Sunstone Hotel Investors, Inc.
Form 10-Q
August 01, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from to

Commission file number 001-32319

Sunstone Hotel Investors, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	20-1296886 (I.R.S. Employer Identification Number)
120 Vantis, Suite 350 Aliso Viejo, California (Address of Principal Executive Offices)	92656 (Zip Code)

Registrant's telephone number, including area code: (949) 330-4000

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

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

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

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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

228,247,370 shares of Common Stock, $0.01 par value, as of July 25, 2018

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SUNSTONE HOTEL INVESTORS, INC.

QUARTERLY REPORT ON

FORM 10-Q

For the Quarterly Period Ended June 30, 2018

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PART I—FINANCIAL INFORMATION

Item 1.Financial Statements

SUNSTONE HOTEL INVESTORS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	June 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$ 544,900	$ 488,002
Restricted cash	74,989	71,309
Accounts receivable, net	46,540	34,219
Inventories	1,223	1,323
Prepaid expenses	11,289	10,464
Assets held for sale, net	42,389	122,807
Total current assets	721,330	728,124
Investment in hotel properties, net	3,089,181	3,106,066
Deferred financing fees, net	785	1,305
Other assets, net	34,317	22,317
Total assets	$ 3,845,613	$ 3,857,812
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 37,495	$ 31,810
Accrued payroll and employee benefits	19,776	26,687
Dividends and distributions payable	14,620	133,894
Other current liabilities	46,662	44,502
Current portion of notes payable, net	5,653	5,477
Liabilities of assets held for sale	4,061	189
Total current liabilities	128,267	242,559
Notes payable, less current portion, net	974,309	977,282
Capital lease obligations, less current portion	26,904	26,804
Other liabilities	30,802	28,989
Total liabilities	1,160,282	1,275,634
Commitments and contingencies (Note 11)		
Equity:		
Stockholders' equity:		
Preferred stock, $0.01 par value, 100,000,000 shares authorized:		

6.95% Series E Cumulative Redeemable Preferred Stock, 4,600,000 shares issued and outstanding at June 30, 2018 and December 31, 2017, stated at liquidation preference of $25.00 per share	115,000	115,000
6.45% Series F Cumulative Redeemable Preferred Stock, 3,000,000 shares issued and outstanding at June 30, 2018 and December 31, 2017, stated at liquidation preference of $25.00 per share	75,000	75,000
Common stock, $0.01 par value, 500,000,000 shares authorized, 228,254,255 shares issued and outstanding at June 30, 2018 and 225,321,660 shares issued and outstanding at December 31, 2017	2,283	2,253
Additional paid in capital	2,724,379	2,679,221
Retained earnings	1,017,181	932,277
Cumulative dividends and distributions	(1,299,121)	(1,270,013)
Total stockholders' equity	2,634,722	2,533,738
Noncontrolling interest in consolidated joint venture	50,609	48,440
Total equity	2,685,331	2,582,178
Total liabilities and equity	$ 3,845,613	$ 3,857,812

See accompanying notes to consolidated financial statements.

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SUNSTONE HOTEL INVESTORS, INC.

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
REVENUES				
Room	$ 220,304	$ 223,653	$ 400,580	$ 414,020
Food and beverage	79,292	78,621	153,558	154,122
Other operating	17,851	16,522	34,755	31,397
Total revenues	317,447	318,796	588,893	599,539
OPERATING EXPENSES				
Room	54,900	54,557	105,995	105,849
Food and beverage	50,885	50,969	101,039	101,506
Other operating	4,357	4,033	8,298	7,864
Advertising and promotion	14,316	14,911	28,222	29,857
Repairs and maintenance	10,851	10,796	21,954	21,763
Utilities	6,974	7,291	14,449	14,513
Franchise costs	9,961	9,881	17,814	17,936
Property tax, ground lease and insurance	21,508	20,791	43,289	42,078
Other property-level expenses	35,518	35,766	69,425	70,504
Corporate overhead	7,594	7,573	14,696	14,352
Depreciation and amortization	37,334	39,525	74,022	80,332
Impairment loss	1,394	—	1,394	—
Total operating expenses	255,592	256,093	500,597	506,554
Operating income	61,855	62,703	88,296	92,985
Interest and other income	2,966	849	4,457	1,570
Interest expense	(11,184)	(13,084)	(20,060)	(24,333)
Loss on extinguishment of debt	—	—	—	(4)
Gain on sale of assets	—	1,189	15,659	45,474
Income before income taxes	53,637	51,657	88,352	115,692
Income tax (provision) benefit, net	(2,375)	(242)	1,365	(450)
NET INCOME	51,262	51,415	89,717	115,242
Income from consolidated joint venture attributable to noncontrolling interest	(2,374)	(2,183)	(4,813)	(4,175)
Preferred stock dividends	(3,207)	(3,207)	(6,414)	(6,414)
INCOME ATTRIBUTABLE TO COMMON STOCKHOLDERS	$ 45,681	$ 46,025	$ 78,490	$ 104,653
Basic and diluted per share amounts:				
Basic and diluted income attributable to common stockholders per common share	$ 0.20	$ 0.21	$ 0.35	$ 0.47
Basic and diluted weighted average common shares outstanding	225,232	220,130	224,760	219,614

