AUBURN NATIONAL BANCORPORATION, INC
Form DEF 14A
April 11, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of the

Securities Exchange Act of 1934

(Amendment No.)

Filed by the Registrant x Filed by a Party other than the Registrant ¨

Check the appropriate box:

¨ Preliminary Proxy Statement

¨ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**

x Definitive Proxy Statement

¨ Definitive Additional Materials

¨ Soliciting Material Pursuant to Rule 14a-12

AUBURN NATIONAL BANCORPORATION, INC.
(Name of Registrant as Specified in Its Charter)

(Name of Person(s) Filing Proxy Statement, if Other Than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.

¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

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(4) Proposed maximum aggregate value of transaction:

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¨ Fee paid previously with preliminary materials.

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(1) Amount previously paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

April 11, 2014

TO OUR SHAREHOLDERS:

You are cordially invited to attend the Annual Meeting of Shareholders of Auburn National Bancorporation, Inc., to be held at the AuburnBank Center, 132 North Gay Street, Auburn, Alabama, on May 13, 2014, at 3:00 p.m., Local Time (collectively, with any adjournments or postponements thereof, the Meeting).

The Notice of Meeting, Proxy Statement, Proxy, and our 2013 Annual Report to Shareholders are enclosed. We hope you can attend and vote your shares in person. In any case, please complete the enclosed Proxy and return it to us. This action will ensure that your preferences will be expressed on the matters that are being considered. If you attend the Meeting, you may vote your shares in person even if you have previously returned your Proxy.

Prior to the meeting, a reception will be held from 2:30 p.m. to 3:00 p.m. in the AuburnBank Center. We hope you can join us!

We thank you for your support this past year, and we encourage you to review our Annual Report. If you have any questions about the Proxy Statement or the Annual Report, please call or write us.

Sincerely,

/s/ E. L. Spencer, Jr.
E. L. Spencer, Jr.
Chairman of the Board and Chief Executive Officer

AUBURN NATIONAL BANCORPORATION, INC.

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

TO BE HELD MAY 13, 2014

Notice is hereby given that the 2014 Annual Meeting of Shareholders of Auburn National Bancorporation, Inc. (the Company) will be held at the AuburnBank Center, 132 North Gay Street, Auburn, Alabama, on Tuesday, May 13, 2014, at 3:00 p.m., Local Time (collectively, with any adjournments or postponements thereof, the Meeting), for the following purposes:

1. *Election of Directors*. To elect 10 directors to the Board of Directors for one-year terms;

2. *Advisory Vote on Executive Compensation*. To approve, on a non-binding, advisory basis, the compensation of the Company s named executive officers as disclosed in the proxy statement that accompanies this notice; and

3. *Other Business*. To transact such other business as may properly come before the Meeting.

Only shareholders of record at the close of business on March 14, 2014, are entitled to notice of and to vote at the Meeting. All shareholders, whether or not they expect to attend the Meeting in person, are requested to complete, date, sign and return the enclosed Proxy in the accompanying envelope.

Also enclosed is a copy of the Company s 2013 Annual Report.

By Order of the Board of Directors,

/s/ C. Wayne Alderman
C. Wayne Alderman
Secretary

April 11, 2014

PLEASE COMPLETE, DATE, AND SIGN THE ENCLOSED PROXY AND RETURN IT PROMPTLY TO THE TRANSFER AGENT IN THE ENVELOPE PROVIDED. IF YOU ATTEND THE MEETING, YOU MAY VOTE IN PERSON BY WRITTEN BALLOT IF YOU WISH, EVEN IF YOU HAVE PREVIOUSLY RETURNED YOUR PROXY.

IMPORTANT NOTICE REGARDING THE AVAILABILITY OF PROXY MATERIALS FOR THE

SHAREHOLDER MEETING TO BE HELD ON TUESDAY, MAY 13, 2014

THE PROXY STATEMENT AND ANNUAL REPORT TO SHAREHOLDERS

ARE AVAILABLE AT WWW.AUBNPROXY.COM

AND OUR COMPANY S WEBSITE WWW.AUBURNBANK.COM

PROXY STATEMENT

ANNUAL MEETING OF SHAREHOLDERS

OF

AUBURN NATIONAL BANCORPORATION, INC.

TO BE HELD MAY 13, 2014

General

This Proxy Statement is being furnished to the shareholders of Auburn National Bancorporation, Inc. (the Company), a Delaware corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended (the BHC Act), in connection with the solicitation of proxies by the Company s Board of Directors from holders of the outstanding shares of the Company s $.01 par value Common Stock (Common Stock) for the 2014 Annual Meeting of Shareholders of the Company (collectively, with any adjournments or postponements, the Meeting). Unless the context otherwise requires, the term Company includes the Company s subsidiary, AuburnBank (the Bank). The Company s Common Stock is listed on the Nasdaq Global Market under the symbol AUBN.

The Meeting is being held to consider and vote upon: (i) the election of 10 directors to the Board of Directors; (ii) on a non-binding, advisory basis, the compensation of the Company s named executive officers (defined below) as disclosed in this Proxy Statement (a say-on-pay proposal); and (iii) such other matters as may properly come before the Meeting.

The Company s Board of Directors knows of no business that will be presented for consideration at the Meeting other than the matters described in this Proxy Statement.

This Proxy Statement and the Proxy are first being mailed on or about April 11, 2014, to Company shareholders of record as of the close of business on March 14, 2014 (the Record Date). The Company s 2013 Annual Report (the Annual Report), including financial statements for the fiscal year ended December 31, 2013, accompanies this Proxy Statement.

Each shareholder is entitled to one vote on each proposal for each share of Common Stock held as of the Record Date. In determining whether a quorum exists at the Meeting for purposes of all matters to be voted on, all votes for or against, as well as all abstentions (including votes to withhold authority to vote in certain cases), will be counted as shares present, and a quorum will exist if a majority of the shares outstanding and entitled to vote at the meeting are present. Under Delaware law, the vote required for the election of directors is a plurality of the votes cast by the shares present, in person or by proxy, at the Meeting, provided a quorum is present. Consequently, with respect to the election of directors, abstentions and broker non-votes will not be counted in determining whether the proposal has received the requisite number of votes for approval. Although on the ballot, the say-on-pay proposal is only a non-binding, advisory vote. This means that the Board of Directors will not be required to take any action on this matter regardless of the number of shares voted in favor of or against the proposal. However, the Board of Directors wants to understand the view of the Company s shareholders on the Company s executive compensation program, so your consideration and vote on this matter will be taken seriously by the Board of Directors. The votes that shareholders cast for the say-on-pay proposal must exceed the number of votes cast against the proposal to pass. Abstentions and broker non-votes will not be counted in determining whether the proposal has received the requisite number of votes for approval. Unless otherwise required by the Company s Certificate of Incorporation or Amended and Restated Bylaws (Bylaws), or by the Delaware General Corporation Law or other applicable law, any other proposal that is properly brought before the Meeting will require approval by the affirmative vote of a majority of all votes cast at the Meeting with respect to such proposal. With respect to any such proposal, abstentions and broker non-votes will not be counted in determining whether such proposal has received the requisite number of votes for approval.

The Company s principal executive offices are located at 100 N. Gay Street, Auburn, Alabama 36830, and its telephone number is (334) 821-9200. The Company maintains an internet website at *www.auburnbank.com*.

Record Date, Solicitation and Revocability of Proxies

The Record Date for the Meeting has been set as the close of business on March 14, 2014. Accordingly, only holders of record of shares of Common Stock on the Record Date will be entitled to vote at the Meeting. At the close of business on such date, there were approximately 3,643,173 shares of Common Stock issued and outstanding, which were held by approximately 442 shareholders of record.

Shares of Common Stock represented by a properly executed Proxy, if such Proxy is received in time and is not revoked, will be voted at the Meeting in accordance with the instructions indicated in such Proxy. **If you properly execute and return your Proxy but do not indicate any voting instructions with respect to one or more matters to be voted upon at the Meeting, or if your voting instructions are unclear, your shares will be voted in accordance with the recommendation of the Board of Directors as to all such matters. Specifically, your shares will be voted FOR the election of all director nominees, and FOR the advisory approval of the say-on-pay proposal, as well as in the discretion of the persons named as proxies on all other matters that may properly come before the Meeting.**

A shareholder who has given a Proxy may revoke it at any time prior to its exercise at the Meeting by either (i) giving written notice of revocation to the Company s Secretary, (ii) properly submitting to the Company a duly executed Proxy bearing a later date, or (iii) appearing in person at the Meeting and voting in person by written ballot. All written notices of revocation or other communications with respect to revocation of Proxies should be addressed as follows: Auburn National Bancorporation, Inc., P.O. Box 3110, Auburn, Alabama 36831-3110, Attention: C. Wayne Alderman, Secretary.

Proxy Solicitation Costs

The cost of soliciting Proxies for the Meeting will be paid by the Company. The Company s officers may also solicit proxies by telephone or otherwise, but will not receive additional compensation for these activities. In addition to the solicitation of shareholders of record by mail, telephone, facsimile, or personal contact, the Company may also make arrangements with brokers, dealers, banks, or voting trustees or their nominees who can be identified as record holders of Common Stock to forward this proxy statement and the 2013 Annual Report to beneficial owners of Common Stock. The Company will reimburse them for the reasonable expenses in connection with these services.

PROPOSAL #1 ELECTION OF DIRECTORS

General

Ten persons have been nominated to serve on the Company s Board of Directors for one-year terms of office expiring at the Company s next scheduled annual meeting of shareholders and until their successors have been elected and qualified. All of the nominees for director are presently directors of the Company.

Proxies cannot be voted for a greater number of persons than the number of nominees specified herein. Cumulative voting for directors is not permitted. All shares represented by valid Proxies received and not revoked before they are exercised will be voted in the manner specified therein. If no specification is made, the Proxies will be voted for the election of the 10 nominees listed below. In the unanticipated event that any nominee is unable to serve, the persons designated as proxy holders will cast votes for the remaining nominees and for such other replacements as may be nominated by the Company s Board of Directors.

The nominees have been nominated by the Company s Board of Directors based on the recommendation of the Nominating and Corporate Governance Committee, and the Board unanimously recommends a vote FOR the election of all ten nominees listed below.

Information about Nominees for Director

The following table sets forth the name and age of each nominee for director, a brief description of his or her principal occupation and business experience, certain other directorships and how long he or she has been a director for the Company or the Bank. In addition, we have also provided a brief discussion of the specific experience, qualifications, attributes or skills that led to the Nominating Committee s conclusion that the nominee should serve as one of our directors. Except for Mr. E. L. Spencer, Jr., Chief Executive Officer and President of the Company and Mr. Dumas, Chief Executive Officer and President of the Bank, none of the nominees is employed by the Company or the Bank or any entity that is an affiliate of the Company or the Bank.

Name, Principal Occupation, Business Experience, Age , Directorships and Qualifications	Director Since
C. Wayne Alderman	2004
Dean of Enrollment Services and former Dean, College of Business, Auburn University; former Director of Financial Operations of the Bank; served as Director of Financial Operations from 2000 to 2007; employed by Auburn University since 1979. Dr. Alderman is 63.	
Dr. Alderman, a certified public accountant and former Torchmark Professor of Accounting at Auburn University, brings a wealth of strategic planning expertise and public accounting knowledge to the Board. He also brings valuable insight and banking knowledge as a result of his service as the bank s Director of Financial Operations from 2000 to 2007, in addition to serving as a director of the Bank since 1993.	
Terry W. Andrus	1998
President and Chief Executive Officer of the East Alabama Medical Center since 1984; Former Director of Blue Cross/Blue Shield of Alabama. Mr. Andrus is 62.	
Mr. Andrus brings executive decision-making, financial expertise, and business-building skills from his service as the Chief Executive Officer of a regional hospital. Mr. Andrus currently serves as Chairman of the Alabama Hospital Association. He also possesses vast banking knowledge through his service as a director of the Bank since 1991.	

Name, Principal Occupation, Business Experience, Age , Directorships and Qualifications	Director Since
J. Tutt Barrett	2010
Mr. Barrett is a senior partner in the law firm of Dean & Barrett, located in Opelika, Alabama, where he has worked since 1992. Mr. Barrett is 62.	
Mr. Barrett brings a wealth of legal and risk management skills to the Board. He also provides governance skills and experience gained through his service on the boards of various charitable organizations. In addition, Mr. Barrett has served on one of the Bank s local advisory boards since 1991.	
Robert W. Dumas	2001
Chief Executive Officer and President of the Bank since 2001; President and Chief Lending Officer of the Bank from 1998 to 2001; employed by the Bank since 1984; Director of East Alabama Medical Center. Mr. Dumas is 60.	
Mr. Dumas brings valuable insight and knowledge to the Board as a result of his service as the Bank s Chief Executive Officer and President of the Bank. Mr. Dumas currently serves on the Auburn University Board of Trustees, Auburn Research and Technology Board of Directors, Federal Reserve Bank of Atlanta s Birmingham Branch Board of Directors, and Alabama Bankers Association Board of Directors and has held numerous other positions in professional leadership, including his service as President and Chairman of the Alabama Bankers Association and a member of the Auburn University Business Advisory Council. Mr. Dumas brings valuable knowledge from his 37 years of service in the banking industry, including serving as a director of the Bank since 1997.	
J.E. Evans	1997
Owner of Evans Realty, a property management company specializing in multi-family residential rental property, since 1971; Chairman of the Board of Directors of J&L Contractors, Inc. since 1976. Mr. Evans is 73.	
Mr. Evans brings a wealth of executive decision-making and risk assessment skills to the Board as a result of his experience in property management and construction and his service as a director of the Bank since 1986.	
William F. Ham, Jr.	2004
Mayor of City of Auburn since 1998; owner of Varsity Enterprises, a company providing coin laundry services, since 1977. Mr. Ham is 60.	
Mr. Ham brings a wealth of business-building skills to the Board as a result of his experience as an entrepreneur and as the Mayor of City of Auburn. He also brings valuable knowledge through his service as a director of the Bank since 1993.	

