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Sunstone Hotel Investors, Inc. (SHO)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen. Thank you for standing by and welcome to the Sunstone Hotel Investors Third Quarter 2021 Earnings Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. I would like to remind everyone that this conference is being recorded today, November 5, 2021, at 12:00 PM Eastern Time.

I will now turn the presentation over to Mr. Aaron Reyes, Senior Vice President and Treasurer. Please go ahead, sir.

Aaron Reyes

Senior Vice President & Treasurer, Sunstone Hotel Investors, Inc.

Thank you, operator, and good morning, everyone. By now, you should have all received a copy of our third quarter earnings release and supplemental, which were made available yesterday. If you do not yet have a copy, you can access them on our website.

Before we begin, I would like to remind everyone that this call contains forward-looking statements that are subject to risks and uncertainties, including those described in our prospectuses, 10-Qs, 10-Ks, and other filings with the SEC, which could cause actual results to differ materially from those projected. We caution you to consider these factors in evaluating our forward-looking statements.

We also note that this call may contain non-GAAP financial information, including adjusted EBITDAre, adjusted FFO, and property level adjusted EBITDAre. We are providing that information as a supplement to information prepared in accordance with generally accepted accounting principles.

With us on the call today are Doug Pasquale, Chairman and Interim Chief Executive Officer; Bryan Giglia, Chief Financial Officer; Robert Springer, Chief Investment Officer; and Chris Ostapovicz, Chief Operating Officer.

On today's call, Doug will discuss our recent value-enhancing hotel transactions and provide his thoughts on the company's near-term priorities and objectives. Bryan will then discuss the current operating environment and recent trends in our business. And, finally, I'll provide a summary of our current liquidity position and a recap of our prior quarter financial results. After our remarks, we will be available to answer your questions.

With that, I would like to turn the call over to Doug. Please go ahead.

Douglas M. Pasquale

Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

Thank you, Aaron. Hello, everyone, and thank you for joining our call today. As many of you know, I have been affiliated with Sunstone for quite some time now having joined the board in 2011 and taking on the role of Chairman in 2015. During my tenure, I have facilitated the management team’s efforts as they repaired the company's balance sheet and upgraded its portfolio following the global financial crisis and most recently as we navigated the unprecedented challenges brought on by the pandemic.

Now, as Interim CEO, I've had the opportunity to become increasingly involved in the day-to-day operations of the company. With that enhanced perspective, I'm more confident than ever that Sunstone has the portfolio, the balance sheet and the management team, to deliver incremental value to its shareholders and do so on a more accelerated basis.

As a first step in this process, we announced a series of hotel transactions yesterday that reflect our renewed commitment to value creation through the sale of assets which are no longer consistent with our strategy, the selected disposition of core assets when pricing is compelling and through the acquisition of Long-Term Relevant Real Estate.

Going forward, you should expect that Sunstone will do more of the same as we further position the company for growth by actively recycling capital and more effectively utilizing leverage and our tax attributes, while still maintaining a solid balance sheet with capacity and flexibility. Overall, I am very pleased with the progress we have made in the first two months of my tenure. And I look forward to continuing to work with the management team to unlock further value for our shareholders.

Before I turn the call over to Bryan, I want to provide an update on the CEO search process being conducted by the board of directors. When I assume the Interim CEO role, I made it clear that my tenure in this position would be for a year or less, and that the board was committed to identifying a permanent CEO who would further advance our existing strategy. The search committee was established in tandem with my appointment and the search process is underway. While we intend to conduct an efficient search, we will be thoughtful and farsighted. We will not rush the process, and we will do everything possible to ensure the right new leader is selected. We expect to have an update as part of our next quarterly call.

And with that, I will turn the call over to Bryan to cover some of the details of our third quarter operations, which came in stronger than anticipated, and to share some encouraging recent trends we are seeing across our portfolio that give us reasons to be more optimistic as we head into the final months of the year and into 2022.

Bryan Albert Giglia

Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

Thank you, Doug. And good morning, everyone. I'll start with a review of the third quarter operating results, which as Doug just mentioned, materially exceeded our expectations with EBITDA more than doubling the prior quarter and marking the return to positive quarterly FFO for the first time since 2019. I will provide an update on the current operating environment and forward booking trends, which point to continued growth in the fourth quarter and into 2022 despite the effects of the Delta variant. Last, I will provide some additional details on the exciting and value enhancing hotel transactions that were announced yesterday.

So, let's begin with the third quarter operations, which came in stronger on both the top and bottom lines. Total revenue was $167 million, an increase of 43% from the second quarter, driven by a nearly 10-point sequential increase in occupancy and an average rate for the comparable portfolio that not only grew 13% from the second quarter of 2021, but was also just above the third quarter of 2019. These strong results were primarily the result of strong leisure demand over the summer vacation season that peaked in July and then moderated in August and September, partly as a result of typical seasonal patterns, but also due to a short term pause in travel demand due to the spread of the Delta variant.