Distributions declared per common share	$ 0.05	$ 0.05	$ 0.10	$ 0.10

See accompanying notes to consolidated financial statements.

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SUNSTONE HOTEL INVESTORS, INC.

UNAUDITED CONSOLIDATED STATEMENT OF EQUITY

(In thousands, except share and per share data)

eferred Stock ries E umber ares	Amount	Series F Number of Shares	Amount	Common Stock Number of Shares	Amount	Additional Paid in Capital	Retained Earnings	Cumulative Dividends and Distributions	N I C
500,000	$ 115,000	3,000,000	$ 75,000	225,321,660	$ 2,253	$ 2,679,221	$ 932,277	$ (1,270,013)	$
—	—	—	—	2,590,854	26	44,315	—	—	
—	—	—	—	341,741	4	843	—	—	
—	—	—	—	—	—	—	—	(22,694)	
—	—	—	—	—	—	—	—	(3,996)	
—	—	—	—	—	—	—	—	(2,418)	
—	—	—	—	—	—	—	—	—	
—	—	—	—	—	—	—	84,904	—	
500,000	$ 115,000	3,000,000	$ 75,000	228,254,255	$ 2,283	$ 2,724,379	$ 1,017,181	$ (1,299,121)	$

See accompanying notes to consolidated financial statements.

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SUNSTONE HOTEL INVESTORS, INC.

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Six Months Ended June 30, 2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 89,717	$ 115,242
Adjustments to reconcile net income to net cash provided by operating activities:		
Bad debt expense	489	310
Gain on sale of assets, net	(15,663)	(45,750)
Loss on extinguishment of debt	—	4
Noncash interest on derivatives and capital lease obligations, net	(4,177)	349
Depreciation	72,690	79,029
Amortization of franchise fees and other intangibles	1,463	1,624
Amortization of deferred financing fees	1,492	1,157
Amortization of deferred stock compensation	4,865	4,340
Impairment loss	1,394	—
Gain on hurricane-related damage	(1,100)	—
Deferred income taxes, net	(1,819)	—
Changes in operating assets and liabilities:		
Accounts receivable	(12,286)	(6,844)
Inventories	(53)	22
Prepaid expenses and other assets	(250)	2,804
Accounts payable and other liabilities	12,246	3,403
Accrued payroll and employee benefits	(5,755)	(5,416)
Net cash provided by operating activities	143,253	150,274
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of assets	137,036	150,155
Proceeds from property insurance	1,100	—
Acquisition deposits	(500)	(7,000)
Acquisitions of intangible assets	(18,484)	—
Renovations and additions to hotel properties and other assets	(87,141)	(59,499)
Payment for interest rate derivative	—	(19)
Net cash provided by investing activities	32,011	83,637
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from common stock offerings	45,125	76,218
Payment of common stock offering costs	(784)	(1,427)
Repurchase of common stock for employee withholding obligations	(4,232)	(3,793)
Proceeds from notes payable	—	240,000
Payments on notes payable	(3,764)	(181,186)
Payments of deferred financing costs	(5)	(13)
Dividends and distributions paid	(148,382)	(134,075)
Distributions to noncontrolling interest	(2,644)	(3,362)
Net cash used in financing activities	(114,686)	(7,638)

Net increase in cash and cash equivalents and restricted cash	60,578	226,273
Cash and cash equivalents and restricted cash, beginning of period	559,311	437,460
Cash and cash equivalents and restricted cash, end of period	$ 619,889	$ 663,733

See accompanying notes to consolidated financial statements.