Name, Principal Occupation, Business Experience, Age , Directorships and Qualifications	Director Since
David E. Housel	2004
Director of Athletics Emeritus at Auburn University since January 2006; Director of Athletics at Auburn University from 1994 to January 2006; employed by Auburn University since 1970. Mr. Housel is 67. Mr. Housel brings valuable business, public relations, and strategic planning skills to the Board through his previous experience managing a major collegiate athletic program with numerous employees and supervising multi-million dollar budgets. He also possesses banking knowledge through his service as a director of the Bank since 1997.	
Anne M. May	1990
Partner, Machen, McChesney & Chastain, Certified Public Accountants, since 1983. Ms. May is 63. Ms. May brings valuable risk management skills, public accounting knowledge and a wealth of expertise related to matters of compensation and tax compliance as a partner and former managing partner for a local accounting firm. She also possesses vast banking knowledge through her service as a director of the Bank 1982.	
E. L. Spencer, Jr.	1984
Director of the Bank since 1975; Chairman of the Company s and Bank s Board of Directors since 1984 and 1980, respectively; Chief Executive Officer and President of the Company since 1990; formerly Chief Executive Officer and President of the Bank from 1990 to 2000; father of Edward Lee Spencer, III. E. L. Spencer, Jr. is 83. Through his 39 years of service, including 24 years as Chief Executive Officer, Mr. E. L. Spencer, Jr. brings to the Board a deep institutional knowledge and perspective regarding our strengths, challenges, and opportunities. His diverse experiences and leadership roles in the banking, construction, retail, healthcare and agriculture industries provide the Board an expanded perspective regarding the relevant risks and opportunities facing financial institutions.	
Edward Lee Spencer, III	2004
Former Vice President, Spencer Lumber Company; employed by Spencer Lumber Company from 1973 to 2006. Son of E. L. Spencer, Jr. Edward Lee Spencer, III is 58. Mr. Edward Lee Spencer, III brings valuable business insights and knowledge as a result of his previous management experience with Spencer Lumber Company, a supplier of building and construction materials. He also brings valuable banking knowledge through his service as a director of the Bank since 1991.	

CORPORATE GOVERNANCE

Board Leadership Structure

The Board of Directors does not have a policy with respect to the separation of the offices of Chairman and the Chief Executive Officer. The Board believes this issue is part of the succession planning process and that it is in the best interests of the Company and our shareholders to retain the flexibility to combine or separate these functions. At this time, the Board believes there are a number of important advantages of combining the positions of Chairman and Chief Executive Officer, including the following:

- Mr. E. L. Spencer, Jr., with 39 years of experience at the Company, including 24 years as Chief Executive Officer, has the knowledge, expertise, and experience to understand the opportunities and challenges facing the Company, as well as the leadership and management skills to promote and execute our values and strategy, particularly during the current difficult economic environment;

- Combining the positions allows Mr. E. L. Spencer, Jr., to lead Board discussions regarding our business and strategy, and provides unified leadership for the Company;

- Combining the positions creates a firm link between management and the Board and promotes the development and implementation of corporate strategy; and

- Combining the positions allows timely communication with the Board on critical business matters given the complexity of our business.

The Board also believes that combining the positions of Chairman and Chief Executive Officer does not undermine the independence of the Board. The Company s Board is comprised of Mr. E. L. Spencer, Jr. and nine other directors, six of whom satisfy the Nasdaq s listing standards regarding independence. The Company has established an independent director committee. Anne M. May is currently the chairperson of the committee and therefore is formally identified as the Lead Independent Director. Our corporate governance guidelines provide that the independent directors will meet at least semi-annually in executive session without management present.

The Company believes the foregoing structure, policies and practices, when combined with the Company s other governance policies and procedures, provide appropriate oversight, discussion and evaluation of decisions and direction from the Board of Directors.

Board s Role in Risk Oversight

The Board of Directors maintains oversight responsibility of the management of the Company s risks. A fundamental part of risk management is not only understanding the risks the Company faces and what steps management is taking to manage those risks, but also understanding what level of risk is appropriate for the Company. The full Board of Directors reviews with management its process for managing enterprise risk.

While the Board of Directors maintains the ultimate oversight responsibility for risk management, certain of the Board s committees have been assigned responsibility for risk management oversight of specific areas. These responsibilities include:

- the Compensation Committee evaluating, with our senior officers, risks posed by our compensation programs and seeking to limit any unnecessary or excessive risks these programs may pose to us, in order to avoid programs that might encourage such risks. The Compensation Committee s role and its relationship with the Board are more fully described under Committees of the Board Compensation Committee and Compensation Committee Report ;

- the Audit and Compliance Committee overseeing risks related to our financial statements, our compliance with legal and regulatory requirements, our financial reporting process and system of internal controls. The Audit and Compliance Committee also evaluates the performance of our independent auditors and our internal auditing department. The Audit Committee periodically meets privately in separate executive sessions with management, our internal audit department, and the independent auditors. The Audit and Compliance Committee s role and its relationship with the Board are more fully described under Committees of the Board Audit and Compliance Committee ; and the Strategic Planning Committee reviewing management and adjusting our risk assessment during the Company s annual strategic planning process. The Strategic Planning Committee s role and its relationship with the Board are more fully described under Committees of the Board Strategic Planning Committee .

While each of these committees is responsible for evaluating certain risks and overseeing the management of these risks, the entire Board of Directors is regularly informed through committee reports about such risks. In addition, each of the Company s directors serves on the Bank s Board of Directors. We believe that Board committees that report at the Bank level are critical to the Company s risk management processes. These committees include the Director s Loan Committee, Asset/Liability Committee, Information Technology/Information Security (IT/IS) Steering Committee, Operations and Bank Secrecy Act (BSA) Committee. These committees each play a role in monitoring the following risks to the Bank and Company: credit, liquidity, interest rate, operational, reputational, compliance, and information technology and security risks.

Director Nominating Process

The Nominating and Corporate Governance Committee, in consultation with the Chairman of the Board, monitors existing director qualifications and periodically examines the composition of the Company s Board of Directors and determines whether the Board of Directors would better serve its purposes with the addition of one or more directors. This assessment includes, among other relevant factors, in the context of the perceived needs of the Board at that time, issues of experience, reputation, judgment, diversity and skills.

If the Nominating and Corporate Governance Committee determines that adding a new director is advisable or if a vacancy on the Board arises, the Nominating and Corporate Governance Committee initiates the search, working with other directors, management and, if it deems appropriate or necessary, a search firm retained to assist in the search. The Nominating and Corporate Governance Committee will consider all appropriate candidates proposed by management, directors and shareholders. Information regarding potential candidates is presented to the Nominating and Corporate Governance Committee, which then evaluates the candidates based on the needs of the Board of Directors at that time and the criteria listed above. Potential candidates are evaluated according to the same criteria, regardless of whether the candidate was recommended by the Nominating and Corporate Governance Committee, a shareholder, another director, management or another third party. The Nominating and Corporate Governance Committee then meets to consider the selected candidate(s) and submits the approved candidate(s) to the full Board of Directors for approval and recommendation to the shareholders. Although neither the Board nor the Nominating and Corporate Governance Committee has a formal policy with regard to the consideration of diversity in identifying director nominees, the director nomination process is designed to ensure that the Board considers members with diverse backgrounds, including race, ethnicity, gender, education, skills and experience, with a focus on appropriate financial and other expertise relevant to the company s business, and also considers issues of judgment, conflicts of interest, integrity, ethics and commitment to the goal of maximizing shareholder value. The goal of this process is to assemble a group of directors with deep, varied experience, sound judgment and commitment to the company s success.

Subject to the requirements of the Company s Certificate of Incorporation and Amended and Restated Bylaws, as well as any requirements of law or regulation, any shareholder entitled to vote for the election of directors may recommend a director nominee. Advance notice of such proposed nomination must be received by the Secretary of the Company not less than 21 days nor more than 60 days prior to any meeting of the shareholders called for the election of directors. Nominations should be submitted in writing to the Secretary of the Company specifying the nominee s name and other required information set forth in the Company s Bylaws. In 2013, there were no shareholder recommendations received, and no third party search firms were used to identify director candidates.

Shareholder Communications

Shareholders who wish to communicate with the Board, or any individual director or group of directors, may do so by sending written communications addressed to: Board of Directors of Auburn National Bancorporation, Inc., c/o C. Wayne Alderman, Secretary, Auburn National Bancorporation, Inc., 100 N. Gay Street, P.O. Box 3110, Auburn, Alabama, 36831-3110. All information will be compiled by the Secretary of the Company and submitted to the Board of Directors or each applicable director at the next regular meeting of the Board of Directors.

Meetings of the Board of Directors

The Boards of Directors of the Company and the Bank, as well as the committees of the Company s and Bank s Boards of Directors, generally hold meetings in tandem. The Company s Board of Directors held 12 meetings during 2013. All directors attended at least 75% of all meetings of the Company s Board of Directors and each committee on which they served. All of the Company s directors are encouraged to attend the Company s annual meetings of shareholders. All of the Company s directors attended the 2013 Annual Meeting of Shareholders.

Committees of the Board of Directors

The Company s Board of Directors has eight standing committees: the Executive Committee, the Proxy Committee, the Property Committee, the Compensation Committee, the Strategic Planning Committee, the Audit and Compliance Committee, the Nominating and Corporate Governance Committee and the Independent Director Committee.

Executive Committee. The Company s Executive Committee is authorized to act in the absence of the Board of Directors on certain matters that require Board approval. E. L. Spencer, Jr., Robert W. Dumas, and Anne M. May. constitute the current members of this committee. This committee held one meeting during 2013.

Proxy Committee. The Proxy Committee is authorized to act on behalf of Company shareholders when authorized by Proxy. E. L. Spencer, Jr. and Terry W. Andrus constitute the current members of this committee. This committee held one meeting during 2013.

Property Committee. The Property Committee evaluates potential properties for expansion or branching activities. E. L. Spencer, Jr., Robert W. Dumas, Anne M. May, J. E. Evans, J. Tutt Barrett and William F. Ham, Jr. constitute the current members of this committee. This committee held one meeting during 2013.

Compensation Committee. The Compensation Committee is authorized to review, recommend and approve the compensation of the Chief Executive Officer, other executive officers and other key employees of the Company and the Bank; to evaluate the Company s incentive compensation plans, including any equity compensation plans; and to select, interview and make hiring recommendations to the Board for the Chief Executive Officer position. In addition, the Committee approves changes to any Company personnel policy manuals or handbooks, and annually evaluates director compensation. Anne M. May, J. Tutt Barrett, and Terry W. Andrus, all of whom are independent directors as defined in the Nasdaq listing standards, constitute the current members of this committee. This committee held ten meetings in 2013.

Strategic Planning Committee. The Strategic Planning Committee evaluates potential acquisitions and the Company s long range goals and oversees the process and risk assessment used for the officers and directors strategic planning sessions. E. L. Spencer, Jr., Anne M. May, Robert W. Dumas, Terry W. Andrus, C. Wayne Alderman and David E. Housel constitute the current members of this committee. This committee held 3 meetings in 2013.

Audit and Compliance Committee. The Audit and Compliance Committee (Audit Committee) is composed of Terry W. Andrus, C. Wayne Alderman, David E. Housel, J. Tutt Barrett and William F. Ham, Jr., all of whom are independent directors, as defined in the Nasdaq listing standards, and meet the independence criteria set forth in SEC Rule 10A-3(b)(1). All members of the Audit Committee meet the financial literacy requirements of the Nasdaq listing standards and SEC regulations. The Audit Committee has the responsibilities set forth in the Audit Committee Charter, including reviewing the Company s financial statements, evaluating internal accounting controls, reviewing reports of regulatory authorities and determining that all audits and examinations required by law are performed. It appoints independent auditors, reviews and approves their audit plan and reviews with the independent auditors the results of the audit and management s response thereto. The Audit Committee also reviews the adequacy of the internal audit budget and personnel, the internal audit plan and schedule, and results of audits performed by the internal audit staff. The Audit Committee is responsible for overseeing the entire audit function and appraising the effectiveness of internal and external audit efforts. This committee held 15 meetings in 2013. The Board of Directors has determined that C. Wayne Alderman and Terry W. Andrus, members of the Audit Committee, are audit committee financial experts, as defined by SEC rules.