While occupancy increased to nearly 55% and benefited from growth in all segments, transient demand remained the standout, with room nights increasing 27% compared to the second quarter. Our total portfolio third quarter average daily rate was $30 higher than the second quarter. And even when excluding Montage Healdsburg, which ran a very robust average daily rate of nearly $1,250, our comparable portfolio ADR of just over $248 in the third quarter came in higher than 2019 levels. A strong desire for leisure travel and a healthy US consumer contributed to strong demand in certain markets and allowed our operators to push rates far beyond pre-pandemic levels.

We achieved meaningful rate growth in Key West, Orlando, New Orleans, and Wailea. In fact, Oceans Edge saw rates increase an astonishing 103% as compared to 2019, and Wailea Beach Resort bested their pre-pandemic rate by 40%.

In addition to a stronger rate performance, out-of-room spend also increased with food and beverage revenues higher by 79% in the third quarter as compared to the second quarter, representing a 47% increase in food and beverage spend per occupied room. Other hotel revenues also increased as higher occupancy drove increased destination fees, spa, and parking revenues. Banquet and catering contribution per occupied group room increased over the second quarter by $96 and achieved approximately 70% of 2019 levels. Combined with stronger ADR, the growth in non-rooms revenue generated a quarterly comparable TRevPAR of $207, a 41% increase from $146 achieved in the second quarter.

Turning to costs, we have been focused on working with our operators to deliver a safe and enjoyable guest experience while looking for ways to achieve efficiencies and permanent expense reductions. Year-to-date, we have eliminated nearly $11 million of costs from our hotels, which we believe will be lasting savings and can be sustained even as business levels and occupancies increase. We recognized that there is a need to balance appropriate service levels and amenities with pricing and profitability, and there will not be a one-size-fits-all approach to margin enhancement at every hotel. And so, we are continuing to work with our operators to identify creative ways to drive profitability across the portfolio.

During the quarter, our comparable hotels generated hotel EBITDA margins of 24.3%. While this is below the low-30% range we maintained historically, delivering mid-20% margins at a portfolio-wide occupancy of just below 55%, is a significant accomplishment and gives us confidence that we will be able to achieve higher stabilized margins once demand returns to a more normalized level.

The combination of higher rates, stronger non-room revenue, permanent expense reductions and other cost controls, contributed to third quarter EBITDA that exceeded expectations and represented a more than two-fold increase over the prior quarter. While strong demand for leisure travel seems to be well-established at this point. In fact, Saturday of Labor Day weekend was our portfolio's highest demand night of the year, with occupancy of 84% at an average rate of nearly $275. We are also seeing positive trends in both group and business transient demand that we expect will accelerate as we move forward.

Let's take a look at each of these segments in a bit more detail, starting with group. While total group room nights for the quarter increased only marginally from the second quarter to 82,000 nights, what is more important to note is that the group activity we saw in the third quarter was increasingly comprised of more traditional corporate and association events, as opposed to the rooms-only and event-driven group business that composed much of the demand in the first two quarters of the year.

While we were certainly pleased to have that business at our hotels earlier in the year, the return of traditional, and higher EBITDA producing, corporate and association meetings and events is a very welcome sign that we are on a path to normalized levels of operations.

Corporate group activity in the quarter grew nearly 30%, and the association business was more than 5 times higher than the previous quarter and generated 24,000 room nights. The Renaissance Orlando, Hilton San Diego, and JW Marriott New Orleans had a substantial increase in association and corporate group business, and the

Wailea Beach Resort experienced a meaningful return of incentive business with 8,000 incentive room nights at a very attractive rate of nearly $600, compared to 6,700 room nights and a rate of $400 in the same quarter of 2019.

The Delta variant impacted group business later in the quarter as our hotels experienced increased cancellations, a decrease in group lead volume, and a decline in overall group production. The majority of the cancellations occurred in August and coincided with the peak in case counts witnessed in late summer from the spread of the Delta variant and were skewed towards corporate group as opposed to association business.

Approximately 9% of our third quarter group room nights cancelled, which were primarily for events in August and September, and approximately 16% of our fourth quarter group rooms canceled, which were primarily for events in October. We believe these headwinds from the Delta variant are largely behind us as group demand and lead volume began to reaccelerate post-Labor Day and have continued into the fourth quarter. In fact, we expect the fourth quarter production to be the strongest of the year. For our five large group hotels, which make up two-thirds of our fourth quarter group room nights, 77% of our forecasted group room nights have already been picked up.

Moving on to transient, which accounted for roughly 75% of our total room nights in the third quarter. Total transient rate for the third quarter came in at $285 compared to $261 in the second quarter, an increase of more than 9%. Even more encouraging was the increased contribution of business travel to the overall transient demand. The number of special corporate rooms increased 103% from the second quarter, with rates higher by 20%.

Several of our hotels, including the Hyatt San Francisco, Boston Park Plaza and Hyatt Chicago witnessed a meaningful acceleration in special corporate room nights during the quarter. While our third quarter business transient volume was only 50% of pre-pandemic levels, future transient booking pace continues to grow every week, and we expect this to accelerate into 2022 as companies increasingly return to the office and business transient travel becomes more widespread.

