third party for $30.1 million, including $4.0 million of seller financing. The sale meets the requirements for accounting under the full accrual method. We recorded a gain on sale of the hotel of approximately $1.3 million, net of a valuation allowance on the loan receivable. The loan provided to the buyer is unsecured and has a one year interest-only period after which the loan will amortize based on a twenty-five year schedule. The loan is included within prepaid and other assets on the accompanying condensed consolidated balance sheet as of June 30, 2014. The loan accrues interest at a floating rate rate of LIBOR plus 650 basis points for the first year. The interest rate margin increases by 100 basis points annually for the remainder of the loan term. The loan is subordinate to the buyer's senior mortgage loan. The loan agreement provides repayment options, which include: (1) the hotel achieving a certain operating profit threshold by mid-2016, (2) refinancing proceeds in excess of the outstanding balance of the senior mortgage loan, or (3) proceeds in excess of the outstanding balance of the senior mortgage loan from the sale of the hotel.

In November 2013, we sold the 487-room Torrance Marriott South Bay to an unaffiliated third party. The operating results are reported in discontinued operations on the accompanying condensed consolidated statement of operations for the three months ended June 30, 2013.

The following table summarizes the components of discontinued operations in the condensed consolidated statement of operations for the three and six months ended June 30, 2013 (unaudited; in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	June 30, 2013		June 30, 2013	
Hotel revenues	$6,170		$11,611	
Hotel operating expenses	(4,477	)	(8,660	)
Operating income	1,693		2,951	
Depreciation and amortization	(586	)	(1,168	)
Income tax expense	(155	)	(158	)
Income from discontinued operations	$952		$1,625	
Basic and diluted income from discontinued operations per share	$0.01		$0.01	

11. Fair Value of Financial Instruments

The fair value of certain financial assets and liabilities and other financial instruments as of June 30, 2014 and December 31, 2013, in thousands, are as follows:

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	June 30, 2014		December 31, 2013	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Debt	$1,125,732	$1,141,178	$1,091,861	$1,087,516

The fair value of our mortgage debt is a Level 2 measurement under the fair value hierarchy (see Note 2). We estimate the fair value of our mortgage debt by discounting the future cash flows of each instrument at estimated market rates. The carrying value of our other financial instruments approximate fair value due to the short-term nature of these financial instruments.

12. Commitments and Contingencies

Litigation

We are subject to various claims, lawsuits and legal proceedings, including routine litigation arising in the ordinary course of business, regarding the operation of our hotels and company matters. While it is not possible to ascertain the ultimate outcome of such matters, management believes that the aggregate amount of such liabilities, if any, in excess of amounts covered by insurance will not have a material adverse impact on our financial condition or results of operations. The outcome of claims, lawsuits and legal proceedings brought against the Company, however, is subject to significant uncertainties.

Westin Boston Waterfront Litigation Settlement

In May 2014, we settled a legal action alleging certain issues related to the original construction of the Westin Boston Waterfront Hotel with the contractors and their insurers for $14.0 million in full and complete satisfaction of our claims against the contractors. The settlement resulted in a net gain of $11.0 million. We recorded the settlement net of a $1.2 million contingency fee paid to our legal counsel and $1.8 million of legal fees and other costs incurred over the course of the legal proceedings. The $1.8 million of legal fees and other costs were previously recorded as corporate expenses and the repayment of those costs through the settlement proceeds is recorded as a reduction of corporate expenses during the three months ended June 30, 2014.