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SUNSTONE HOTEL INVESTORS, INC.

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

Supplemental Disclosure of Cash Flow Information

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported within the consolidated balance sheet to the amount shown in the consolidated statements of cash flows:

	June 30,	
	2018	2017
Cash and cash equivalents	$ 544,900	$ 597,318
Restricted cash	74,989	66,415
Total cash and cash equivalents and restricted cash shown on the consolidated statements of cash flows	$ 619,889	$ 663,733

The Company paid the following amounts for interest and income taxes, during the six months ended June 30, 2018 and 2017:

	Six Months Ended June 30,	
	2018	2017
Cash paid for interest	$ 22,144	$ 17,686
Cash paid for income taxes	$ 242	$ 447

Supplemental Disclosure of Noncash Investing and Financing Activities

The Company's noncash investing and financing activities during the six months ended June 30, 2018 and 2017 consisted of the following:

	Six Months Ended June 30,	
	2018	2017
Increase (decrease) in accounts payable related to renovations and additions to hotel properties and other assets	$ 175	$ (6,776)
Amortization of deferred stock compensation — construction activities	$ 214	$ 309
Dividends and distributions payable	$ 14,620	$ 14,465

See accompanying notes to consolidated financial statements.

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SUNSTONE HOTEL INVESTORS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Description of Business

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

As a REIT, certain tax laws limit the amount of “non-qualifying” income the Company can earn, including income derived directly from the operation of hotels. The Company leases all of its hotels to its TRS Lessee, which in turn enters into long-term management agreements with third parties to manage the operations of the Company’s hotels, in transactions that are intended to generate qualifying income. As of June 30, 2018, the Company had interests in 25 hotels (the “25 hotels”), one of which was considered held for sale, leaving 24 hotels currently held for investment (the “24 hotels”). The Company’s third-party managers included the following:

	Number of Hotels	
Subsidiaries of Marriott International, Inc. or Marriott Hotel Services, Inc. (collectively, “Marriott”)	9	
Interstate Hotels & Resorts, Inc.	4	
Highgate Hotels L.P. and an affiliate	3	
Crestline Hotels & Resorts	2	
Hilton Worldwide	2	
Hyatt Corporation	2	(1)
Davidson Hotels & Resorts	1	
HEI Hotels & Resorts	1	
Singh Hospitality, LLC	1	
Total hotels owned as of June 30, 2018	25	

(1) The Hyatt Regency Newport Beach, California was considered held for sale as of June 30, 2018, and subsequently sold in July 2018.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements as of June 30, 2018 and December 31, 2017, and for the three and six months ended June 30, 2018 and 2017, include the accounts of the Company, the Operating Partnership, the TRS Lessee and their controlled subsidiaries. All significant intercompany balances and transactions have been eliminated. If the Company determines that it has an interest in a variable interest entity, the Company will consolidate the entity when it is determined to be the primary beneficiary of the entity.

The accompanying interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") and in conformity with the rules and regulations of the Securities and Exchange Commission. In the Company's opinion, the interim financial statements presented herein reflect all adjustments, consisting solely of normal and recurring adjustments, which are necessary to fairly present the interim financial statements. These financial statements should be read in conjunction with the financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017, filed with the Securities and Exchange Commission on February 14, 2018. Operating results for the three and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

The Company does not have any comprehensive income other than what is included in net income. If the Company has any comprehensive income in the future such that a statement of comprehensive income would be necessary, the Company will include such statement in one continuous consolidated statement of operations.

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

Use of Estimates

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

Earnings Per Share

The Company applies the two-class method when computing its earnings per share. Net income per share for each class of stock (common stock and convertible preferred stock) is calculated assuming all of the Company’s net income is distributed as dividends to each class of stock based on their contractual rights.

Unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are considered participating securities and are included in the computation of earnings per share.