As I mentioned earlier, our operators have been able to aggressively push rates in response to very healthy leisure demand. We saw strength in leisure rates at hotels across the portfolio, including Key West, Orlando, New Orleans, Napa/Sonoma, and Wailea. The ability to achieve premium pricing has been most evident in our resort properties, with Montage Healdsburg achieving a rate of approximately $1,250 for the quarter and Oceans Edge and Wailea Beach Resort seeing rate increases of 103% and 40%, respectively, compared to the third quarter of 2019. This level of rate growth should also translate into profitability that exceeds our underwriting at Montage and that outpaces pre-pandemic levels at Oceans Edge and in Wailea. Given the substantial pricing increase our operators have implemented, we are closely monitoring guest feedback to ensure our satisfaction scores remain competitive and that we are balancing near-term profitability with each hotel's long-term positioning. Wailea continues to command a strong TripAdvisor rating despite a $185 higher rate than third quarter of 2019, an impressive achievement especially given its luxury peers.

As we move into the fourth quarter, we are encouraged by what we are seeing for October. Our preliminary results for the month show a re-acceleration of demand with RevPAR of approximately $150 made up of occupancy of 57% and a $264 average daily rate. October RevPAR is second only to our peak month of July and is above August and September by nearly 10% and 14%, respectively. Given the current trends, we expect a strong finish to the end of the year with November and December benefiting from increased levels of business transient and group demand and continued ability to drive strong leisure rates during the holiday season.

Shifting to our capital projects, we invested $25 million into our portfolio in the third quarter with a focus on enhancing the quality and future earnings potential of the portfolio. In July, we completed work on Boston Park Plaza's newest meeting space, The Square, a 7,000 square foot indoor space that will give the hotel incremental capacity to host in-house group business and reduce its reliance on citywide events. At the Hilton San Diego Bayfront, we completed a total redesign of the food and beverage options, including an addition of a market concept that will provide a better guest experience at a higher profit margin. Additionally, in San Diego, we converted unused space into 6,800 square feet of new, high-quality meeting space that looks out onto the San Diego Bay.

During the quarter, we also continued to make progress on the transformation of the soon to be rebranded Westin Washington D.C. The ballroom and meeting space renovations will be completed by the end of the year, and work on the guest rooms and lobby will occur in 2022. Once the meeting space is completed, the hotel will be able to host group business next year while the rooms renovation is completed. We are pleased with the reception the in-process conversion is receiving from meeting and event planners and look forward to the incremental growth the hotel will generate as it captures higher rates and incremental share under the Westin brand.

Moving on to transaction activity. As Doug noted, yesterday, we announced three transactions that enhance our portfolio quality, strengthen our balance sheet, and provide additional capacity for future growth and acquisitions. First, we completed the sale of the 348-room Renaissance Westchester for gross proceeds of approximately $19 million. This hotel was a noncore asset in a challenged market that lacked sufficient demand to merit reopening after operations were suspended at the onset of the pandemic. The net proceeds from the sale after the payment of termination fees and severance costs, was approximately $11 million, and the disposition removes an asset that was expected to be a drag on cash flow and growth going forward.

Next, we are under contract to sell the 340-room Embassy Suites La Jolla for $226.7 million or approximately $667,000 per key. This is a tremendous outcome and is a perfect example of the embedded value that can be generated from the ownership of long-term relevant real estate.

In addition to being a high-quality Embassy Suites and a productive cash generator, the hotel sits on phenomenal real estate. We were able to capitalize on its highly desirable location and sell the hotel to a buyer that will be able to better optimize the entire parcel. We expect the sale to close during the fourth quarter. Net proceeds after the mortgage loan are expected to be approximately $165 million.

Finally, we are excited to announce the acquisition of the Four Seasons Resort Napa Valley. This one-of-a-kind asset located on the famous Silverado Trail is a terrific example of Long-Term Relevant Real Estate. We are acquiring the resort for a gross purchase price of $177.5 million, a meaningful discount to its development cost.

In addition to the 85-room resort and its abundant event space and full suite of luxury amenities, the acquisition price also includes nearly 4.5 acres of vineyards and the Elusa Winery along with the inventory of prior wine vintages. The investment in the Four Seasons Napa Valley is the perfect complement to our previous wine country acquisition, Montage Healdsburg, which we acquired in April and is already surpassing our expectations.

Between the Four Seasons and the Montage, we will have approximately 10% of our asset value in one of the most supply-constrained, sought-after, and highest-rated leisure destinations in the country. We will own the two premier assets and establish a market-leading position in wine country with ownership of approximately 24% of the luxury room inventory and 32% of the luxury event space.

The purchase of the Four Seasons Resort in Napa Valley is consistent with our stated strategy of acquiring Long-Term Relevant Real Estate in the early phases of a cyclical recovery and its addition further elevates our overall quality and earnings potential of our portfolio. We expect Four Seasons to contribute meaningfully to our per share future earnings as we deploy more of our balance sheet capacity and benefit from the strong demand for leisure travel.

To sum things up, third quarter results exceeded expectations as a result of continued strong leisure demand, steady improvement in business transient travel and an improving group mix. Although expectations for the fourth quarter have moderated due to group cancellations related to the Delta variant, we have seen demand reaccelerate in recent weeks and based on forward booking information, we are optimistic that these trends will continue in the fourth quarter and into 2022.