Hotel under Development

We are party to a purchase and sale agreement to acquire, upon completion, a hotel property under development on West 42nd Street in Times Square, New York City. Upon completion by the third-party developer, the hotel will have 282 guest rooms. The contractual purchase price is approximately $127 million, or approximately $450,000 per guest room. The purchase and sale agreement is for a fixed-price and we are not assuming any construction risk (including not assuming the risk of construction cost overruns). We expect that the hotel will open during September 2014. We have made deposits totaling $26.9 million with a third-party escrow agent. All deposits are interest bearing. We will forfeit our deposits if we do not close on the acquisition of the hotel upon substantial completion of construction, unless the seller fails to meet certain conditions, including substantial completion of the hotel within a specified time frame and construction of the hotel within the contractual scope.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and includes this statement for purposes of complying with these safe harbor provisions. These forward-looking statements are generally identifiable by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project” or similar expressions, whether in the negative or affirmative. Forward-looking statements are based on management’s current expectations and assumptions and are not guarantees of future performance. Factors that may cause actual results to differ materially from current expectations include, but are not limited to, the risks discussed herein and the risk factors discussed from time to time in our periodic filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended December 31, 2013 as updated by our Quarterly Reports on Form 10-Q. Accordingly, there is no assurance that the Company’s expectations will be realized. Except as otherwise required by the federal securities laws, the Company disclaims any obligations or undertaking to publicly release any updates or revisions to any forward-looking statement contained in this report to reflect events, circumstances or changes in expectations after the date of this report.

Overview

DiamondRock Hospitality Company is a lodging-focused Maryland corporation operating as a real estate investment trust (REIT). As of June 30, 2014, we owned a portfolio of 25 premium hotels and resorts that contain 10,735 guest rooms. We also have the right to acquire, upon completion, a hotel under development. As an owner, rather than an operator, of lodging properties, we receive all of the operating profits or losses generated by the hotels after the payment of fees due to hotel managers, which are calculated based on the revenues and profitability of each hotel.

Our vision is to be the premier allocator of capital in the lodging industry. Our mission is to deliver long-term stockholder returns through a combination of dividends and enduring capital appreciation. Our strategy is to utilize disciplined capital allocation and focus on the acquisition, ownership and innovative asset management of high quality lodging properties in North American markets with superior growth prospects and high barriers to entry.

We differentiate ourselves from our competitors by adhering to three basic principles in executing our strategy:

- owning high-quality urban and destination resort hotels;

- implementing innovative asset management strategies; and

- maintaining a conservative capital structure.

Our portfolio is concentrated in key gateway cities and destination resort locations. Each of our hotels is managed by a third party and most are operated under a brand owned by one of the leading global lodging brand companies (Marriott International, Inc. (“Marriott”), Starwood Hotels & Resorts Worldwide, Inc. (“Starwood”) and Hilton Worldwide (“Hilton”)).

We critically evaluate each of our hotels to ensure that we own a portfolio of hotels that conforms to our vision, supports our mission and corresponds with our strategy. On a regular basis, we analyze our portfolio to identify opportunities to invest capital in certain projects or market non-core assets for sale in order to increase our portfolio

quality.

We are committed to a conservative capital structure with prudent leverage. We regularly assess the availability and affordability of capital in order to maximize the stockholder value and minimize enterprise risk. In addition, we are committed to following sound corporate governance practices and being open and transparent in our communications with stockholders.

High Quality Urban- and Destination Resort-Focused Branded Hotel Real Estate

As of June 30, 2014, we owned 25 premium hotels and resorts throughout North America and the U.S. Virgin Islands. Our hotels and resorts are primarily categorized as upper upscale as defined by Smith Travel Research and are generally located in high barrier-to-entry markets with multiple demand generators.

Our properties are concentrated in key gateway cities (primarily New York City, Chicago, Boston and Los Angeles) and in destination resort locations (such as the U.S. Virgin Islands and Vail, Colorado). We consider lodging properties located in gateway cities and resort destinations to be the most capable of creating dynamic cash flow growth and achieving superior long-term capital

appreciation. We also believe that these locations are better insulated from new supply due to relatively high barriers-to-entry, including expensive construction costs and limited development sites.

We have been executing on our strategy to elevate and enhance our hotel portfolio by actively recycling capital early in the recovery phase of this lodging cycle. Our efforts have led to the repositioning of our portfolio through the acquisition of $1.3 billion of urban hotels that align with our strategic goals while disposing of more than $400 million in slower-growth, non-core hotels. These acquisitions increased our urban exposure with additional hotels in cities such as New York, San Francisco, Boston, Denver, Washington D.C. and San Diego. Over 85% of our portfolio EBITDA is currently derived from core urban and resort hotels. Our capital recycling program over the past three years also achieved several other important strategic portfolio goals that include improving our portfolio's geographic and brand diversity and achieving a mix of 50 percent brand-managed and 50 percent third-party managed hotels in our portfolio.