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Numerator:				
Net income	$ 51,262	$ 51,415	$ 89,717	$ 115,242
Income from consolidated joint venture attributable to noncontrolling interest	(2,374)	(2,183)	(4,813)	(4,175)
Preferred stock dividends	(3,207)	(3,207)	(6,414)	(6,414)
Distributions paid on unvested restricted stock compensation	(59)	(60)	(118)	(120)
Undistributed income allocated to unvested restricted stock compensation	(179)	(188)	(298)	(437)
Numerator for basic and diluted income attributable to common stockholders	$ 45,443	$ 45,777	$ 78,074	$ 104,096
Denominator:				
Weighted average basic and diluted common shares outstanding	225,232	220,130	224,760	219,614
Basic and diluted income attributable to common stockholders per common share	$ 0.20	$ 0.21	$ 0.35	$ 0.47

The Company’s unvested restricted shares associated with its long-term incentive plan and shares associated with common stock options have been excluded from the above calculation of earnings per share for the three and six months ended June 30, 2018 and 2017, as their inclusion would have been anti-dilutive.

New Accounting Standards and Accounting Changes

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

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transaction price to the performance obligations in the contract; and (5) recognize revenue when (or as) the entity satisfies a performance obligation.

In March 2016, the FASB clarified the principal versus agent guidance in ASU No. 2014-09 with its issuance of Accounting Standards Update No. 2016-08, “Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)” (“ASU No. 2016-08”). In particular, ASU No. 2016-08 clarifies how an entity should identify the unit of accounting for the principal versus agent evaluation and how it should apply the control principle to certain types of arrangements, such as service transactions by explaining what a principal controls before the specified good or service is transferred to the customer. In addition, ASU No. 2016-08 reframes the indicators to focus on evidence that an entity is acting as a principal rather than as an agent.

In May 2016, the FASB amended ASU No. 2014-09’s guidance on transition, collectability, noncash consideration and the presentation of sales and other similar taxes with its issuance of Accounting Standards Update No. 2016-12, “Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients” (“ASU No. 2016-12”). The amendments clarify that, for a contract to be considered completed at transition, all (or substantially all) of the revenue must have been recognized under legacy GAAP. This clarification is important because entities that use the modified retrospective transition approach need to apply the standard only to contracts that are not complete as of the date of initial application, and entities that use the full retrospective approach may apply certain practical expedients to completed contracts. In addition, ASU No. 2016-12 clarifies that an entity should consider the probability of collecting substantially all of the consideration to which it will be entitled in exchange for goods and services expected to be transferred to the customer rather than the total amount promised for all the goods or services in the contract. ASU No. 2016-12 also clarifies that an entity may consider its ability to manage its exposure to credit risk as part of the collectability assessment, as well as that the fair value of noncash consideration should be measured at contract inception when determining the transaction price. Finally, ASU No. 2016-12 allows an entity to make an accounting policy election to exclude from the transaction price certain types of taxes collected from a customer if it discloses that policy.

The Company adopted ASU No. 2014-09, along with the related clarifications and amendments in ASU No. 2016-08 and ASU No. 2016-12, in January 2018, using the modified retrospective approach to contracts that were not complete as of January 1, 2018. Due to the short-term nature of the Company’s revenue streams, the adoption of ASU No. 2014-09 did not have a material impact on the amount and timing of revenue recognized from rooms, food and beverage and other ancillary hotel services. In addition, the Company determined that presenting its revenue streams disaggregated into the categories of rooms, food and beverage, and other on its consolidated statements of operations depicts how the nature, timing and uncertainty of revenue and cash flows are affected by economic factors, and that no further disaggregation is needed. See Revenue Recognition in Note 2 for additional disclosures.