Additionally, our investments, both internally and externally, will provide additional growth as travel demand moves closer to pre-pandemic levels. Furthermore, we are in the enviable position to use our strong balance sheet and debt capacity to grow the company and to create value for our shareholders.

And with that, I'll turn the call over to Aaron. Aaron, please go ahead.

Aaron Reyes

Senior Vice President & Treasurer, Sunstone Hotel Investors, Inc.

Thank you, Bryan. As of the end of the third quarter, we had approximately $222 million of total cash and cash equivalents, including $42 million of restricted cash. In addition to cash on hand, we also maintain full availability on our $500 million revolving credit facility, which equates to over $700 million of total existing liquidity. We are slated to close on the acquisition of Four Seasons Resort Napa Valley in the fourth quarter and expect to fund the transaction through a combination of cash on hand and from borrowings under our credit facility. As Bryan mentioned earlier, net cash proceeds from the sale of Embassy Suites La Jolla are expected to be approximately $165 million after the buyer's assumption of the existing $57 million mortgage loan. We expect the sale to also be completed in the fourth quarter.

Shifting to the third quarter financial results, the full details of which are provided in our earnings release and our supplemental, the quarterly results reflect an improving operating environment driven by continued strong leisure demand, an increasing amount of commercial transient volume, and an improving mix of group business. Third quarter adjusted EBITDAre was $35 million, and third quarter adjusted FFO was $0.10 per diluted share. These results surpassed our previous expectations and mark the return to positive quarterly FFO for the first time since the end of 2019.

During the third quarter, we recognized $1.6 million of restoration expense and an impairment charge of $1 million as a result of damage incurred at our two hotels in New Orleans following Hurricane Ida. The Hilton New Orleans St. Charles sustained the bulk of the damage, and we are working with our insurers to identify and settle a property damage claim but we expect that future losses from the restoration work at this hotel will be mitigated by the property's insurance deductible of approximately $3 million.

Now turning to dividends, we have suspended our common dividend until we return to taxable income. Separately, our board has approved the quarterly distributions for each of our series G, H, and I preferred securities.

And with that, we can now open the call to questions. So, that we were able to speak with as many participants as possible. We ask that you please limit yourself to one question. Operator, please go ahead.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And your first question comes from the line of Rich Hightower from Evercore. Your line is open.

Rich Allen Hightower
Analyst, Evercore Group LLC

Q

Hi. Good – sorry, good morning out there, guys. So, I want to go to one of the comments Doug made in the prepared commentary just in terms of accelerating the recycling of capital and so forth and using leverage and tax attributes maybe in a different way versus the prior CEO regime. You know it clearly anything that has been announced recently or is closed recently or is pending, you know, would have been formulated under John Arabia. And so, you know, implicitly, that means you've got more sort of in the works there. So, maybe just help us understand the mix of before and after, and then also addressing specifically some of those comments around leverage and tax attributes? Thanks.

Douglas M. Pasquale
Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

A

So, thank you for participating. So, you're correct, I mean, complicated, convoluted transactions like the ones we described take time to accomplish. The real credit for that goes to the executives in the room here for carrying it over the finish line. It's been a long, arduous process, and you're also correct that we have a lot of things in the works now. And as we said from the very beginning of my tenure, we intend to utilize momentum and to continue this so that this becomes more of a regular and predictable occurring process where you're seeing transactions from the company over the course of many quarters and years to come.

So, I really want to congratulate them for all their efforts to get these accomplished in a relatively short period of time. There was a lot of work to be done in – and most outcomes were not certain, there was a lot of questions and ambiguities and decisions that had to be made. So, the intent now really is to continue this. We don't intend to be and will not be a one hit wonder. The team is already in the recording studio working on what we hopefully will be other hits, and we're intent on creating an album of things to come. So, you know, time will tell but I'm highly confident that what you see is just an indicator of good things to come down the road.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

And then, Rich, when it comes to the comment on tax attributes. And I don't think that there's really a differing view or a way that we're going to look at the tax attributes going forward. You know, we did use NOLs throughout the last cycle, we think that that is a good way to retain capital and grow the company. It allowed us last cycle to delever the balance sheet and accrete to the shareholders equity that way. Going forward, it will be somewhat fungible but our net NOLs will allow us to shield gains, shield some taxable income, most likely a combination of both, and allow us to especially if there are asset sales, and when you look at an asset sale like La Jolla, which has a very large gain to it, that's one way that we can then preserve some of that value that we unlock, and then go reinvest it and try to do it again to create value for the shareholders.

Operator: Thank you. And your next question comes from the line of Smedes Rose from Citi. Your line is open.

Michael Jason Bilerman
Analyst, Citigroup Global Markets, Inc.

Q

Hey. It's Michael Bilerman here with Smedes. Good morning. Doug, I was wondering if you can just...

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Good morning.

Michael Jason Bilerman
Analyst, Citigroup Global Markets, Inc.