Nominating and Corporate Governance Committee. The Nominating and Corporate Governance Committee is composed of Anne M. May, J. Tutt Barrett and Terry W. Andrus, all of whom are independent directors as defined in the Nasdaq listing standards. The purpose of the Nominating and Corporate Governance Committee is to identify individuals qualified to become members of the Company s Board of Directors and recommend to the Board the director nominees for the next annual meeting of shareholders. This committee also takes a leadership role in shaping corporate governance policies and practices of the Company. The responsibilities and duties of the Nominating and Corporate Governance Committee are more fully set out in the Nominating and Corporate Governance Committee Charter. The Nominating and Corporate Governance Committee held one meeting in 2013.

Independent Directors Committee. The Independent Directors Committee was formed to comply with the Nasdaq listing standards, which require that the Company s independent directors meet separately from the other directors in regularly scheduled executive sessions at least twice annually, and at such other times as may be deemed appropriate by the Company s independent directors. Nasdaq listing standards also require that a majority of the Company s directors be independent directors. The Board has affirmatively determined that the following directors, constituting a majority of the Company s Board of Directors, are independent directors: William F. Ham, Jr., C. Wayne Alderman, David E. Housel, J. Tutt Barrett, Anne M. May, and Terry W. Andrus. The Company s Board of Directors has appointed Anne M. May to serve as the Board s Lead Independent Director. This committee held two meetings in 2013.

The Board of Directors has adopted a Code of Conduct and Ethics applicable to the Company s directors, officers and employees, including the Company s principal executive officer, principal financial and principal accounting officer, controller and other senior financial officers. The Code of Conduct and Ethics, as well as the charters for the Audit Committee, Compensation Committee, and the Nominating and Corporate Governance Committee, can be found by clicking the heading About Us on the Company s website, *www.auburnbank.com*, and then clicking on Investor Relations. In addition, this information is available in print to any shareholder who requests it. Written requests for a copy of the Company s Code of Conduct or the Audit Committee, Compensation Committee, or Nominating and Corporate Governance Committee charters may be sent to Auburn National Bancorporation, Inc., 100 N. Gay Street, Auburn, Alabama 36830, Attention: Marla Kickliter, Senior Vice President of Compliance and Internal Audit. Requests may also be made via telephone by contacting Ms. Kickliter or Laura Carrington, Vice President of Human Resources, at (334) 821-9200. As additional corporate governance standards are adopted, they will be disclosed on an ongoing basis on the Company s website.

Board Compensation

The Chairman receives $1,700 and each director receives $850, respectively, for each Board meeting attended. Generally the Board of Directors of the Company and the Bank meet on the same day, and in such cases, a fee is paid for one board meeting only. In addition, members of the Audit Committee and the Compensation Committee of the Company, which also serve as the members of the Audit Committee and the Compensation Committee of the Bank, respectively, receive an additional fee of $200 for each committee meeting attended, while each Chairman of these committees receives $400 per meeting attended. Members of the Bank s Loan Committee, Asset/Liability Committee and IT/IS Steering Committee receive $200 for each committee meeting attended, while each Chairman of these committees receives $400 per meeting. The Company s and the Bank s directors may receive year-end cash bonuses based upon the Company s financial performance. In 2013, aggregate fees paid to Company and Bank Directors, including cash bonuses, totaled approximately $213,350. The compensation of directors may be changed from time to time by the Board of Directors upon recommendation of the Compensation Committee, without shareholder approval.

The following table provides information concerning the compensation of the Company s non-employee directors for 2013. Compensation paid to E. L. Spencer, Jr. and Robert W. Dumas for their service as directors is reported in the Summary Compensation Table on page 18.

Name	Fees Earned or Paid in Cash	Non-equity Incentive Plan Compensation(1)	Total
C. Wayne Alderman	$ 20,800	$ 3,650	$ 24,450
Terry W. Andrus	15,400	3,650	19,050
J. Tutt Barrett	15,000	3,650	18,650
J.E. Evans	20,400	3,650	24,050
William F. Ham, Jr.	15,350	3,650	19,000
David E. Housel	14,350	3,650	18,000
Anne M. May	14,800	3,650	18,450
Edward Lee Spencer, III	14,800	3,650	18,450

(1) Amounts represent cash bonuses paid to the Company s directors.

PROPOSAL #2 ADVISORY VOTE ON EXECUTIVE COMPENSATION

The purpose of the Company s compensation policies and procedures is to attract and retain experienced, highly qualified executives critical to our long-term success and enhancement of shareholder value. The Board believes our compensation policies and procedures achieve this objective, and therefore recommend shareholders vote FOR the say-on-pay proposal through approval of the following resolution:

RESOLVED, that the compensation paid to the Company s named executive officers, as disclosed in the Company s Proxy Statement for the 2014 Annual Meeting of Shareholders pursuant to the compensation disclosure rules of the Securities and Exchange Commission, including the Compensation Discussion and Analysis, the compensation tables and any related material disclosed in the Proxy Statement, is hereby APPROVED.

This say-on-pay proposal gives you as a shareholder the opportunity to endorse or not endorse the compensation we pay to our named executive officers (identified in Compensation Disclosure and Analysis below) by voting to approve or not approve such compensation as described in this Proxy Statement. This vote is advisory, which means that it is not binding on the Company, the Board or the Compensation Committee. However, the Board and the Compensation Committee will consider the outcome of the vote when considering future executive compensation arrangements.

In last year s Proxy Statement for the 2013 Annual Meeting, a similar advisory vote was requested by the Company. The results of last year s vote were as follows:

	2013 Vote Count	Percent
For	1,936,391	95%
Against	5,576	0%
Abstain	99,691	5%
	2,041,658	100%

The vote on this resolution is not intended to address any specific element of compensation, but rather relates to the overall compensation of our named executive officers, as described in this Proxy Statement in accordance with the compensation disclosure rules of the SEC. We encourage you to closely review our Compensation Discussion and Analysis included herein and the tabular summary compensation disclosure which follows it. Most of our tabular disclosure is backward-looking. When possible, we have discussed our plans for changes to compensation practices for the current year and beyond.

We have included this proposal in our Proxy Statement pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act and Section 14A of the Securities Exchange Act of 1934.

The Board recommends you vote FOR the approval of this Resolution related to the compensation of the Company s named executive officers.

EXECUTIVE OFFICERS

Executive officers generally are appointed annually at a meeting of the respective Boards of Directors of the Company and the Bank in January to serve for one-year terms and until successors are chosen and qualified. In addition to Mr. E. L. Spencer, Jr. and Mr. Dumas, whose information is included under Proposal One Election of Directors, our other executive officers are:

Name	Information About Executive Officers
Jo Ann Hall	Executive Vice President and Chief Operations Officer since 2005; former Senior Vice President and Chief Operations Officer of the Bank since 1994; various other positions with the Bank since 1974. Ms. Hall is 64.
Vernon C. Bice, Jr.	Senior Vice President (Residential Real Estate) of the Bank since 2013; prior to joining the Company, Mr. Bice worked for Cadence Bank and its predecessor Superior Bank, from 2002 to 2013, where he worked in various roles, including Executive Vice President of Alabama Special Assets, Chief Credit Officer, Tennessee Valley Area President, and Huntsville City President. Mr. Bice is a native of Auburn, Alabama and is 58.
Terrell E. Bishop	City President, Valley Branch and Senior Vice President and Senior Mortgage Lending Officer of the Bank since 1991. Mr. Bishop is 77.
Kris W. Blackmon	Vice President and Chief Investment Officer of the Bank since 2007; various other positions with the Bank since 2001. Mr. Blackmon is 43.
James E. Dulaney	Senior Vice President, Bent Creek Branch (Business Development & Commercial/Consumer Lending) since 2010; formerly Senior Vice President (Business Development/Marketing) of the Bank since 2004; various other positions with the Bank since 1993. Mr. Dulaney is 55.
David A. Hedges	Senior Vice President, Controller and Chief Financial Officer of the Company and the Bank since April 2014; formerly Vice President, Controller and Chief Financial Officer of the Company and the Bank since 2008; various other positions with the Company and Bank since 2006. Mr. Hedges is 35.
W. Thomas Johnson	Senior Vice President (Commercial and Consumer Lending) and Senior Lending Officer of the Bank since 2001; formerly Vice President (Commercial and Consumer Lending) of the Bank since 1999. Mr. Johnson is 66.
Marla L. Kickliter	Senior Vice President of Compliance/Internal Audit of the Bank since 2007; formerly Vice President of Compliance/Internal Audit since 2005; various other positions with the Bank since 2001. Ms. Kickliter is 44.
Shannon S. O Donnell	Chief Risk Officer since April 2014 and Senior Vice President of Credit Administration since 2007; formerly Vice President of Credit Administration since 2001. Ms. O Donnell is 44.

Name	Information About Executive Officers
Jerome B. Siegel	Senior Vice President and Chief Technology Officer since 2008, formerly Vice President and Chief Technology Officer since 2002. Mr. Siegel is 50.
C. Eddie Smith, Jr.	City President, Opelika Branch and Senior Vice President of the Bank since 2003; Senior Vice President (Commercial and Consumer Lending) of the Bank since 2001; formerly Vice President (Commercial and Consumer Lending) of the Bank since 1999. Mr. Smith is 57.
Robert L Smith, Jr.	Senior Vice President of the Bank and Chief Lending Officer since April 2014; Vice President (Commercial and Consumer Lending) of the Bank since 2001; Mr. Smith is 45.

COMPENSATION DISCUSSION AND ANALYSIS

Overview

The following discussion and analysis are focused on the compensation of the Company s executive officers, with additional detail provided for the Company s named executive officers. The Company s named executive officers are the Company s Chief Executive Officer (Mr. E. L. Spencer, Jr.), Chief Financial Officer (Mr. Hedges), and the three other most highly compensated executive officers for 2013 (Messrs. Dumas and Bishop and Ms. Hall). Information regarding the compensation of the named executive officers is provided under Executive Compensation following this section.

Compensation Committee

The Compensation Committee of the Company s Board of Directors oversees the design and administration of the Company s compensation program. Because officers are compensated only for service at the Bank (and not separately for services to the Company), this compensation program effectively relates to the needs of the Bank. The Compensation Committee s members are appointed by the Board of Directors, and the Compensation Committee is composed entirely of non-employee, independent directors.

The Compensation Committee:

- establishes the Bank s compensation philosophy;
- evaluates the Chief Executive Officer s performance;
- determines benefits and compensation for the Chief Executive Officer;
- reviews the Chief Executive Officer s recommendations for and approves benefits and compensation for officers other than the Chief Executive Officer;
- makes recommendations to the Board on matters relating to organization and succession of senior management;
- oversees the administration of the Company s 401(k) plan, which is a defined contribution plan; and
- makes recommendations to the Board concerning director compensation.

The Compensation Committee s charter reflects these various responsibilities, and the Compensation Committee and the Board annually review the charter.

The authority of the Compensation Committee may not be delegated to persons who are not on the Compensation Committee. Individuals not on the Compensation Committee, including advisors and executive officers, can make recommendations to the Compensation Committee. The Compensation Committee may consider such recommendations at its discretion and such recommendations are not binding on the Compensation Committee.

The Compensation Committee held ten meetings during 2013, the majority of which were executive sessions with no officers or employees present. Our Human Resource Department provides support to the Compensation Committee. All Compensation Committee members are actively engaged in the review of matters presented, and the members regularly communicate with each other and management before and after meetings about compensation issues.

Compensation Program Review

In 2013, the Compensation Committee completed an internal review of the Company s officer compensation program. This review was requested in order to update the Compensation Committee on current compensation levels and compensation program design features. Current compensation program features at banks comparable in asset size, location and performance to the Bank were reviewed and the reasonableness of the Company s officer compensation and benefits program was considered. The Compensation Committee utilized certain compensation surveys and other resources, including the Community Bankers Association of Alabama 2013 Compensation Survey, the American Bankers Association 2013 Compensation and Benefits Survey, and other similar purchased third party sources. The internal report completed in 2014 indicated that the Bank s compensation program is comparable to other publicly held banks of comparable asset size, location, and performance within the southeast region of the United States, especially the State of Alabama, and provides competitive qualified benefits.

The Compensation Committee will continue to review the elements and objectives of the Company s executive compensation program, as well as the methods the Compensation Committee utilizes to determine both the types and amounts of compensation to award to the Company s executive officers.

Compensation Philosophy and Objectives

In making decisions with respect to compensation for its executive officers, the Compensation Committee is guided by a pay-for-performance philosophy. The Compensation Committee believes that a portion of each executive s total compensation opportunity should vary with achievement of the Company s performance goals. In designing the compensation program for the Company s executive officers, the Compensation Committee seeks to achieve the following key objectives:

Motivate Executives. The compensation program should reward employees for strong individual and Company performance and increased compensation should be earned through an employee s increased contribution to the Company.