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, “Leases (Topic 842)” (“ASU No. 2016-02”), which will require lessees to put most leases on their balance sheets but recognize expenses in the income statement in a manner similar to today’s accounting. A lessee will be required to record a right-of-use asset and a lease liability for all leases with a term greater than 12 months regardless of their classification. Leases with a term of 12 months or less will be accounted for similarly to existing guidance for operating leases today. ASU No. 2016-02 also eliminates today's real estate-specific provisions and changes the guidance on sale-leaseback transactions, initial direct costs and lease executory costs for all entities. All entities will classify leases to determine how to recognize lease-related revenue and expense. Classification will continue to affect amounts that lessors record on the balance sheet. ASU No. 2016-02 will become effective during the first quarter of 2019, and initially required a modified retrospective approach for leases that exist or are entered into after the date of initial application, with an option to use certain transition relief. In January 2018, the FASB issued Accounting Standards Update No. 2018-01, "Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842" ("ASU No. 2018-01"), which allows a company to elect a practical expedient regarding land easements. By electing this practical expendient, the Company will not be required to reassess whether a land easement not previously accounted for as a lease would now be a lease. In July 2018, the FASB issued Accounting Standards Update No. 2018-10, "Codification Improvements to Topic 842, Leases" ("ASU No. 2018-10") and Accounting Standards Update No. 2018-11, "Leases (Topic 842): Targeted Improvements" ("ASU No. 2018-11"), both of which provide practical expendients that the Company intends to adopt. By adopting these practical expedients, the Company will not be required to reassess (i) whether an expired or existing contract meets the definition of a lease; (ii) the lease classification at the adoption date for existing leases; and (iii) whether costs previously capitalized as initial direct costs would continue to be amortized. In addition, the Company intends to adopt the lessor practical expedient provided by ASU No. 2018-11 whereby lessors, by class of underlying asset, will not be required to separate nonlease components from the associated lease component, if certain conditions are met. The Company does not intend to elect the hindsight practical expedient. ASU No. 2018-11 also adds a transition option to the new leases standard that allows entities to apply the transition provisions of the new standard at its adoption date instead of the earliest comparative period presented in its financial statements. The Company is creating an inventory of its leases and is analyzing its current ground lease obligations. The Company is evaluating the impact that ASU No. 2016-02, as well as the FASB's transition option, will have on its consolidated financial statements, and, other than the inclusion of operating leases on the Company's balance sheet, such effects have not yet been determined.

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In November 2016, the FASB issued Accounting Standards Update No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)" ("ASU No. 2016-18"), which requires entities to show the changes in total cash, cash equivalents, restricted cash and restricted cash equivalents in the statement of cash flows. As a result, entities no longer present transfers between cash and cash equivalents and restricted cash and restricted cash equivalents in the statement of cash flows. When cash, cash equivalents, restricted cash and restricted cash equivalents are presented in more than one line item on the balance sheet, the guidance requires a reconciliation of the totals in the statement of cash flows to the related caption in the balance sheet. The Company adopted ASU No. 2016-18 in January 2018. As a result, amounts included in restricted cash on the Company's consolidated balance sheet are included with cash and cash equivalents on the consolidated statement of cash flows. A reconciliation of the totals in the statement of cash flows to the related caption in the balance sheet has been added as a supplemental disclosure to the Company's consolidated statements of cash flows. The adoption of this standard did not change the Company's balance sheet presentation.

In January 2017, the FASB issued Accounting Standards Update No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business" ("ASU No. 2017-01"), which changes the definition of a business to assist entities with evaluating when a set of transferred assets and activities is a business. Under the new guidance, an entity first determines whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If this threshold is met, the set of transferred assets and activities is not a business. If it is not met, the entity then evaluates whether the set meets the requirement that a business include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The Company adopted ASU No. 2017-01 in January 2018. The Company will analyze future hotel acquisitions and sales to determine if the transaction qualifies as the purchase or disposition of a business or an asset. Transaction costs associated with asset acquisitions will be capitalized, while the same costs associated with a business combination will continue to be expensed as incurred. In addition, asset acquisitions will not be subject to a measurement period, as are business combinations. Depending on the Company's conclusion, ASU No. 2017-01 may have an effect on its consolidated financial statements.

In January 2017, the FASB issued Accounting Standards Update No. 2017-04, "Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment" ("ASU No. 2017-04"), which eliminates the requirement to calculate the implied fair value of goodwill (i.e., Step 2 of today's goodwill impairment test) to measure a goodwill impairment charge. Under the new guidance, if a reporting unit's carrying amount exceeds its fair value, an entity will record an impairment charge based on that difference. The impairment charge will be limited to the amount of goodwill allocated to that reporting unit. The standard does not change the guidance on completing Step 1 of the goodwill impairment test. An entity will still be able to perform today's optional qualitative goodwill impairment assessment before determining whether to proceed to Step 1. ASU No. 2017-04 will become effective in the first quarter of 2019, with early adoption permitted, and the guidance is to be applied prospectively. The Company elected to early adopt ASU No. 2017-04 in January 2018, with no material impact on its consolidated financial statements.