Q

Maybe elaborate a little bit on the decision to sort of terminate John and now run a search. And you've talked a little bit about how you've been on the board for the last 10 years. Obviously, you know the long-term history with this company. I think this will be CEO number six or seven over the last 15 years. And so, what are you looking for in the next CEO that the prior CEO wasn't delivering? And at the same time, can you talk a little bit about the board, which also has gone through pretty dramatic change. You know you have two new members just joined this past May. I don't know how much they had understanding of where the company was. And so just help understand some of the dynamics because it doesn't feel as though Sunstone was underperforming to the degree that we've seen some other CEOs being terminated in the business.

Douglas M. Pasquale
Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

A

Sure. Let me try and address this as briefly as I can because we've talked to many investors one-on-one, and I don't want to be too repetitive. But first of all, you know...

Michael Jason Bilerman
Analyst, Citigroup Global Markets, Inc.

Q

Well, it should be on the public domain, right. I think that the public at large and the investment community needs to understand, it's not every day that a CEO gets terminated.

Douglas M. Pasquale
Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

A

Sure. So, first of all, John and I have a long and good history. We've known each other and have been friends for a long period of time. And I have a great amount of respect for him and appreciation for all the things he contributed to the company. John was a seven or so years ago, going on seven years, John was, we thought, a really great candidate to assume the role of CEO because of what the company's needs were at that time.

Specifically, we were over-levered, we needed better corporate governance and some leadership in that regard and John had very strong beliefs about that and did really a fine job of helping us on those two fronts.

With the passage of time, as the company grew and evolved, it was the board's determination that notwithstanding the fact that over certain periods of time the company performed well on a relative basis that there was significant more opportunity to create value. And in order to best accomplish that, it was the board's view that new attributes and traits were important including someone who had more of a real estate background and transaction background. And so that was the primary fundamentals on the decision. And it's really, I think, a fairly natural evolution of how companies should work. Companies are supposed to grow. They're supposed to evolve. And for most companies, that means that at different times in its history, it needs different leadership attributes. And so, that was the determination that was made. You're right, we have added new directors, but those were for reasons that were sound and consistent with the times.

We were working hard on creating diversity on our board. We had some long tenured directors whose time was approaching where it was best for them to cycle off. They were terrific directors, but again, we thought board refreshment was in order. And so, that influenced decisions there. We strongly believe we're on the right track. We understand that the reasoning wasn't completely evident to people. As I have said, if it were evident to everybody what our thinking was and what the reasons were, it means that we acted reactively instead of proactively.

It's true that John played an important role in the transactions that we announced. But again, as I said, nothing was assured, nothing was done, and a lot of work had to be completed to do that. And I'm confident that if John was in the room speaking, he would be passing the credit to the same gentleman that I'm passing the credit to. So, I understand why there's questions, but the past is the past. In 60 days, a lot's been accomplished and my track record, for those of you who have known me, is one when we commit to get something done, we're going to get it done. And I believe, as I said, that a lot of things are in place now that will set the stage for many quarters to come. The search process is underway and we're finalizing the attributes that we believe are necessary for our next CEO. We're well aware that there's been far too many CEOs in this company. That's among our top considerations as to identifying leadership that can provide stability and growth and better maximize shareholder value. So, that's our commitment. That's our intent and we're going to know if it's right or not as we go forward into the future and perform.

Operator: Thank you. And your next question comes from the line of Patrick Scholes from Truist Securities. Your line is open.

Patrick Scholes
Analyst, Truist Securities, Inc.

Q

Sorry. I was on mute there. Good morning. Good afternoon, everyone.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Good afternoon, Patrick.

Patrick Scholes
Analyst, Truist Securities, Inc.

Q

In addition to looking for a new CEO, is the company being marketed for sale as sometimes happens when there is a void in leadership?

Douglas M. Pasquale
Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

A

Sure. The board is completely focused on maximizing shareholder value and believes that the company has a clear path to achieve its goals. As I mentioned, we're actively conducting a search process now to find a new CEO to continue executing on our capital recycling and growth plans. And as you can see from yesterday's announced transactions, we're executing on that strategy. I believe we're off to a great start. And as I've said a couple of times already, we expect to continue to build on this momentum.

So, we know our commitment is to maximize shareholder value and that's what we're doing. And we believe we have a very good strategic plan. We have a great balance sheet. We have great management team. And we have a very good portfolio that we have every intent on building and improving upon.

Operator: Okay. Thank you. And your next question comes from the line of Anthony Powell from Barclays. Your line is open.

Anthony F. Powell
Analyst, Barclays Capital, Inc.

Q

Hi, good morning out there. Just shifting gears a bit. A question on pricing, especially on leisure resorts. You know, we've seen some extraordinary pricing here in your portfolio and elsewhere. And how do you underwrite, you know, pricing and ADR for things like Four Seasons Napa over a long period of time? Are you assuming any kind of deceleration or backsliding as more travel options open in the next couple of years? And just an overall Sunstone opinion on the stickiness of resort pricing, it would be super helpful.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Yeah. Good morning, Anthony. When we look at the two most recent acquisitions, Montage and the announced Four Seasons, there has been and as we've seen in other leisure destinations in Maui and also in KeyWest, there's been tremendous rate growth over this last year.