Alignment with Stockholders. The compensation program should align the interests of management and shareholders by rewarding service based on Company and individual performance.

Attract and Retain Talented Executives. The compensation program should be competitive with compensation paid by other financial institutions of comparable size and performance in the southeastern United States. This objective is intended to enable the Company to attract and retain key personnel in its highly competitive markets.

Mitigating Risk. The compensation program should link compensation to performance in a way that does not encourage unnecessary or excessive risk, and ensure that the structure of the compensation program is consistent with effective controls and strong corporate governance.

The Compensation Committee monitors the various criteria that make up the program and adjusts them as necessary to continue to meet these objectives.

Consideration of Say-On-Pay Vote and Related Matters

The Dodd-Frank Wall Street Reform and Consumer Protection Act provides that the Company s stockholders shall have the right to vote, on a non-binding basis, on the approval of the compensation of the Company s named executive officers at specified intervals. The Company s stockholders most recently voted on this matter at the 2013 Annual Meeting of Stockholders, and at that time the stockholders also approved a proposal providing that the stockholders would vote on such compensation every year. As a result, the Company has scheduled a similar vote at the 2014 Annual Meeting of Stockholders, and intends to schedule it again at the 2015 Annual Meeting of Stockholders.

At the 2013 Annual Meeting of Stockholders, approximately 95% of the shares voted in person or by proxy voted for the approval of the compensation paid to our named executive officers. The Company believes that this stockholder vote strongly endorses its compensation philosophy and practices. After considering the result of the 2013 advisory vote on executive compensation, the Company did not believe it was necessary to undertake any material changes in the Company s compensation philosophy and practices. In addition to consideration given to the results of any say-on-pay proposal, the Company considers general developments in executive compensation principles and any appropriate direct or indirect input from shareholders, in the development and implementation of the Company s executive compensation philosophy and practices.

Components of Compensation

Executive officer compensation is currently composed of base salary and annual cash bonuses. These components are established based on individual performance as measured by pre-established goals and Company performance relative to pre-established profitability measures. In addition, the Company offers certain basic benefits as described in more detail below.

The Company does not currently have an equity incentive or long-term incentive plan, and, therefore, does not provide equity incentive or long-term incentive awards to its executive officers. The Company s Long-Term Incentive Plan expired in May 2004, with the last of the stock options outstanding thereunder being exercised in 2006. The Compensation Committee will continue to review its options regarding the implementation of an equity incentive or long-term incentive plan. Any equity incentive plans or other long-term incentive plans will consider the appropriate use of common stock and predictable expense recognition, and will be submitted for shareholder approval when necessary and appropriate.

Base Salary

We believe we provide our named executive officers and other officers with the opportunity to earn a competitive annual base salary. We provide this opportunity to attract and retain appropriate talent for the positions, to recognize that similar base salary rates are provided at other companies that we compete with for talent, and to provide a base salary that is not subject "bottom" ALIGN="right">(21,687) (55,646)

Comprehensive loss attributable to the noncontrolling interests in SHR s operating partnership

106 709

Comprehensive loss attributable to the noncontrolling interests in consolidated affiliates

595 1,599

Comprehensive Loss Attributable to SHR

$(20,986) $(53,338)

Net Loss

$(28,419) $(34,611)

Net loss attributable to the noncontrolling interests in SHR s operating partnership

138 442

Net loss attributable to the noncontrolling interests in consolidated affiliates

595 1,599

Net Loss Attributable to SHR

(27,686) (32,570)

Preferred shareholder dividends

(7,721) (7,721)

Net Loss Attributable to SHR Common Shareholders

$(35,407) $(40,291)

Amounts Attributable to SHR:

Loss from continuing operations

$(27,847) $(34,346)

Income from discontinued operations

161 1,776

Net loss

$(27,686) $(32,570)

Basic and Diluted Loss Per Share:

Loss from continuing operations attributable to SHR common shareholders

$(0.23) $(0.55)

Income from discontinued operations attributable to SHR common shareholders

- 0.02

Net loss attributable to SHR common shareholders

$(0.23) $(0.53)

Weighted average common shares outstanding

157,333 75,572

See accompanying notes to unaudited condensed consolidated financial statements.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES (SHR)

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

	Three Months Ended March 31, 2011	2010
Operating Activities:		
Net loss	$ (28,419)	$ (34,611)
Adjustments to reconcile net loss to net cash provided by operating activities (including discontinued operations):		
Deferred income tax benefit	(2,921)	(1,669)
Depreciation and amortization	30,605	35,857
Amortization of deferred financing costs, discount and interest rate swap costs	6,413	10,978
Equity in losses of unconsolidated affiliates	1,600	560
Share-based compensation	9,958	864
Gain on sale of assets	(2,654)	-
Foreign currency exchange gain	(197)	(6,068)
Recognition of deferred gains	(1,205)	(1,219)
Mark to market of derivative financial instruments	(4,366)	-
(Increase) decrease in accounts receivable	(7,326)	5,483
Decrease in other assets	94	1,352
Increase (decrease) in accounts payable and accrued expenses	2,077	(444)
Net cash provided by operating activities	3,659	11,083
Investing Activities:		
Proceeds from sale of investments	9,000	-
Cash received from unconsolidated affiliates	716	113
Unconsolidated affiliates recapitalization	(57,380)	-
Unrestricted cash acquired through acquisition and recapitalization	30,600	-
Capital expenditures	(9,578)	(7,722)
Increase in restricted cash and cash equivalents	(12,155)	(4,911)
Increase in security deposits related to sale-leasebacks	(1,270)	(84)
Net cash used in investing activities	(40,067)	(12,604)
Financing Activities:		
Proceeds from issuance of common stock	50,000	-
Equity issuance costs	(273)	-
Borrowings under bank credit facility	67,000	17,000
Payments on bank credit facility	(88,000)	-
Payments on mortgages and other debt	(1,635)	(4,946)
Debt financing costs	(1,038)	-
Interest rate swap costs	(3,921)	(27,940)
Other financing activities	(500)	(160)
Net cash provided by (used in) financing activities	21,633	(16,046)
Effect of exchange rate changes on cash	3,418	(2,084)
Net change in cash and cash equivalents	(11,357)	(19,651)
Change in cash of assets held for sale	990	-
Cash and cash equivalents, beginning of period	78,842	116,310
Cash and cash equivalents, end of period	$ 68,475	$ 96,659

See accompanying notes to unaudited condensed consolidated financial statements.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES (SHR)

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS CASH FLOWS Continued

(In Thousands)

	Three Months Ended March 31,	
	2011	**2010**
Supplemental Schedule of Non-Cash Activities:		
Acquisition of hotel properties (see note 3)	$ 89,273	$ -
(Gain) loss on mark to market of derivative instruments (see notes 2 and 9)	$ (9,375)	$ 21,400
Increase in capital expenditures recorded as liabilities	$ 2,692	$ 1,063
Cash Paid For:		
Interest, net of interest capitalized	$ 16,963	$ 13,616
Income taxes, net of refunds	$ 416	$ 1,084

See accompanying notes to unaudited condensed consolidated financial statements.

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. GENERAL

Strategic Hotels & Resorts, Inc. (SHR and, together with its subsidiaries, the Company) was incorporated in January 2004 to acquire and asset-manage upper upscale and luxury hotels that are subject to long-term management contracts. As of March 31, 2011, the Company s portfolio included 18 full-service hotel interests located in urban and resort markets in: the United States; Paris, France; Punta Mita, Nayarit, Mexico; Hamburg, Germany; and London, England. The Company operates in one reportable business segment, hotel ownership.

SHR operates as a self-administered and self-managed real estate investment trust (REIT), which means that it is managed by its board of directors and executive officers. A REIT is a legal entity that holds real estate interests and, through payments of dividends to stockholders, is permitted to reduce or avoid federal income taxes at the corporate level. For SHR to continue to qualify as a REIT, it cannot operate hotels; instead it employs internationally known hotel management companies to operate its hotels under management contracts. SHR conducts its operations through its direct and indirect subsidiaries, including its operating partnership, Strategic Hotel Funding, L.L.C. (SH Funding), which currently holds substantially all of the Company s assets. SHR is the sole managing member of SH Funding and holds approximately 99% of its membership units as of March 31, 2011. SHR manages all business aspects of SH Funding, including the sale and purchase of hotels, the investment in these hotels and the financing of SH Funding and its assets.

As of March 31, 2011, SH Funding owned or leased the following 18 hotels:

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

(1) The Company has a ground lease interest in one land parcel at this property.
(2) This property is owned by an unconsolidated affiliate in which the Company indirectly holds a 34.3% interest (see note 5).
(3) These properties are owned by consolidated affiliates in which the Company indirectly holds 51% interests.
(4) The Company had a leasehold interest in this property. On April 6, 2011, the Company sold its leasehold interest in this property (see note 4).
(5) The Company has a leasehold interest in this property.
(6) These properties are subject to ground lease arrangements.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation:

The accompanying unaudited condensed consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and in conformity with the rules and regulations of the SEC applicable to interim financial information. As such, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted in accordance with the rules and regulations of the SEC. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring accruals, necessary to present fairly the financial position of the Company and its results of operations and cash flows for the interim periods presented. The Company believes the disclosures made are adequate to prevent the information presented from being misleading. However, the

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

unaudited condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements included in SHR s Annual Report on Form 10-K for the year ended December 31, 2010. The accompanying unaudited condensed consolidated financial statements include the accounts of SHR, its subsidiaries and other entities in which the Company has a controlling interest.

If the Company determines that it is the holder of a variable interest in a variable interest entity (VIE) within the meaning of new accounting guidance adopted on January 1, 2010, which amends the consolidation guidance of VIEs, and it is the primary beneficiary under this new guidance, then the Company will consolidate the entity. For entities that are not considered VIEs, the Company consolidates those entities it controls. It accounts for those entities over which it has a significant influence but does not control using the equity method of accounting. At March 31, 2011, SH Funding owned the following interests in unconsolidated affiliates, which are accounted for using the equity method of accounting: a 31% interest in the unconsolidated affiliate that owns the Four Seasons Residence Club Punta Mita (RCPM) and a 34.3% interest in the unconsolidated affiliate that owns the Hotel del Coronado (New Hotel Venture) (see note 5). At March 31, 2011, SH Funding also owned an 85.8% controlling interest in the entity that owns both a condominium-hotel development adjacent to the Hotel del Coroando (North Beach Venture) and a 40.0% interest in the New Hotel Venture (see note 5), and 51% controlling interests in each of the entities that own the InterContinental Chicago and the Hyatt Regency La Jolla hotels, which are consolidated in the accompanying financial statements.

All significant intercompany transactions and balances have been eliminated in consolidation. Certain amounts included in the financial statements for prior periods have been reclassified to conform to the current financial statement presentation as a result of discontinued operations.

Use of Estimates:

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

Restricted Cash and Cash Equivalents:

At March 31, 2011 and December 31, 2010, restricted cash and cash equivalents included $16,745,000 and $15,920,000, respectively, that will be used for property and equipment replacement in accordance with hotel management or lease agreements. At March 31, 2011 and December 31, 2010, restricted cash and cash equivalents also included reserves of $24,663,000 and $18,698,000, respectively, required by loan and other agreements.

Income Taxes:

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

Deferred tax assets and liabilities are established for net operating loss carryforwards and temporary differences between the financial reporting basis and the tax basis of assets and liabilities at the enacted tax rates expected to be in effect when the net operating loss carryforwards are utilized and when the temporary

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

differences reverse. The Company evaluates uncertain tax positions in accordance with applicable accounting guidance. A valuation allowance for deferred tax assets is provided if the Company believes all or some portion of the deferred tax asset may not be realized. Any increase or decrease in the valuation allowance that results from a change in circumstances that causes a change in the estimated realizability of the related deferred tax asset is included in earnings.

The Company completed an equity offering during the second quarter of 2010 (see note 8), which resulted in an ownership change under Section 382 of the Tax Code. As a result, some of the Company s net operating loss carryforwards were reduced or eliminated in accordance with the provisions of Section 382. A full valuation reserve has been provided against net operating loss carryforwards not subject to Section 382 due to uncertainty of realization. Therefore, the ownership change had no impact to the statements of operations.