In May 2017, the FASB issued Accounting Standards Update No. 2017-09, "Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting" ("ASU No. 2017-09"), which clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. The new guidance will allow companies to make certain changes to awards without accounting for them as modifications, but it does not change the accounting for modifications. Under ASU No. 2017-09, an entity will not apply modification accounting to a share-based payment award if all of the following are the same immediately before and after the change: the award's fair value (or calculated or intrinsic value, if those measurement methods are used); the award's vesting conditions; and the award's classification as an equity or liability instrument. The Company adopted ASU No. 2017-09 in January 2018 with no impact to its consolidated financial statements.

Noncontrolling Interest

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

At both June 30, 2018 and December 31, 2017, the noncontrolling interest reported in the Company's financial statements consisted of a third-party's 25.0% ownership interest in the Hilton San Diego Bayfront.

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Property and Equipment

Impairment losses are recorded on long-lived assets to be held and used by the Company when indicators of impairment are present and the future undiscounted net cash flows expected to be generated by those assets, based on the Company's expected investment horizon, are less than the assets' carrying amount. If such assets are considered to be impaired, the related assets are adjusted to their estimated fair value and an impairment is recognized. The impairment recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. In computing fair value, the Company uses a discounted cash flow analysis to estimate the fair value of its hotel properties, taking into account each property's expected cash flow from operations and estimated proceeds from the disposition of the property. The factors addressed in determining estimated proceeds from disposition include anticipated operating cash flow in the year of disposition and terminal capitalization rate.

Revenue Recognition

Revenues are recognized when control of the promised goods or services is transferred to hotel guests, which is generally defined as the date upon which a guest occupies a room and/or utilizes the hotel's services. Room revenue is recognized over a guest's stay at a previously agreed upon daily rate. Additionally, some of the Company's hotel rooms are booked through independent internet travel intermediaries. If the guest pays the independent internet travel intermediary directly, revenue for the room is booked by the Company at the price the Company sold the room to the independent internet travel intermediary, less any discount or commission paid. If the guest pays the Company directly, revenue for the room is booked by the Company on a gross basis. A majority of the Company's hotels participate in frequent guest programs sponsored by the hotel brand owners whereby the hotel allows guests to earn loyalty points during their hotel stay. The Company expenses charges associated with these programs as incurred, and recognizes revenue at the amount it will receive from the brand when a guest redeems their loyalty points by staying at one of the Company's hotels. In addition, some contracts for rooms or food and beverage services require an advance deposit, which the Company records as deferred revenue (or a contract liability) and recognizes once the performance obligations are satisfied.

Food and beverage revenue and other ancillary services revenue are generated when a customer chooses to purchase goods or services separately from a hotel room. These revenue streams are recognized during the time the goods or services are provided to the customer at the amount the Company expects to be entitled to in exchange for those goods or services. For those ancillary services provided by third parties, the Company assesses whether it is the principal or the agent. If the Company is the principal, revenue is recognized based upon the gross sales price. If the Company is the agent, revenue is recognized based upon the commission earned from the third party.

Additionally, the Company collects sales, use, occupancy and other similar taxes at its hotels, which the Company presents on a net basis (excluded from revenues) in its consolidated statements of operations.

Trade receivables and contract liabilities consisted of the following (in thousands):

	June 30, 2018 (unaudited)	December 31, 2017
Trade receivables, net (1)	$ 22,342	$ 20,773
Contract liabilities (2)	$ 13,738	$ 13,454

(1) Trade receivables are included in accounts receivable, net on the accompanying consolidated balance sheets.
(2) Contract liabilities consist of advance deposits, and are included in other current liabilities on the accompanying consolidated balance sheets. Of the amount outstanding at December 31, 2017, approximately $2.1 million and $11.5 million was recognized in revenue during the three and six months ended June 30, 2018, respectively.