Our expectations are, it really depends on property by property, but with the two Napa Valley properties, they're ramping up, they're both brand new assets. There will be opportunity for occupancy growth over the coming years. The rate growth, by no means has as big of increase in rate over this time period. There may even be a time where rate would be flat for a time period as occupancy grows. But we do think that these are newassets that will be ramping up and there is opportunity on both the rate and occupancy side. Our stabilized rate that we're looking at in both hotels is not dramatically higher and stabilizes over a couple of year period than where we are today. The rates are higher right now than where we were underwriting.

There is also opportunity when you look at a market like Key West, where Oceans Edge has, as we said, 100% rate increase. Well, that's part of the executing on the strategy of that hotel and positioning it to perform better against the downtown set in Key West, and so really leveraging off of the hotel's room size, location, amenities, and that. And so, part of that is the demand for leisure. And then part of that is just the long-term strategyand executing on that plan.

Operator: All right. Thank you. And your next question comes from the line of David Katz from Jefferies. Your line is open.

David Katz
Analyst, Jefferies LLC

Q

Hi. Good morning, everyone. Thanks for taking my question.

Douglas M. Pasquale
Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

A

Good morning.

David Katz
Analyst, Jefferies LLC

Q

I wanted to just talk about the balance sheet. Given the transition that's underway, I wonder if you can comment on the perspectives that the balance sheet could be argued as under-levered. And how you think about whether that is or isn't correct, and what kinds of ways or avenues would you like the next chapter to pursue in order to you know, put it where you think it should belong.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Sure. Morning, David. The overall view on leverage hasn't changed as far as this is a highly volatile asset class that you need to maintain a low levered balance sheet throughout all phases of the cycle and that's always been the way we've looked at things. And we have said in the past that our leverage towards the end of last cycle was much lower than where our target was. Part of that worked out okay given what we have gone through since then.

But you know, to Doug's point earlier about being more active on the recycling front and, you know, during that time period what we ended up doing was take an absolute bet that the cycle was going to turn. And while we were recycling capital, you know, could we have acquired a property or two during that time period. It probably long-term would have worked out.

That said, as we go forward, we do have tremendous capacity in the balance sheet. We are never looking to be 1 times levered again but the expectation from us will be that we will be in that bottom third of our peer set as far as leverage goes and there will be times, and as we said, we will look earlier in the cycle as we are doing now and as we are deploying capacity now, we'll grow that, you know, we'll grow the balance sheet, leverage will move up.

But as, as you know, if we look at it on a pro forma basis and a normalized basis for all of 2022, our balance sheet snaps back to kind of a 3-ish times levered balance sheet, which allows us to do deals like The Four Seasons. It allows us to recycle capital. And if we find a deal that makes sense, if we find a value-add play or something that we think we can make strong returns for our investors, that balance sheet capacity is there to use, in addition to capital recycling we will do throughout the cycle.

Operator: Sir, thank you. And your next question comes from the line of Thomas Allen from Morgan Stanley. Your line is open.

Thomas G. Allen
Analyst, Morgan Stanley & Co. LLC

Q

Hey. Good morning. Can you just help us estimate what your leisure versus corporate mix is now pro forma for all the deals? And then, just help us think about the strategy going forward where you want it to go? Thank you.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Good morning, Thomas. One second. So, where we are as of the quarter, we're on a pro forma basis kind of call it the pre-COVID with a stabilized level for the acquisitions. We're about 28% leisure, about 36% business transient. And then, the rest of it is group and association. So, when you look at that and you look at the type of hotels that have worked well for us through and even during the pandemic, we like to have a group component to our hotels. And we like the group with the business transient or group with leisure. Obviously, something like Wailea, where we have a strong leisure component, and that leisure can take up the group demand when group demand falls off, have worked out better than the urban transient hotels that are group and business transient.

Looking forward, we do think that the urban hotels and the group business transient hotels will have better growth than the leisure hotels next year. And so that will always be an important component of our segmentation. But when you look at it overall, there's probably a little bit more room in the portfolio for a little bit more leisure. The last two deals we've done or have announced are two hotels that have strong leisure components also have group, you know, components in Napa Valley. It just so happened that bothof those are were leisure. The next deal or two may or may not be leisure, but I think overall, over longer periods of time that we'd like to take that 28% mix and move it up a little bit more.

Operator: All right, thank you. And your next question comes from the line of Michael Bellisario from Baird. Your line is open.

Michael J. Bellisario
Analyst, Robert W. Baird & Co., Inc.

Q

Thanks. Good morning, everyone. Doug, a question for you. I know the company issued stock in June. It was just above $13 a share. I think the signaling done was that was around NAV. So, my questions are do you agree that that price was plus or minus representative of NAV at the time. And then how has your view of the portfolio's NAV changed since then, especially relative to some of the transactions you've announced and completed thus far?

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Hey, Mike, let me start off with this one. You know, all equity issuance, and repurchase for that matter have been and will continue to be something that we discussed very frequently and closely with the board. And so, while as you know, we do not comment specifically on NAV, we did issue shares during that time period.So, that should, you know, that can give some level of indication of where our head was.