For the three months ended March 31, 2011 and 2010, income tax benefit related to continuing operations is summarized as follows (in thousands):

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Current tax (expense):		
Europe	$ (6)	$ -
Mexico	(224)	(863)
United States	(1,402)	-
	(1,632)	(863)
Deferred tax (expense) benefit:		
Mexico	(139)	(75)
United States	3,419	1,775
	3,280	1,700
Total income tax benefit	$ 1,648	$ 837

Per Share Data:

Basic loss per share is computed by dividing the net loss attributable to SHR common shareholders by the weighted average common shares outstanding during each period. Diluted loss per share is computed by dividing the net loss attributable to SHR common shareholders as adjusted for the impact of dilutive securities, if any, by the weighted average common shares outstanding plus potentially dilutive securities. Dilutive securities may include restricted stock units (RSUs), options to purchase shares of SHR common stock (Options), exchangeable debt securities and noncontrolling interests that have an option to exchange their interests to shares of SHR common stock. No effect is shown for securities that are anti-dilutive. The following table sets forth the components of the calculation of loss from continuing operations attributable to SHR common shareholders for the three months ended March 31, 2011 and 2010 (in thousands):

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Numerator:		
Loss from continuing operations attributable to SHR	$ (27,847)	$ (34,346)
Preferred shareholder dividends	(7,721)	(7,721)

Loss from continuing operations attributable to SHR common shareholders	$ (35,568)	$ (42,067)
Denominator:		
Weighted average common shares basic and diluted	157,333	75,572

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STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Securities that could potentially dilute basic loss per share in the future that are not included in the computation of diluted loss per share because they are anti-dilutive as of March 31, 2011 and 2010 are as follows (in thousands):

	Computation For Three Months Ended March 31,	
	2011	**2010**
Noncontrolling interests	853	955
Options and RSUs	1,904	1,894

Accumulated Other Comprehensive Loss:

The Company s accumulated other comprehensive loss (OCL) results from mark to market of certain derivative financial instruments and unrealized gains or losses on foreign currency translation adjustments (CTA). The following tables provide the components of accumulated OCL as of March 31, 2011 and 2010 (in thousands):

	Derivative and Other Adjustments	CTA	Accumulated OCL
Balance at January 1, 2011	$ (94,933)	$ (12,231)	$ (107,164)
Mark to market of derivative instruments	9,321	-	9,321
Reclassification to equity in losses of unconsolidated affiliates	54	-	54
CTA activity	-	(2,643)	(2,643)
Balance at March 31, 2011	$ (85,558)	$ (14,874)	$ (100,432)

	Derivative and Other Adjustments	CTA	Accumulated OCL
Balance at January 1, 2010	$ (81,449)	$ 12,108	$ (69,341)
Mark to market of derivative instruments	(21,319)	-	(21,319)
Reclassification to equity in losses of unconsolidated affiliates	(81)	-	(81)
CTA activity	-	365	365
Balance at March 31, 2010	$ (102,849)	$ 12,473	$ (90,376)

New Accounting Guidance:

In December 2010, the Financial Accounting Standards Board issued new guidance that amends the criteria for performing the second step of the goodwill impairment test for reporting units with zero or negative carrying amounts and requires performing the second step if qualitative factors indicate that it is more likely than not that a goodwill impairment exists. The Company adopted the new guidance on January 1, 2011, and determined that it did not have a material impact to the financial statements.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. INVESTMENT IN HOTEL PROPERTIES, NET

The following summarizes the Company s investment in hotel properties as of March 31, 2011 and December 31, 2010, excluding the leasehold interest in the Marriott Hamburg, unconsolidated affiliates and assets held for sale (in thousands):

	March 31, 2011	December 31, 2010
Land	$ 343,943	$ 318,756
Land held for development	107,908	107,908
Leasehold interest	11,633	11,633
Buildings	1,468,185	1,405,462
Building and leasehold improvements	95,487	95,487
Site improvements	44,333	43,487
Furniture, fixtures and equipment	438,957	423,588
Improvements in progress	15,435	10,679
Total investment in hotel properties	2,525,881	2,417,000
Less accumulated depreciation	(612,312)	(581,549)
Total investment in hotel properties, net	$ 1,913,569	$ 1,835,451
Consolidated hotel properties	15	13
Consolidated hotel rooms	6,727	6,403

Acquisition of Four Seasons Silicon Valley and Four Seasons Jackson Hole

On March 11, 2011, the Company acquired the Four Seasons Silicon Valley and Four Seasons Jackson Hole hotels in exchange for an aggregate of 15,200,000 shares of SHR s common stock at a price of $6.08 per share based on the March 11, 2011 SHR common share closing price, or approximately $92,416,000. Due to the acquisition completion date near the March 31, 2011 quarter-end, the allocation of the purchase price is preliminary and is based on the initial accounting of the assets acquired and liabilities assumed at their respective estimated fair values on the acquisition date of March 11, 2011. The final allocation of the purchase price may result in adjustments to the recognized amounts of assets and liabilities, which could be significant. The Company expects to finalize the preliminary allocation as soon as possible, but no later than one year from the acquisition date. The preliminary allocation of the purchase price for the acquisition is as follows (in thousands):

	Four Seasons Silicon Valley	Four Seasons Jackson Hole
Land	$ 5,518	$ 19,669
Buildings	27,269	33,450
Site improvements	400	444
Furniture, fixtures and equipment	2,827	4,236
Intangible assets	88	372
Net working capital	378	(2,235)
	$ 36,480	$ 55,936

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. DISCONTINUED OPERATIONS

The results of operations of hotels sold or assets held for sale are classified as discontinued operations and segregated in the consolidated statements of operations for all periods presented. The following is a summary of income from discontinued operations for the three months ended March 31, 2011 and 2010 (in thousands):

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Hotel operating revenues	$ 8,805	$ 13,521
Operating costs and expenses	8,682	12,577
Depreciation and amortization	-	1,814
Total operating costs and expenses	8,682	14,391
Operating income (loss)	123	(870)
Interest expense	-	(3,186)
Interest income	-	7
Foreign currency exchange gain	58	6,519
Other income, net	326	-
Income tax expense	(359)	(59)
Gain (loss) on sale	14	(612)
Income from discontinued operations	$ 162	$ 1,799

Assets Held for Sale:

Paris Marriott

On April 6, 2011, the Company sold its leasehold interest in the Paris Marriott hotel for consideration of 29,200,000 ($41,567,000). As part of the transaction, the Company received 10,100,000 ($14,500,000) of an additional 11,600,000 ($16,630,000) owed related to the release of the security deposit and other closing adjustments for total proceeds of approximately 40,800,000 ($58,197,000). The Company anticipates recording a gain on sale of the property due to the recognition of an existing deferred gain resulting from a sale-leaseback transaction related to this hotel (see note 6).

The hotel s assets and liabilities owned by the Company have been classified as held for sale on the accompanying consolidated balance sheets as of March 31, 2011 and December 31, 2010. The significant components of assets held for sale and liabilities of assets held for sale at March 31, 2011 and December 31, 2010 consist of the following (in thousands):

	March 31, 2011	December 31, 2010
Investment in hotel properties, net	$ 6,443	$ 6,226
Cash	2,009	2,999
Restricted cash	1,350	1,320
Accounts receivable, net of allowance for doubtful accounts	4,917	5,636
Deferred tax asset (a)	27,944	26,712

Other assets	2,480	2,252
Assets held for sale	$ 45,143	$ 45,145
Accounts payable and accrued expenses	$ 4,922	$ 6,969
Deferred gain on sale of hotel (a)	90,495	86,237
Liabilities of assets held for sale	$ 95,417	$ 93,206

(a) In 2003, the Company recorded a sale-leaseback of the Paris Marriott and the related gain on sale was deferred for financial reporting purposes. The gain on sale was recognized for French income tax

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

purposes, which resulted in recognition of a deferred tax asset. The deferred tax asset is reduced as the deferred gain is amortized over the life of the lease. The balance also fluctuates based on changes in foreign currency exchange rates.

Assets Sold:

InterContinental Prague

On December 15, 2010, the Company sold the InterContinental Prague hotel for an approximate consideration of 106,090,000 ($141,368,000). The consideration included the assignment of the hotel s third party debt of 101,600,000 ($135,385,000) and the interest rate swap liability related to the third party indebtedness, estimated to be approximately 4,490,000 ($5,983,000) . For the year ended December 31, 2010, the Company received net sales proceeds of $3,564,000. In addition, as part of the transaction, approximately 2,000,000 ($2,665,000) of restricted cash related to the hotel was released to the Company.

5. INVESTMENT IN UNCONSOLIDATED AFFILIATES

Investment in unconsolidated affiliates as of March 31, 2011 and December 31, 2010 includes the following (in thousands):

	March 31, 2011	December 31, 2010
New Hotel Venture (a)	$ 96,488	$ -
Hotel and North Beach Ventures (a)	-	7,787
Four Seasons RCPM (b)	3,950	3,878
BuyEfficient (c)	-	6,359
Total investment in unconsolidated affiliates	$ 100,438	$ 18,024

(a) As of December 31, 2010, the Company owned 45.0% ownership interests in SHC KSL Partners, LP (Hotel Venture), the then owner of the Hotel del Coronado, and in HdC North Beach Development, LLLP (North Beach Venture), the owner of an adjacent residential condominium-hotel development. The Company earned asset management, development and financing fees under agreements with the Hotel and North Beach Ventures. The Company recognized income of 55.0% of these fees, representing the percentage of the Hotel and North Beach Ventures not owned by the Company. These fees amounted to $135,000 for the three months ended March 31, 2010, and are included in other income, net in the consolidated statement of operations.

In January 2006, the Hotel Venture entered into non-recourse mortgage and mezzanine loans with principal amounts of $610,000,000. The loans accrued interest at the London Interbank Offered Rate (LIBOR) plus a blended spread of 2.08%. In addition, the Hotel Venture entered into a $20,000,000 non-recourse revolving credit facility that bore interest at LIBOR plus 2.50%. At December 31, 2010, there was a balance of $18,500,000 on the revolving credit facility and there were no letters of credit outstanding. In December 2010, the Hotel Venture purchased a $37,500,000 mezzanine layer of the debt structure for a discounted pay-off of $13,000,000. The remaining principal on the loans and revolving credit facility had a maturity date of January 7, 2011. On January 7, 2011, the Hotel Venture obtained an extension of the maturity date to February 9, 2011.

On February 4, 2011, the Hotel and North Beach Ventures completed a recapitalization (the Transaction) through a series of contemporaneous transactions. Under the terms of the Transaction, the Company acquired the ownership interest of an existing member of the Hotel and North Beach Ventures, and, along with the remaining members of the Hotel Venture, formed a partnership, BSK Del Partners, L.P. (New Hotel Venture) with an unaffiliated third party, an affiliate of Blackstone Real Estate Advisors VI L.P. (Blackstone), to own the Hotel del Coronado. As part of the Transaction, the Company contributed $57,380,000 of cash drawn from the Company s bank credit facility to fund its contribution. This payment included the purchase of the existing member s ownership in the Hotel and North Beach Ventures and is net of a

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$1,700,000 financing fee earned as part of the Transaction. The Hotel Venture contributed substantially all of the assets and liabilities to the New Hotel Venture. The New Hotel Venture then settled all contributed debts outstanding by paying balances off in full or agreeing to convert debt to equity. In connection with the Transaction, the Company also acquired its partner s interest in HdC DC Corporation, a taxable corporation, with assets of $25,597,000 and an existing deferred tax liability of approximately $48,575,000. As a result of the Transaction, the Company recorded an equity method investment of $97,649,000. Pursuant to the terms of the Transaction, Blackstone will be the general partner of the New Hotel Venture with a 60.0% ownership interest and the Company will be a limited partner with an indirect 34.3% ownership interest.

The New Hotel Venture secured $425,000,000 of five-year debt financing at a weighted average rate of LIBOR plus 480 basis points, subject to a 1% LIBOR floor. After the third year of the loan, the final two one-year extensions require payment to the lender of a 25 basis point extension fee. Additionally, the New Hotel Venture purchased a two-year, 2.0% LIBOR cap, which was required by the loan.

The Company will continue to act as asset manager and will earn a quarterly asset management fee equal to 1.0% of gross revenue, certain development fees, and when applicable, an incentive fee equal to one-third of the incentive fee paid to the hotel operator under the hotel management agreement. As part of the New Hotel Venture with Blackstone, the Company and the other remaining member of the Hotel Venture earn a profit-based incentive fee of 20.0% of all distributions of the New Hotel Venture that exceed both a 20.0% internal rate of return and two times return on invested equity. For the three months ended March 31, 2011, the Company recognized fees of $1,293,000, which are included in other income, net on the consolidated statement of operations.

(b) The Company owns a 31% interest in and acts as asset manager for an unconsolidated affiliate with two unaffiliated parties that is developing the Four Seasons RCPM, a luxury vacation home product that is being sold in fractional ownership interests on the property adjacent to the Company s Four Seasons Punta Mita Resort in Mexico. The Company earns asset management fees and recognizes income of 69% of these fees, representing the percentage not owned by the Company. These fees amounted to $20,000 and $39,000 for the three months ended March 31, 2011 and 2010, respectively, and are included in other income, net on the consolidated statements of operations.