Moreover, the primary focus of our acquisitions over the past three years was on hotels that we believe presented unique value-add opportunities, such as repositioning through a change in brand or comprehensive renovation or changing the third-party hotel manager to a more efficient operator. For example, we executed a $140 million capital expenditure program in 2013, which included major capital investments at the Lexington Hotel New York, Courtyard Manhattan/Fifth Avenue, Courtyard Manhattan/Midtown East, Westin Washington D.C. City Center, Westin San Diego, Hilton Boston Downtown and Hilton Minneapolis.

We leverage some of the leading global hotel brands with all but two of our hotels flagged under a brand owned by Marriott, Hilton or Starwood. We believe that premier global hotel brands create significant value as a result of each brand's ability to produce incremental revenue through their strong reservation and rewards systems and sales organizations with the result being that branded hotels are able to generate greater profits than similar unbranded hotels. We are primarily interested in owning hotels that are currently operated under, or can be converted to, a globally-recognized brand. We would also consider opportunities to acquire other non-branded hotels located in premier or unique markets where we believe that the returns on such a hotel may be higher than if the hotel were operated under a globally-recognized brand.

Innovative Asset Management

We believe we can create significant value in our portfolio through innovative asset management strategies such as rebranding, renovating and repositioning and we engage in a process of regular evaluations of our portfolio in order to determine if there are opportunities to employ these value-add strategies.

Our asset management team is focused on improving hotel profit margins through revenue management strategies and cost control programs. Our asset management team also focuses on identifying new and potential value creation opportunities across our portfolio, including adding new resort fees, creating incremental guest rooms, leasing out restaurants to more profitable third party operators, converting unused space to revenue-generating meeting space, and implementing programs to reduce energy usage.

Our senior management team has established a broad network of hotel industry contacts and relationships, including relationships with hotel owners, financiers, operators, project managers and contractors and other key industry participants. We use our broad network of hotel industry contacts and relationships to maximize the value of our hotels. Under the federal income tax rules governing REITs, we are required to engage a hotel manager that is an eligible independent contractor to manage each of our hotels pursuant to a management agreement with one of our subsidiaries. We strive to negotiate management agreements that give us the right to exert influence over the

management of our properties, annual budgets and all capital expenditures (all, to the extent permitted under the REIT rules), and then to use those rights to continually monitor and improve the performance of our properties. We cooperatively partner with our hotel managers in an attempt to increase operating results and long-term asset values at our hotels. In addition to working directly with the personnel at our hotels, our senior management team also has long-standing professional relationships with our hotel managers' senior executives, and we work directly with these senior executives to improve the performance of the hotels in our portfolio that they manage.

Conservative Capital Structure

We believe that a conservative capital structure maximizes investment capacity while reducing enterprise risk. We currently employ a low-risk and straight-forward capital structure with no corporate level debt, preferred equity, or convertible bonds. Moreover, we have significant balance sheet flexibility with capacity under our $200 million senior unsecured credit facility as well as almost half of our hotels being unencumbered by mortgage debt. We believe it is imprudent to increase the inherent risk of highly cyclical lodging fundamentals through the use of a highly leveraged capital structure.

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We believe our strategically designed capital structure is a value creation tool that can be used over the entire lodging cycle. Specifically, we believe lower leverage benefits us in the following ways:

- provides capacity to fund attractive early-cycle acquisitions;
- provides optionality to fund acquisitions with the most efficient funding source;
- enhances our ability to maintain a sustainable dividend;
- enables us to opportunistically repurchase shares during periods of stock price dislocation; and
- provides capacity to fund late-cycle capital needs.

Our current debt outstanding consists primarily of fixed interest rate mortgage debt. We prefer that a significant portion of our portfolio remains unencumbered by debt in order to provide maximum balance sheet flexibility. In addition, to the extent that we incur additional debt, our preference is non-recourse secured mortgage debt. We expect that our strategy will enable us to maintain a balance sheet with an appropriate amount of debt throughout all phases of the lodging cycle.