As we look forward, there's, you know, as to the path and trajectory into next year. And as we look at pace, as we look at other metrics and confidence grows that the portfolio will continue to perform into next year, we look at market comps of where things are trading, you know, Embassy Suites La Jolla alone, obviously, you know, that sale added value to NAV, somewhere around close to $100 million more than what the view of value of that was, so that obviously will increase the NAV, and just the overall growth of the portfolio and the current pricing.

So, I think if you look at it to wherever NAV was then, there have been a couple specific events, and thengeneral increases in value that would notch that up some.

Douglas M. Pasquale
Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

A

I would just add that, that NAV, I think we would all agree is an important indicator and an important metric to think about and to reference. But in terms of capital raising or whatnot, it's not in my view, the only one, it's an input to the overall business, which is investing in real estate. So, there are a lot of considerations.
NAV is an important one, but it's certainly not an exclusive one in my view, and it's very dynamic, and it moves

around quite a bit, periodically and particularly, when you're at inflection points, or maybe at inflection points around different things going on in the marketplace, in the capital markets, so.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

And looking at our past transactions over a longer period of time, whether it be share issuance or repurchase, I think we have a pretty solid track record demonstrating that we are very mindful of our shareholders equity, and we do a or at least try to do a very good job of making sure that we are careful and issue or repurchase at appropriate levels.

Operator: Great. Thank you, and your next question comes from the line of Chris Woronka from Deutsche Bank. Your line is open.

Chris Woronka
Analyst, Deutsche Bank Securities, Inc.

Q

Hey, good morning, guys. Want to ask a little bit about The Four Seasons acquisition. I know you've put it kind of the stabilized yield target out there. Can we get a little bit more color, higher level on how you're kind of underwriting like room versus not room revenue? I'm trying to get a sense for, you know, this seems like a pretty big operation. That's a pretty small room count. Do you have any ability to make additional ROI investments there? Thanks.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

So, let's start with, you know, just kind of a recap of the asset first. First, this is a, as we've said, with Montage and now with Four Seasons developing assets in the Valley takes a long time. What we are acquiring is 22.5 acres right off the Silverado Trail, which includes 4.5 acres of vineyards. The hotel has incredible amenities, including a working winery on site, which allows guests to have the grape-to-glassexperience, which is unique to that hotel and no other hotels in the area. We are buying at an attractive valuation,especially given what it would cost to recreate that asset today. As you said, the yield we project is a 6% to7% stabilized cash yield on the hotel based on other transactions we're seeing in the markets and maybe some expected yields on limited-service hotels, we think that this on a risk-adjusted basis is a very compelling investment and a very compelling return, especially relative to what we're seeing in the market.

And then, as we own the two hotels, we will have about greater than 20% of the luxury room supply about 30% of the meeting event space supply. It's also the newest event space. So, it's purpose built tohandle corporate functions and really kind of integrated seamlessly throughout the property. So, from that standpoint, we are very excited about these transactions. Why don't I let Robert kind of give you a breakdown ofthe other revenue? But as you said, yes, 85 rooms, it will have a very desirable food and beverage operation. It will have the winery operation, also spa and then, you know, fantastic meeting facilities.

Robert C. Springer
Chief Investment Officer & Executive VP, Sunstone Hotel Investors, Inc.

A

Yeah. And I think that covers most of it. I mean, the one thing that wasn't touched upon is there are also for sale residential homes here that will have the option to join a rental program. That's not that terribly uncommon for these type of ultra-luxury developments these days. And we are bullish about the opportunity for those type of product to join the hotel in a rental situation. We think there's customers that seek out that type of product specifically and enjoy and will pay for that type of product.

But hopefully you have an opportunity to see it, it's an impressive campus going through and just stating the amenities doesn't really give them credit. And we do think the amenities will attract more than just the base of hotel customers. Bryan mentioned the winery, the restaurant, the spa and, quite frankly, the introduction of a leading luxury – ultra-luxury brand into one of the highest demand luxury leisure markets in the US that they frankly haven't had exposure to. We think will be an avenue to a strong amount of customer interest, a large amount of meeting space, multiple venues and event barn and so on and so forth.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Thanks, Chris.

Operator: All right. Thank you. And your next question comes from the line of Stephen Grambling from Goldman Sachs. Your line is open.

Stephen Grambling
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thanks. Let me take one more bite at the apple here. When you are talking about or thinking about acceleration of growth, where do you think Sunstone can have a differentiated view or a differentiated approach in the current transaction market to create value? Thanks.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Hey, Stephen. It really comes down to as you said it, what is that differentiating view? There's a lot ofcapital out there. There are all of our peers and private equity looking at different deals. And what, at the end of the day, causes someone to be the day the most aggressive, honest individual asset comes down to where you've had success and where your core competency is. And what your view of that asset is.