Segment Reporting

The Company considers each of its hotels to be an operating segment, none of which meets the threshold for a separate reportable segment. Currently, the Company operates in one reportable segment, hotel ownership.

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3. Investment in Hotel Properties

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

	June 30, 2018 (unaudited)	December 31, 2017
Land	$ 604,866	$ 605,054
Buildings and improvements	3,039,104	3,049,569
Furniture, fixtures and equipment	488,042	484,749
Intangible assets	60,413	48,371
Franchise fees	980	980
Construction in progress	56,569	54,280
Investment in hotel properties, gross	4,249,974	4,243,003
Accumulated depreciation and amortization	(1,160,793)	(1,136,937)
Investment in hotel properties, net	$ 3,089,181	$ 3,106,066

In May 2018, the Company paid $18.4 million, including closing costs, to acquire the exclusive perpetual rights to use portions of the Renaissance Washington DC building that the Company had previously leased from an unaffiliated third party (the "Element"). The acquisition of the Element eliminates approximately $1.3 million of annual space rent. Also in May 2018, the Company paid $0.1 million, including closing costs, to acquire two additional dry boat slips at the Oceans Edge Resort & Marina. Both the Element and the dry boat slips have indefinite useful lives, and, therefore, are not amortized. These non-amortizable intangible assets will be reviewed annually for impairment and more frequently if events or circumstances indicate that the assets may be impaired.

During the second quarter of 2018, the Company recorded an impairment loss of $1.4 million on its two Houston hotels due to current market conditions (see Note 5).

4. Disposals

Held for Sale

The Company classified the Hyatt Regency Newport Beach as held for sale at June 30, 2018, and subsequently sold the hotel in July 2018 (see Note 12). The sale did not represent a strategic shift that had a major impact on the Company's business plan or its primary markets; therefore, the sale did not qualify as a discontinued operation. The Company classified the assets and liabilities of the Hyatt Regency Newport Beach as held for sale at June 30, 2018 as follows (in thousands):

	June 30, 2018
Accounts receivable, net	$ 832
Inventories	153
Prepaid expenses	432
Investment in hotel properties, net	40,794
Other assets	178
Assets held for sale, net	$ 42,389
Accounts payable and accrued expenses	$ 484
Accrued payroll and employee benefits	1,156
Other current liabilities	1,988
Other liabilities	433
Liabilities of assets held for sale	$ 4,061

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Disposals

In January 2018, the Company sold the Marriott Philadelphia and the Marriott Quincy, located in Pennsylvania and Massachusetts, respectively, for net proceeds of $137.0 million. The Company recognized a net gain on the sale of $15.7 million. Neither of these sales qualified as a disposition of a business. In addition, neither sale represented a strategic shift that had a major impact on the Company's business plan or its primary markets; therefore, neither of these sales qualified as a discontinued operation. The Company classified the assets and liabilities of both hotels as held for sale at December 31, 2017 as follows (in thousands):

	December 31, 2017	
Accounts receivable	$	1,676
Prepaid expenses		193
Investment in hotel properties, net		120,916
Other assets		22
Assets held for sale, net	$	122,807
Accounts payable and accrued expenses	$	69
Other current liabilities		41
Other liabilities		79
Liabilities of assets held for sale	$	189

The following table provides summary unaudited results of operations for the Marriott Philadelphia and the Marriott Quincy, along with the Fairmont Newport Beach and the Marriott Park City, both of which were sold in 2017, which are included in continuing operations for their respective ownership periods (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenues	$ —	$ 15,210	$ 603	$ 33,554
Income (loss) before income taxes	$ —	$ 2,565	$ (943)	$ 5,186
Gain on sale of assets	$ —	$ 1,189	$ 15,659	$ 45,474

5. Fair Value Measurements and Interest Rate Derivatives

Fair Value of Financial Instruments

As of June 30, 2018 and December 31, 2017, the carrying amount of certain financial instruments, including cash and cash equivalents, restricted cash, accounts receivable, accounts payable and accrued expenses were representative of their fair values due to the short-term maturity of these instruments.