We have mortgage debt with significant maturities in 2015 (approximately $230 million, which assumes the extension of the Lexington Hotel mortgage loan) and 2016 (approximately $305 million). We anticipate addressing these maturities, as well as other capital needs, with a combination of the following:

- refinancing proceeds on existing encumbered hotels;
- borrowing capacity on our existing unencumbered hotels;
- proceeds from the disposition of non-core hotels;
- capacity under our $200 million senior unsecured credit facility; and
- annual cash flow from operations.

We prefer a relatively simple but efficient capital structure. We have not invested in joint ventures and have not issued any operating partnership units or preferred stock. We structure our hotel acquisitions to be straightforward and fit within our conservative capital structure; however, we will consider a more complex transaction if we believe that the projected returns to our stockholders will significantly exceed the returns that would otherwise be available.

Key Indicators of Financial Condition and Operating Performance

We use a variety of operating and other information to evaluate the financial condition and operating performance of our business. These key indicators include financial information that is prepared in accordance with U.S. GAAP, as well as other financial information that is not prepared in accordance with U.S. GAAP. In addition, we use other information that may not be financial in nature, including statistical information and comparative data. We use this information to measure the performance of individual hotels, groups of hotels and/or our business as a whole. We periodically compare historical information to our internal budgets as well as industry-wide information. These key indicators include:

- Occupancy percentage;
- Average Daily Rate (or ADR);
- Revenue per Available Room (or RevPAR);
- Earnings Before Interest, Income Taxes, Depreciation and Amortization (or EBITDA) and Adjusted EBITDA; and
- Funds From Operations (or FFO) and Adjusted FFO.

Occupancy, ADR and RevPAR are commonly used measures within the hotel industry to evaluate operating performance. RevPAR, which is calculated as the product of ADR and occupancy percentage, is an important statistic for monitoring operating performance at the individual hotel level and across our business as a whole. We evaluate individual hotel RevPAR performance

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on an absolute basis with comparisons to budget and prior periods, as well as on a company-wide and regional basis. ADR and RevPAR include only room revenue. Room revenue comprised approximately 70% of total revenues for the six months ended June 30, 2014 and is dictated by demand, as measured by occupancy percentage, pricing, as measured by ADR, and our available supply of hotel rooms.

Our ADR, occupancy percentage and RevPAR performance may be impacted by macroeconomic factors such as U.S. economic conditions generally, regional and local employment growth, personal income and corporate earnings, office vacancy rates and business relocation decisions, airport and other business and leisure travel, new hotel construction and the pricing strategies of competitors. In addition, our ADR, occupancy percentage and RevPAR performance is dependent on the continued success of our hotels' global brands.

We also use EBITDA, Adjusted EBITDA, FFO and Adjusted FFO as measures of the financial performance of our business. See “Non-GAAP Financial Measures.”

Our Hotels

The following table sets forth certain operating information for the six months ended June 30, 2014 for each of our hotels.

Property	Location	Number of Rooms	Occupancy (%)		ADR($)	RevPAR($)	% Change from 2013 RevPAR (1)	
Chicago Marriott	Chicago, Illinois	1,198	69.8	%	$199.04	$ 139.02	(6.1	)%
Los Angeles Airport Marriott	Los Angeles, California	1,004	91.1	%	125.11	114.00	17.0	%
Hilton Minneapolis	Minneapolis, Minnesota	821	71.4	%	138.01	98.48	(3.1	)%
Westin Boston Waterfront Hotel	Boston, Massachusetts	793	76.1	%	221.08	168.24	10.9	%
Lexington Hotel New York	New York, New York	725	87.5	%	225.90	197.60	92.9	%
Salt Lake City Marriott Downtown	Salt Lake City, Utah	510	68.7	%	144.34	99.21	(4.0	)%
Renaissance Worthington	Fort Worth, Texas	504	71.0	%	178.05	126.44	11.2	%
Frenchman’s Reef & Morning Star Marriott Beach Resort	St. Thomas, U.S. Virgin Islands	502	90.3	%	273.65	247.18	4.3	%
Orlando Airport Marriott	Orlando, Florida	485	85.3	%	111.88	95.39	12.9	%
Westin San Diego	San Diego, California							