And so, when we look through our successes and in assets where we've had, we've created the most value, those are ones where we can look and try to find, maybe we will see more in an acquisition than someone else. We are definitely not shy of doing the larger value adds, those have been some of the most rewarding transactions that we've done. They do take time, they take capital, and that's why we have the balance sheet that we have. But we will look to do big turnarounds and then we will also look in markets where we think that we can use our asset management to get more out of the asset. Now, remember when we acquired the Hyatt San Francisco, there was a rooms renovation that happened, but quite frankly it was just a pretty average cyclical rooms renovation. But we did see a ton of asset management opportunities where we could remix the hotel and drive rate and get a food and beverage margin up from basically none to into the teens. And so, that's something that, we look to our past to help determine where we are going to pick our spots and invest our shareholders capital to get them the returns that they require.

Douglas M. Pasquale
Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

A

Let me just add to that. That was a good commentary by Bryan. Let me just add to it. My experience being in and around REITs for quite a while and running Nationwide Health Properties and being on several REIT boards is that you have to be in the market. Investors are entrusting their capital to you to invest in real estate, in our case in hotel real estate. And to do that well, I think you have to be in the market all the time, meaning you're constantly looking for acquisition opportunities and you're constantly looking for disposition opportunities. To do that well, you have to be agnostic about your assets. You effectively underwrite them every year and you ask yourself the question, would I buy this hotel based on what I think its future prospects are or not? And you make decisions on that.

I think the team is evolving to the point that they're increasingly agnostic. They subscribe to that notion that that's a good way to view it. And you have to accept the market is the market, right. You do what you can through relationshipsand off-market transactions to try and acquire intelligently. But the market is the market. And you can choose either to retreat and go to the sidelines and hope for conditions to become more favorable, or you stay in the market, and you invest intelligently. Sometimes you do that relatively aggressively and sometimes you do it more aggressively. Sometimes you do it not at all but it's not because you're not in the market, you just believe that thechoice at this particular point in time is to not make investments are you just haven't matched things up.

If you're too much on the sidelines, my view is good luck finding the perfect alignment for the capital markets and the real estate markets and everything else is in a perfect alignment. So, I believe that we know how to make really intelligent decisions to value add to assets to find assets in our portfolio, and they exist, with like La Jolla transaction. And I hope people really reflect on that. That's a terrific transaction. We unleashed a lot of capital that people did not ascribe to that hotel because they didn't understand the land value. So, there's a lot of opportunities there. You have to be in the market. You have to have good people. You have to be working to grow the business on an intelligent basis. And every year our portfolio should improve, and it will.

Operator: Thank you. And your next question comes from the line of Jeff Pierce with Snow Park. Your line is open.

Jeffrey Stanford Pierce
Managing Partner, Snow Park Capital Partners LP

Q

Hey, guys. Thanks for taking my call. You know...

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Hi, Jeff.

Jeffrey Stanford Pierce
Managing Partner, Snow Park Capital Partners LP

Q

Hey. Good to talk to you guys again. Yeah.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

A

Good to hear you.

Jeffrey Stanford Pierce
Managing Partner, Snow Park Capital Partners LP

Q

You know, I went through the proxy. And by my calculations, there is a $2.25 million signing bonus for Doug, $5 million of retention bonuses and obviously the $11 million in severance. But it's just a dead weight, so that's $20 million to $25 million and you know, the explanation that was given on a disorderly transition, I think is unsatisfactory.

You know, saying it's the right time to move on and creating a disorderly transition that costs shareholders $20 million, I think is very disrespectful to shareholders. I just wanted to give you guys another chance to kind of give shareholders something that makes a little bit more sense. Because a lot of our money went out the door.

Douglas M. Pasquale
Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

A

A lot of the money did.

Jeffrey Stanford Pierce
Managing Partner, Snow Park Capital Partners LP

Q

...on this transition, and he was arguably the most well-liked CEO in the space. And you know, all the good things you're talking about, he set up.

Douglas M. Pasquale
Chairman & Interim Chief Executive Officer, Sunstone Hotel Investors, Inc.

A

So, I don't disagree that John was very well liked. I am among his biggest fans, okay. And so, let's start with that and now I'm going to set it aside. I wish John nothing but the best. I hope at some point in time we're able to rekindle our friendship. He's a very intelligent man. He's a good man. We made the decision that his skillset did not match what the needs of the company are. That cost money. That's how business works. That's how it was set up. You're going to be able to tell if we made a good decision or not based on what we do from here.

And I'm telling you, and I think the actions suggest, what was accomplished in the last 60 days, that we pushed a lot of things over the finish line. We found value in La Jolla that we weren't even sure existed. And there's more of these things to come. So, I respect your opinion. I understand it. But it doesn't change my point of view and I don't think it changed the board's point of view one iota.

We know we've got a lot to prove. We know that there were costs incurred. We expect to get a good return on that investment.

Operator: All right. And we have reached the end of our Q&A session. I'll hand the call back to Mr. Bryan Giglia for closing remarks.

Bryan Albert Giglia
Chief Financial Officer & Executive Vice President, Sunstone Hotel Investors, Inc.

Thank you, everybody, for your time today and interest in and support of the company. We look forward to meetingwith many of you in the upcoming conferences over the next several weeks. Thank you.

Operator: And, ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.