(c) On December 7, 2007, the Company acquired a 50% interest in BuyEfficient for $6,346,000. BuyEfficient is an electronic purchasing platform that allows members to procure food, operating supplies, furniture, fixtures and equipment. In January 2011, the Company sold its 50% interest for $9,000,000 and recognized a gain on sale of $2,640,000 for the three months ended March 31, 2011, which is included in other income, net on the consolidated statement of operations.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Combined Financial Information of Investment in Unconsolidated Affiliates

The following is summarized financial information for the Company s unconsolidated affiliates as of March 31, 2011 and December 31, 2010 and for the three months ended March 31, 2011 and 2010 (in thousands):

	March 31, 2011	December 31, 2010
Assets		
Investment in hotel properties, net	$ 548,828	$ 298,362
Goodwill	-	23,401
Intangible assets, net	44,436	49,000
Cash and cash equivalents	23,958	22,400
Restricted cash and cash equivalents	8,464	12,087
Other assets	30,783	20,842
Total assets	$ 656,469	$ 426,092
Liabilities and Partners Equity (Deficit)		
Mortgage and other debt payable	$ 425,000	$ 592,476
Other liabilities	34,034	33,472
Partners equity (deficit)	197,435	(199,856)
Total liabilities and partners equity (deficit)	$ 656,469	$ 426,092

	Three Months Ended March 31,	
	2011	2010
Revenues		
Hotel operating revenue	$ 23,964	$ 23,736
Residential sales	1,638	3,513
Other	4,298	1,142
Total revenues	29,900	28,391
Expenses		
Hotel operating expenses	20,961	18,209
Residential costs of sales	541	1,829
Depreciation and amortization	4,463	4,236
Other operating expenses	1,878	2,042
Total operating expenses	27,843	26,316
Operating income	2,057	2,075
Interest expense, net	(6,554)	(4,270)
Other (expenses) income, net	(518)	313
Net loss	$ (5,015)	$ (1,882)

Equity in losses in unconsolidated affiliates				
Net loss	$	(5,015)	$	(1,882)
Partners share of loss of unconsolidated affiliates		2,889		973
Adjustments for basis differences, taxes and intercompany eliminations		526		349
Total equity in losses of unconsolidated affiliates	$	(1,600)	$	(560)

As a result of the Transaction, the Company recorded the net assets of the New Hotel Venture at their fair values. To the extent that the Company s cost basis is different than the basis reflected at the unconsolidated affiliate level, the basis difference, excluding amounts attributable to land and goodwill, is amortized over the life of the related asset and included in the Company s share of equity in losses of the unconsolidated affiliates.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. OPERATING LEASE AGREEMENTS

In June 2004, the Company recorded a sale of the Marriott Hamburg, and the Company s leaseback of the hotel was reflected as an operating lease. A deferred gain was recorded in conjunction with the sale and is being recognized as a reduction of lease expense over the life of the lease. The Company recognized $53,000 and $54,000 of the deferred gain for the three months March 31, 2011 and 2010, respectively. As of March 31, 2011 and December 31, 2010, the deferred gain on the sale of the Marriott Hamburg recorded on the accompanying consolidated balance sheets amounted to $4,029,000 and $3,930,000, respectively. On a monthly basis, the Company makes minimum rent payments aggregating to an annual total of 3,654,000 (adjusting by an index formula) ($5,179,000 based on the foreign exchange rate as of March 31, 2011) and pays additional rent based upon the performance of the hotel, which are recorded as lease expense in the Company s consolidated statements of operations. A euro-denominated security deposit at March 31, 2011 and December 31, 2010 was $2,693,000 and $2,540,000, respectively, and is included in other assets on the Company s consolidated balance sheets. The Company subleases its interest in the Marriott Hamburg to a third party. The Company has reflected the sublease arrangement as an operating lease and records lease revenue.

In June 2004, the Company recorded a sale of the Paris Marriott, and the Company s leaseback of the hotel was reflected as an operating lease. A deferred gain was recorded in conjunction with the sale and is being recognized as a reduction of lease expense over the life of the lease. On April 6, 2011, the Company sold its leasehold interest in the Paris Marriott (see note 4). The hotel s assets and liabilities owned by the Company have been classified as held for sale on the accompanying consolidated balance sheets as of March 31, 2011 and December 31, 2010 and the results of operations have been classified as discontinued operations in the consolidated statements of operations for all periods presented.

The Company recognized $1,152,000 and $1,165,000 of the deferred gain related to the Paris Marriott in income from discontinued operations for the three months ended March 31, 2011 and 2010, respectively. As of March 31, 2011 and December 31, 2010, the deferred gain on the sale of the Paris Marriott amounted to $90,495,000 and $86,237,000, respectively, which is recorded in liabilities of assets held for sale. On a monthly basis, the Company makes minimum rent payments aggregating to an annual total of 12,295,000 (adjusting by an index formula) ($17,427,000 based on the foreign exchange rate as of March 31, 2011) and pays additional rent based upon the performance of the hotel, which are included in income from discontinued operations, in the Company s consolidated statements of operations. At March 31, 2011 and December 31, 2010, a euro-denominated security deposit was $14,055,000 and $14,459,000, respectively, and is included in other assets on the Company s consolidated balance sheets. The entire security deposit will be returned to the Company within six months after the sale of the Paris Marriott leasehold interest (see note 4).

7. INDEBTEDNESS

Mortgages and Other Debt Payable:

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

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Mortgages and other debt payable at March 31, 2011 and December 31, 2010 consisted of the following (in thousands):

			Balance Outstanding at	
Debt	**Spread (a) (basis points)**	**Maturity**	**March 31, 2011**	**December 31, 2010**
Fairmont Scottsdale	56	September 2011(b)	$ 180,000	$ 180,000
InterContinental Chicago	106	October 2011(b)	121,000	121,000
InterContinental Miami	73	October 2011(b)	90,000	90,000
Loews Santa Monica Beach Hotel	63	March 2012(c)	118,250	118,250
Ritz-Carlton Half Moon Bay	67	March 2012(c)	76,500	76,500
Hyatt Regency La Jolla	100	September 2012	97,500	97,500
Marriott London Grosvenor Square (d)	110	October 2013	118,982	117,281
Fairmont Chicago (d)	Fixed	June 2017	97,750	97,750
Westin St. Francis (d)	Fixed	June 2017	220,000	220,000
Total mortgages payable			1,119,982	1,118,281
Other debt (e)	Fixed	January 2013	1,476	-
Total mortgages and other debt payable			$ 1,121,458	$ 1,118,281

(a) Interest is paid monthly at the applicable spread over LIBOR (0.24% at March 31, 2011) for all loans except for those secured by the Marriott London Grosvenor Square, the Westin St. Francis, and the Fairmont Chicago. Interest on the Marriott London Grosvenor Square loan is paid quarterly at the applicable spread over three-month GBP LIBOR (0.82% at March 31, 2011). Interest on the Westin St. Francis and Fairmont Chicago loans is paid monthly at an annual fixed rate of 6.09%.

(b) The Company is currently working to restructure, refinance or extend these loans.

(c) In February 2011, the Company exercised the final options to extend the maturity dates of these loans by an additional year to March 2012.

(d) These loan agreements require maintenance of financial covenants, all of which the Company was in compliance with at March 31, 2011.

(e) The North Beach Venture assumed the mortgage loan on a hotel-condominium unit, which accrues interest at an annual fixed rate of 5.0% and is secured by the hotel-condominium unit. The hotel-condominium unit, with a carrying value of $1,594,000, is included in other assets on the consolidated balance sheet as of March 31, 2011.

Other Debt:

In connection with the acquisition of a 60-acre oceanfront land parcel in Punta Mita, Nayarit, Mexico, the Company executed two $17,500,000 non-interest bearing promissory notes. The Company recorded these notes at their present value based on an imputed interest rate of 9.5% and amortized the resulting discount over the life of the promissory notes. On September 30, 2008, the Company paid the first of the $17,500,000 non-interest bearing promissory notes. The second note was due August 31, 2009. In August 2009, the Company entered into an agreement with the holder of the promissory note whereby the holder released the Company from its final installment payment of $17,500,000 that was due in August 2009 in exchange for the Company agreeing to provide the note holder with the right to an interest in the property. The Company will receive a preferred position which will entitle it to receive the first $12,000,000 of distributions generated from the property with any excess distributions split equally among the partners. The Company s obligations under this agreement, recorded as other liabilities in accounts payable and accrued expenses on the Company s consolidated balance sheets, are subject to the note holder being able to obtain certain permits and licenses to develop the land. If they are unable to obtain such permits and licenses within a prescribed time period, the Company would have the right to a full refund of the amounts previously paid to purchase the property, and the land ownership would revert back to the seller.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Exchangeable Notes:

On April 4, 2007, SH Funding issued $150,000,000 in aggregate principal amount of 3.50% Exchangeable Senior Notes due 2012 (Exchangeable Notes) and on April 25, 2007 issued an additional $30,000,000 of Exchangeable Notes in connection with the exercise by the initial purchasers of their over-allotment option. The Exchangeable Notes were issued at 99.5% of par value. The Company received proceeds of $175,593,000, net of underwriting fees and expenses and original issue discount. On January 1, 2009, the Company adopted the provisions of new guidance on accounting for convertible debt instruments that may be settled in cash upon conversion, including partial cash settlements, and retrospectively recorded an additional discount on the Exchangeable Notes of $20,978,000 as of the issuance date. The Exchangeable Notes paid interest in cash semi-annually in arrears on April 1 and October 1 of each year beginning October 1, 2007.

On May 10, 2010, the Company announced a cash tender offer to purchase any and all of the Exchangeable Notes outstanding. On June 7, 2010, the Company completed the tender offer and accepted for purchase, at par, $180,000,000 of the principal amount of its outstanding Exchangeable Notes. The aggregate consideration for the Exchangeable Notes accepted for purchase was approximately $181,208,000, which included accrued and unpaid interest of approximately $1,208,000. The Company allocated $169,939,000 of the consideration to the settlement of the liability and $10,061,000 to equity. This allocation was based on the fair value of the Exchangeable Notes excluding the conversion feature using unobservable (Level 3) inputs, which included a discount cash flow analysis and the Company s nonconvertible debt borrowing rate.

The table below presents the effect of the Exchangeable Notes on the Company s consolidated statement of operations for the three months ended March 31, 2010 (in thousands):

		Three Months Ended March 31, 2010
Statement of Operations:		
Coupon interest	$	1,575
Discount amortization		1,106
Total interest	$	2,681
Effective interest rate		6.25%

Bank Credit Facility:

On February 23, 2011, SH Funding exercised its option to extend the maturity date of the bank credit facility from March 9, 2011 to March 9, 2012 and entered into the fourth amendment to the bank credit facility. The following summarizes key terms of the bank credit facility that were amended:

the maximum facility size was reduced to $350,000,000 from $400,000,000;

maximum availability is now determined by the lesser of a 1.2 times (previously 1.3 times) debt service coverage on the borrowing base assets (based on the trailing 12 months net operating income for these assets divided by a 7% (previously 8%) debt constant on the balance outstanding under the bank credit facility, as defined in the loan agreement) or a 55% (previously 45%) advance rate against the appraised value of the borrowing base assets; and maximum corporate leverage, as defined in the loan agreement, decreased to 70% from 80%.

Prior to the fourth amendment in February 2011, SH Funding entered into a third amendment to the bank credit facility in February 2009, which, among other things, reduced the maximum facility size to $400,000,000 but provided the Company with additional flexibility with respect to its financial covenants and related financial calculations. The amended interest rate on the facility is LIBOR plus a margin of 3.75% in

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the case of each LIBOR loan and base-rate plus a margin of 2.75% in the case of each base rate loan and a commitment fee of 0.50% per annum based on the unused revolver balance.

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

The weighted average interest rate for the three months ended March 31, 2011 was 4.08%. At March 31, 2011, maximum availability was determined by the lesser of a 1.2 times debt service coverage on the borrowing base assets or a 55% advance rate against the appraised value of the borrowing base assets. Based on these requirements, the Company had approximately $310,290,000 available under the bank credit facility at March 31, 2011. At March 31, 2011, there was $7,000,000 of borrowings outstanding under the bank credit facility and outstanding letters of credit of $2,500,000 (see note 12). The agreement also requires maintenance of financial covenants, all of which SH Funding and SHR were in compliance with at March 31, 2011.

Debt Maturity:

The following table summarizes the aggregate maturities as of March 31, 2011 for all mortgages and other debt payable and the Company s bank credit facility (in thousands):

Years ending December 31,	**Amounts**
2011 (remainder)	$ 392,653
2012	310,952
2013	124,423
2014	9,481
2015	10,075
Thereafter	280,874
Total	$ 1,128,458

Interest Expense:

Total interest expense in continuing and discontinued operations includes a reduction related to capitalized interest of $232,000 and $145,000 for the three months ended March 31, 2011 and 2010, respectively. Total interest expense in continuing and discontinued operations includes amortization of deferred financing costs of $1,280,000 and $1,830,000 for the three months ended March 31, 2011 and 2010, respectively.