A fair value measurement is based on the assumptions that market participants would use in pricing an asset or liability in an orderly transaction. The hierarchy for inputs used in measuring fair value is as follows:

Level 1	Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
Level 2	Inputs reflect quoted prices for identical assets or liabilities in markets that are not active; quoted prices for similar assets or liabilities in active markets; inputs other than quoted prices that are observable for the asset or the liability; or inputs that are derived principally from or corroborated by observable market data by correlation or other means.
Level 3	Unobservable inputs reflecting the Company's own assumptions incorporated in valuation techniques used to determine fair value. These assumptions are required to be consistent with market participant assumptions that are reasonably available.

As of June 30, 2018 and December 31, 2017, the only financial instruments that the Company measures at fair value on recurring bases are its interest rate derivatives, along with a life insurance policy and a related retirement benefit agreement. The Company estimates the fair value of its interest rate derivatives using Level 2 measurements based on quotes obtained from the counterparties, which are based upon the consideration that would be required to terminate the agreements. Both the life insurance policy and the related retirement benefit agreement, which are for a former Company associate, are valued using Level 2 measurements.

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Due to weakness in the Houston market, the Company identified indicators of impairment and reviewed both of its Houston hotels for possible impairment. Using Level 3 measurements, including each hotel's undiscounted cash flow, which took into account each hotel's expected cash flow from operations, anticipated holding period and estimated proceeds from disposition, the Company determined that neither hotel's carrying value was fully recoverable. As such, during the second quarter of 2018, the Company recorded an impairment charge of $1.4 million on the Houston hotels, which is included in impairment loss on the Company's consolidated statements of operations for the three and six months ended June 30, 2018.

The following table presents the Company's assets measured at fair value on a recurring and nonrecurring basis at June 30, 2018 and December 31, 2017 (in thousands):

		Fair Value Measurements at Reporting Date		
	Total	Level 1	Level 2	Level 3
June 30, 2018 (unaudited):				
Houston hotels, net	$ 32,396	$ —	—	$ 32,396
Interest rate cap derivatives	2	—	2	—
Interest rate swap derivatives	7,669	—	7,669	—
Life insurance policy (1)	408	—	408	—
Total assets measured at fair value at June 30, 2018	$ 40,475	$ —	$ 8,079	$ 32,396
December 31, 2017:				
Houston hotels, net	$ 34,473	$ —	—	$ 34,473
Interest rate cap derivatives	4	—	4	—
Interest rate swap derivatives	3,390	—	3,390	—
Life insurance policy (1)	645	—	645	—
Total assets measured at fair value at December 31, 2017	$ 38,512	$ —	$ 4,039	$ 34,473

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

The following table presents the Company's liabilities measured at fair value on a recurring and nonrecurring basis at June 30, 2018 and December 31, 2017 (in thousands):

		Fair Value Measurements at Reporting Date		
	Total	Level 1	Level 2	Level 3

June 30, 2018 (unaudited):				
Retirement benefit agreement (1)	$ 408	$ —	$ 408	$ —
Total liabilities measured at fair value at June 30, 2018	$ 408	$ —	$ 408	$ —
December 31, 2017:				
Retirement benefit agreement (1)	$ 645	$ —	$ 645	$ —
Total liabilities measured at fair value at December 31, 2017	$ 645	$ —	$ 645	$ —

(1) Includes the retirement benefit agreement for a former Company associate. The agreement calls for the balance of the retirement benefit to be paid out to the former associate in ten annual installments, beginning in 2011. The Company has paid the former associate a total of $1.6 million through June 30, 2018, which was reimbursed to the Company using funds from the related split life insurance policy noted above. These amounts are included in accrued payroll and employee benefits on the accompanying consolidated balance sheets.

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Interest Rate Derivatives

The Company's interest rate derivatives, which are not designated as effective cash flow hedges, consisted of the following at June 30, 2018 (unaudited) and December 31, 2017 (in thousands):

Hedged Debt	Type	Strike / Capped Rate	Index	Effective Date	Maturity Date	Notional Amount	Estimated Fair Value Asset June 30, 2018	Estimated Fair Value Asset December 31, 2017
Hilton San Diego Bayfront (1)	Cap	4.250 %	1-Month LIBOR	May 1, 2017	May 1, 2019	$ 108,834	$ —	