8. EQUITY AND DISTRIBUTION ACTIVITY

Common Shares:

The following table presents the changes in the issued and outstanding shares of SHR common stock since December 31, 2010 (excluding 853,461 and 954,571 units of SH Funding (OP units) outstanding at March 31, 2011 and December 31, 2010, respectively, which are redeemable for shares of SHR common stock on a one-for-one basis, or the cash equivalent thereof, subject to certain restrictions and at the option of SHR) (in thousands):

Outstanding at December 31, 2010	151,305
RSUs redeemed for shares of SHR common stock	193
OP units redeemed for shares of SHR common stock	101
Common stock issued	23,200
Outstanding at March 31, 2011	174,799

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Common Stock

On March 11, 2011, the Company issued an aggregate of 15,200,000 shares of SHR s common stock in connection with the acquisition of the Four Seasons Silicon Valley and Four Seasons Jackson Hole hotels (see note 3). In addition, the Company issued 8,000,000 shares of SHR s common stock to an affiliate of the seller in a concurrent private placement at a price of $6.25 per share. The shares issued in connection with the acquisition of the hotels and the concurrent private placement are restricted from being transferred for twelve months from the closing date, subject to certain exceptions in the stock transfer restriction and registration rights agreement. After expenses, net proceeds from the concurrent private placement totaled approximately $49,727,000, which were used to repay existing indebtedness under the Company s bank credit facility.

On May 19, 2010, SHR completed a public offering of common stock by issuing 75,900,000 shares at a price of $4.60 per share. After discounts, commissions, and expenses, SHR raised net proceeds of approximately $331,832,000. These proceeds were used to fund the cash tender offer of the Exchangeable Notes (see note 7) and repay existing indebtedness under the Company s bank credit facility.

As of March 31, 2011, no shares of SHR common stock have been repurchased under the $50,000,000 share repurchase program.

Stockholder Rights Plan

In November 2008, SHR s board of directors adopted a stockholder rights plan. Under the plan, SHR declared a dividend of one preferred share purchase right (Right) for each outstanding share of SHR common stock. The dividend was payable on November 28, 2008 to the stockholders of record as of the close of business on November 28, 2008. Each Right will allow its holder to purchase from SHR one one-thousandth of a share of a new series of SHR participating preferred stock for $20.00, once the Rights become exercisable. The Rights will become exercisable and will separate from SHR s common stock only upon the occurrence of certain events. On November 24, 2009, the Company entered into an amendment to extend the stockholder rights plan through November 30, 2012, unless the rights are earlier redeemed or amended by SHR s board of directors.

Distributions:

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

Distributions are declared quarterly to holders of shares of SHR preferred stock. In February 2009, SHR s board of directors elected to suspend the quarterly dividend beginning with the first quarter of 2009 to holders of shares of 8.50% Series A Cumulative Redeemable Preferred Stock, 8.25% Series B Cumulative Redeemable Preferred Stock, and 8.25% Series C Cumulative Redeemable Preferred Stock. Dividends on the preferred stock are cumulative. As of March 31, 2011, unpaid cumulative dividends on SHR s preferred stock were as follows:

	Aggregate (in thousands)	Per Share
8.50% Series A Cumulative Redeemable Preferred Stock	$ 21,462	$ 4.78
8.25% Series B Cumulative Redeemable Preferred Stock	$ 21,347	$ 4.64
8.25% Series C Cumulative Redeemable Preferred Stock	$ 26,684	$ 4.64

Pursuant to the articles supplementary governing the preferred stock, if the Company does not pay quarterly dividends on its preferred stock for six quarters, whether or not consecutive, the size of its board of directors will be increased by two and the holders of the preferred stock will have the right to elect two additional directors to the board. As of March 31, 2011, the Company did not pay quarterly dividends for nine quarters. There have been no new directors added to the board pursuant to this right.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Noncontrolling Interests:

The following tables reflect the reconciliation of the beginning and ending balances of the equity attributable to SHR and the noncontrolling owners (in thousands):

	SHR Shareholders Equity	Nonredeemable Noncontrolling Interests	Total Permanent Shareholders Equity	Total Redeemable Noncontrolling Interests (Temporary Equity) (a)
Balance at December 31, 2010	$ 620,262	$ 25,082	$ 645,344	$ 5,050
Common shares issued	141,462	-	141,462	682
RSUs redeemed for common shares	2	-	2	-
Net loss	(27,686)	(595)	(28,281)	(138)
CTA	(2,630)	-	(2,630)	(13)
Derivatives activity	9,330	-	9,330	45
Share-based compensation	275	-	275	1
Redemption value adjustment	(272)	-	(272)	272
Noncontrolling interests assumed in the Transaction	-	10,725	10,725	-
Other	394	153	547	(394)
Balance at March 31, 2011	$ 741,137	$ 35,365	$ 776,502	$ 5,505

	SHR Shareholders Equity	Nonredeemable Noncontrolling Interests	Total Permanent Shareholders Equity	Total Redeemable Noncontrolling Interests (Temporary Equity) (a)
Balance at December 31, 2009	$ 568,980	$ 23,188	$ 592,168	$ 2,717
RSUs redeemed for common shares	2	-	2	-
Net loss	(32,570)	(1,599)	(34,169)	(442)
CTA	360	-	360	5
Derivatives activity	(21,128)	-	(21,128)	(272)
Share-based compensation	272	-	272	4
Distributions	(35)	-	(35)	-
Redemption value adjustment	(2,034)	-	(2,034)	2,034
Other	(12)	(38)	(50)	12
Balance at March 31, 2010	$ 513,835	$ 21,551	$ 535,386	$ 4,058

(a) The historical cost of the redeemable noncontrolling interests is based on the proportional relationship between the carrying value of equity associated with SHR s common shareholders relative to that of the unitholders of SH Funding, as SH Funding units may be exchanged into SHR common stock on a one-for-one basis. The interests held by the noncontrolling partners are stated at the greater of carrying value or their redemption value.

As of March 31, 2011 and December 31, 2010, the redeemable noncontrolling interests had a redemption value of approximately $5,505,000 (based on the March 31, 2011 SHR common share closing price of $6.45) and $5,050,000 (based on the December 31, 2010 SHR common share closing price of $5.29), respectively. As of March 31, 2010 and December 31, 2009, the redeemable noncontrolling interests had a redemption value of approximately $4,058,000 (based on the March 31, 2010 SHR common share closing price of $4.25) and $1,776,000 (based on the December 31, 2009 SHR common share closing price of $1.86), respectively.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. DERIVATIVES

The Company manages its interest rate risk by varying its exposure to fixed and variable rates while attempting to minimize its interest costs. The Company manages its fixed interest rate and variable interest rate risk through the use of interest rate caps and swaps. The Company enters into interest rate caps and swaps with high credit quality counterparties and diversifies its positions among such counterparties in order to reduce its exposure to credit losses. The caps limit the Company s exposure on its variable-rate debt that would result from an increase in interest rates. The Company s lenders, as stipulated in the respective loan agreements, generally require such caps. Upon extinguishment of debt, income effects of cash flow hedges are reclassified from accumulated OCL to interest expense, equity in losses of unconsolidated affiliates, loss on early extinguishment of debt, or income from discontinued operations, as appropriate. The Company records all derivatives at fair value as either other assets or accounts payable and accrued expenses in the accompanying consolidated balance sheets.

The valuation of the interest rate swaps and caps is determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The Company incorporates credit valuation adjustments (CVA) to appropriately reflect its own nonperformance risk and the respective counterparty s nonperformance risk. When assessing nonperformance risk, the Company has considered the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts, and guarantees.

Except for the CVA, all inputs used to measure fair value of the derivative financial instruments are Level 2 inputs. The Company has concluded that the inputs used to measure its CVA are Level 3 inputs. If the inputs used to measure fair value fall in different levels of the fair value hierarchy, the level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company assessed the impact of the CVA on the overall fair value of its derivative instruments and concluded that the CVA has a significant impact to the fair values as of March 31, 2011 and December 31, 2010. As of March 31, 2011 and December 31, 2010, all derivative liabilities are categorized as Level 3.

Derivatives in Cash Flow Hedging Relationships:

The Company s objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and caps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

The effective portion of changes in the fair value of derivatives in cash flow hedging relationships is recorded in accumulated OCL and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During the three months ended March 31, 2011 and 2010, such derivatives were used to hedge the variable cash flows associated with existing variable-rate debt. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

Amounts reported in accumulated OCL related to derivatives will be reclassified to interest expense as interest payments are made on the Company s variable-rate debt. During the next twelve months, the Company estimates that an additional $40,083,000 will be reclassified as an increase to interest expense.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of March 31, 2011, the Company had the following outstanding interest rate derivatives that were designated as cash flow hedges of interest rate risk:

Interest Rate Derivatives	Number of Instruments	Notional Amount (in thousands)
Interest rate swaps	8	$ 600,000
Interest rate swap	1	£ 74,160

At March 31, 2011 and December 31, 2010, the aggregate notional amount of the Company s domestic interest rate swaps designated as cash flows was $600,000,000 and $725,000,000, respectively. The Company s swaps have fixed pay rates against LIBOR ranging from 4.84% to 5.50% and maturity dates ranging from July 2012 to February 2016.

In addition, at March 31, 2011 and December 31, 2010, the Company had a GBP LIBOR interest rate swap agreement with a notional amount of £74,160,000 and £75,190,000, respectively. The swap has a current fixed pay rate against GBP LIBOR of 5.72% and a maturity date of October 2013.

Termination of Cash Flow Hedges

In February 2011, the Company paid $4,201,000 to terminate three interest rate swaps with a combined notional amount of $125,000,000. The interest rate swaps were originally entered into to hedge the Company s forecasted LIBOR-based debt. The Company concluded that it was probable that the originally forecasted levels of LIBOR-based debt would still occur; therefore, any amounts previously recorded in accumulated OCL related to these swaps will be reclassified into earnings over the life of the swap.

Derivatives Not Designated as Hedging Instruments:

Derivatives not designated as hedges are not speculative and are used to manage the Company s exposure to interest rate movements and other identified risks but do not meet the hedge accounting requirements. Changes in the fair value of derivatives not designated in hedging relationships are recorded directly in earnings. As of March 31, 2011, the Company had the following outstanding interest rate derivatives that were not designated as hedging instruments:

Interest Rate Derivatives	Number of Instruments	Notional Amount (in thousands)
Interest rate swap	1	$ 100,000
Interest rate caps	8	$ 585,750

During the second quarter of 2010, the Company de-designated one interest rate swap as a cash flow hedge with a notional amount of $100,000,000. The swap has a fixed pay rate against LIBOR of 4.96% and a maturity date of December 2014.

At March 31, 2011 and December 31, 2010, the aggregate notional amount of the Company s purchased and sold interest rate cap agreements was $585,750,000 and $594,750,000, respectively. These caps have LIBOR strike rates ranging from 6.00% to 7.50% and maturity dates ranging from September 2011 to March 2012.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fair Values of Derivative Instruments:

The table below presents the fair value of the Company s derivative financial instruments as well as their classification on the consolidated balance sheets as of March 31, 2011 and December 31, 2010 (in thousands):

		Fair Value as of	
	Balance Sheet Location	**March 31, 2011**	**December 31, 2010**
Derivatives in cash flow hedging relationships:			
Interest rate swaps (a)	Accounts payable and accrued expenses	$ (74,802)	$ (86,166)
Derivatives not designated as hedging instruments:			
Interest rate swap (a)	Accounts payable and accrued expenses	$ (11,084)	$ (12,164)
Interest rate caps	Accounts payable and accrued expenses	$ -	$ -

(a) This liability is based on an aggregate termination value of $(90,179,000) and $(105,657,000) excluding accrued interest and includes a CVA of $4,293,000 and $7,327,000 as of March 31, 2011 and December 31, 2010, respectively.

The Company does not have any fair value measurements using inputs based on quoted prices in active markets (Level 1 or Level 2) as of March 31, 2011 or December 31, 2010. The following table reflects changes in interest rate swap liabilities categorized as Level 3 for the three months ended March 31, 2011 and 2010 (in thousands):

Balance as of January 1, 2011	$ (98,330)
Interest rate swap transactions (b)	3,921
Unrealized gains	8,523
Balance as of March 31, 2011	$ (85,886)
Balance as of January 1, 2010	$ (63,755)
Interest rate swap transactions (c)	27,940
Unrealized losses	(29,505)
Balance as of March 31, 2010	$ (65,320)

(b) During the three months ended March 31, 2011, the Company paid transaction fees of $4,201,000, which includes accrued interest of $280,000, to terminate three interest rate swaps. Amounts existing in accumulated OCL will be reclassified into earnings over the life of the swaps.

(c) During the three months ended March 31, 2010, the Company paid transaction fees of $24,672,000 to buy down certain domestic interest rate swap fixed pay rates. The modified swaps had effective dates of February 15, 2010 and were designated as cash flow hedges at the time of the buy down transactions. The transaction fees were recorded in accumulated OCL. Amounts existing in accumulated OCL will be reclassified into earnings over the life of the swaps.

During the three months ended March 31, 2010, the Company paid $3,268,000 to buy down a EURIBOR interest rate swap fixed pay rate from 4.53% to 3.32% for the period from March 2010 through March 2015. The modified swap remained designated as a cash flow hedge and any amounts in accumulated OCL existing from the original transaction were reclassified into earnings over the life of the swap. On December 15, 2010, the Company sold the InterContinental Prague. The EURIBOR interest rate swap related to the hotel was assigned to the third party buyer as part of the transaction. Amounts related to this were eliminated from the Company s consolidated financial statements at the time the transaction closed.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Effect of Derivative Instruments on the Statements of Operations:

The tables below present the effect of the Company s derivative financial instruments on the statements of operations for the three months ended March 31, 2011 and 2010 (in thousands):

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Derivatives in Cash Flow Hedging Relationships		
Interest rate swaps:		
Effective portion of loss recognized in accumulated OCL	$ (712)	$ (35,796)
Effective portion of loss reclassified into interest expense continuing operations	$ (10,033)	$ (12,730)
Effective portion of loss reclassified into interest expense discontinued operations	$ -	$ (1,666)
Ineffective portion of (loss) gain recognized in interest expense continuing operations	$ (326)	$ 743
Ineffective portion of loss recognized in interest expense discontinued operations	$ -	$ (837)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Derivatives Not Designated as Hedging Instruments		
Interest rate swap:		
Mark to market gain recognized in interest expense	$ 95	$ -
Interest rate caps:		
Loss recognized in other income, net	$ (23)	$ (51)
Loss recognized in equity in losses of unconsolidated affiliates	$ (54)	$ (70)

Credit-risk-related Contingent Features:

The Company has agreements with each of its derivative counterparties that contain a provision where if the Company defaults and its indebtedness is accelerated or declared due or capable of being accelerated or declared due, then the Company could also be declared in default on its derivative obligations associated with the relevant indebtedness.

As of March 31, 2011, the termination value of derivatives in a net liability position, which includes accrued interest but excludes any CVA, related to these agreements was $(92,994,000). As of March 31, 2011, the Company has not posted any collateral related to these agreements. If the Company had breached any of these provisions at March 31, 2011, it would have been required to settle its obligations under the agreements at their termination value of $(92,994,000). The Company has not breached any of the provisions as of March 31, 2011.

10. SHARE-BASED EMPLOYEE COMPENSATION PLANS

On June 21, 2004, the Company adopted the 2004 Incentive Plan (the Plan). The Plan provided for the grant of equity-based awards in the form of, among others, Options, RSUs, and stock appreciation rights (SARs), which are collectively referred to as the Awards. On May 22, 2008, SHR s shareholders approved SHR s Amended and Restated 2004 Incentive Plan (the Amended Plan). The Amended Plan: (a) added units of SH Funding as an additional type of award (OP Units); (b) adjusted the number of authorized shares from 3,000,000 shares of SHR common stock to 4,200,000 shares of SHR common stock or OP Units; (c) limited the maximum term of Options and SARs to no more than 10 years and prohibited the repricing of Options and SARs; and (d) established minimum vesting periods for certain awards.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

RSUs:

The Company recorded compensation expense of $777,000 and $358,000 related to RSUs and performance-based RSUs (net of estimated forfeitures) for the three months ended March 31, 2011 and 2010, respectively. The compensation expense is recorded in corporate expenses on the accompanying condensed consolidated statements of operations. As of March 31, 2011, there was unrecognized compensation expense of $4,846,000 related to nonvested RSUs and $808,000 related to performance-based RSUs granted under the Amended Plan. That cost is expected to be recognized over a weighted average period of 2.47 years for nonvested RSUs and 0.75 year for performance-based RSUs.

Value Creation Plan:

On August 27, 2009, the Company adopted the Value Creation Plan to further align the interests and efforts of key employees to the interests of the Company s stockholders in creating stockholder value and providing key employees an added incentive to work towards the Company s growth and success. The Value Creation Plan provides for up to 2.5% of SHR s market capitalization (limited to a maximum market capitalization based on a common stock price of $20.00 per share) to be provided to participants in the Value Creation Plan in 2012 if the highest average closing price of SHR s common stock during certain consecutive twenty trading day periods in 2012 is at least $4.00 (Normal Distribution Amount). In addition, if a change of control occurs at any time prior to December 31, 2012, participants in the Value Creation Plan will generally not be entitled to the Normal Distribution Amount and will instead be entitled to receive 2.5% of SHR s market capitalization based on the value of a share of SHR s common stock upon the change of control (Change of Control Price), regardless of whether the Change of Control Price is at least $4.00 or greater than $20.00. A total of up to one million units (representing the opportunity to earn an amount equal to 2.5% of SHR s market capitalization) can be allocated under the Value Creation Plan to key employees. As of March 31, 2011, all one million units have been granted under the Value Creation Plan. Payments upon a unit of distribution may be made in cash, in shares of SHR s common stock (subject to approval by the stockholders of the Company), in some combination thereof or in any other manner approved by the committee of the board administering the Value Creation Plan.

The Company has accounted for the Value Creation Plan as a liability award and has recorded the liability in accounts payable and accrued expenses on the consolidated balance sheets. The fair value of the Value Creation Plan will be re-measured at the end of each reporting period, and the Company will make adjustments to the compensation expense and liability to reflect the fair value. The fair value of the liability at March 31, 2011 and December 31, 2010 was $21,903,000 and $12,722,000, respectively. The compensation expense recognized for the three months ended March 31, 2011 and 2010 was $9,181,000 and $506,000, respectively.

11. RELATED PARTY TRANSACTIONS

On August 16, 2007, the Company entered into a consulting agreement with Sir David M.C. Michels, a member of SHR s board of directors. On August 5, 2009, the Company and Mr. Michels agreed to terminate the consulting agreement. All prior grants made by the Company to Mr. Michels pursuant to the consulting agreement shall continue to vest provided the conditions to such vesting contained in the consulting agreement are satisfied. For the three months ended March 31, 2011 and 2010, the Company recognized expense of $15,000 and $25,000, respectively, in corporate expenses on the consolidated statements of operations, related to the consulting agreement.

12. COMMITMENTS AND CONTINGENCIES

Environmental Matters:

Generally, the properties acquired by the Company have been subjected to environmental reviews. While some of these assessments have led to further investigation and sampling, none of the environmental assessments have revealed, nor is the Company aware of any environmental liability that it believes would have a material adverse effect on its business or financial statements.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Litigation:

The Company is party to various claims and routine litigation arising in the ordinary course of business. Based on discussions with legal counsel, the Company does not believe that the results of these claims and litigation, individually or in the aggregate, will have a material adverse effect on its business or financial statements.

Letters of Credit:

As of March 31, 2011, the Company provided $500,000 in letters of credit related to its corporate office space lease and $2,000,000 in connection with the Four Seasons Mexico City hotel purchase and sale agreement to secure the indemnity obligations of the seller thereunder. On April 29, 2011, the letter of credit associated with the Four Seasons Mexico City transaction expired.

13. FAIR VALUE OF FINANCIAL INSTRUMENTS

As of March 31 2011 and December 31, 2010, the carrying amounts of certain financial instruments employed by the Company, including cash and cash equivalents, restricted cash and cash equivalents, accounts receivable, and accounts payable and accrued expenses were representative of their fair values because of the short-term maturity of these instruments.

At March 31, 2011 and December 31, 2010, the fair value of the fixed-rate mortgage and other debt approximated the carrying value of $319,226,000 and $317,750,000, respectively.

To calculate the estimated fair value of the variable-rate mortgage debt and bank credit facility as of March 31, 2011, the Company estimated that in the current market the spread over the applicable index (LIBOR or GBP LIBOR, as applicable) would be in the range of 300 to 600 basis points as compared to the current contractual spread as disclosed (see note 7). Using these estimated market spreads, the Company estimated the fair value of the variable-rate mortgage debt and bank credit facility to be approximately $17,000,000 to $41,000,000 lower than the total carrying value of $809,232,000. For every 100 basis point change in the assumed market spread, the corresponding change in the fair value of the total variable-rate debt would be approximately $8,000,000.

To calculate the estimated fair value of the variable-rate mortgage debt and bank credit facility as of December 31, 2010, the Company estimated that the market spread over the applicable index (LIBOR or GBP LIBOR, as applicable) would be in the range of 400 to 600 basis points as compared to the contractual spread as disclosed (see note 7). Using these estimated market spreads, the Company estimated the fair value of the variable-rate mortgage debt and bank credit facility to be approximately $31,000,000 to $50,000,000 lower than the total carrying value of $828,531,000. For every 100 basis point change in the assumed market spread, the corresponding change in the fair value of the total variable-rate debt would be approximately $10,000,000.

14. GEOGRAPHIC AND BUSINESS SEGMENT INFORMATION

The Company operates in one reportable business segment, hotel ownership. As of March 31, 2011, the Company s foreign operations (excluding discontinued operations) and long-lived assets (excluding assets held for sale) consisted of one Mexican hotel property, two Mexican development sites, a 31% interest in a Mexican unconsolidated affiliate, and two European properties, including a leasehold interest in a German hotel property.

STRATEGIC HOTELS & RESORTS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following tables present revenues (excluding unconsolidated affiliates and discontinued operations) and long-lived assets (excluding assets held for sale) for the geographical areas in which the Company operates (in thousands):

	Three Months Ended March 31,	
	2011	**2010**
Revenues:		
United States	$ 157,059	$ 133,514
Mexico	10,561	14,093
Europe	7,920	8,269
Total	$ 175,540	$ 155,876

	March 31, 2011	**December 31, 2010**
Long-lived Assets:		
United States	$ 1,708,341	$ 1,631,637
Mexico	171,864	173,050
Europe	107,073	103,743
Total	$ 1,987,278	$ 1,908,430

15. MANAGEMENT AGREEMENTS

The Company has amended terms of its management agreements with various hotel operators. Consideration resulting from these amendments, including amounts previously recognized as termination liabilities, are classified as deferred credits and will be recognized ratably in earnings (as an offset to management fee expense) over the expected remaining initial terms of the respective management agreements. At March 31, 2011 and December 31, 2010, deferred credits of $8,064,000 and $8,276,000, respectively, were included in accounts payable and accrued expenses on the consolidated balance sheets.

Asset Management Agreements

The Company has entered into asset management agreements with unaffiliated third parties to provide asset management services to four hotels not owned by the Company. On March 11, 2011, the Company purchased two of these hotels (see note 3) and terminated the respective asset management agreements. Under the remaining agreements, the Company earns base management fees and has the potential to earn additional incentive fees. The Company recognized fees of $138,000 and $100,000 for the three months ended March 31, 2011 and 2010, respectively, under these agreements, which are included in other income, net in the consolidated statements of operations.

16. SUBSEQUENT EVENT

On April 6, 2011, the Company sold its leasehold interest in the Paris Marriott hotel (see note 4).

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Note on Forward-Looking Statements

On one or more occasions, we may make statements regarding our assumptions, projections, expectations, targets, intentions or beliefs about future events. All statements other than statements of historical facts included or incorporated by reference in this Form 10-Q are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act).

Words or phrases such as anticipates, believes, estimates, expects, intends, may, plans, potential, predicts, projects, should, continue, will likely result or other comparable expressions or the negative of these words or phrases identify forward-looking statements. Forward-looking statements reflect our current views about future events and are subject to risks, uncertainties, assumptions and changes in circumstances that may cause actual results or outcomes to differ materially from those expressed in any forward-looking statement. We caution that while we make such statements in good faith and we believe such statements are based on reasonable assumptions, including without limitation, management s examination of historical operating trends, data contained in records and other data available from third parties, we cannot assure you that our projections will be achieved.

Some important factors that could cause actual results or outcomes for us to differ materially from these forward-looking statements are discussed in the cautionary statements contained in Exhibit 99.1 to this Form 10-Q, which are incorporated herein by reference. In assessing forward-looking statements contained herein, readers are urged to read carefully all cautionary statements contained in this Form 10-Q.

Overview

We were incorporated in Maryland in January 2004 to acquire and asset-manage upper upscale and luxury hotels (as defined by Smith Travel Research). Our accounting predecessor, Strategic Hotel Capital, L.L.C. (SHC LLC) was founded in 1997 by Laurence Geller, our president and chief executive officer, Goldman, Sachs & Co. s Whitehall Fund and others. We made an election to be taxed as a real estate investment trust (REIT) under the Sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the Tax Code). On June 29, 2004, we completed our initial public offering (IPO) of our common stock. Prior to the IPO, 21 hotel interests were owned by SHC LLC. Concurrent with and as part of the transactions relating to the IPO, a reverse spin-off distribution to shareholders separated SHC LLC into two companies, a new, privately-held SHC LLC, with interests, at that time, in seven hotels and Strategic Hotels & Resorts, Inc. (SHR), a public entity with interests, at that time, in 14 hotels. See Item 1. Financial Statements 1. General for the hotel interests owned by us as of March 31, 2011.

We operate as a self-administered and self-managed REIT, which means that we are managed by our board of directors and executive officers. A REIT is a legal entity that holds real estate interests and, through payments of dividends to stockholders, is permitted to reduce or avoid federal income taxes at the corporate level. To continue to qualify as a REIT, we cannot operate hotels; instead we employ internationally known hotel management companies to operate our hotels under management contracts. We conduct our operations through our direct and indirect subsidiaries including our operating partnership, Strategic Hotel Funding, L.L.C. (SH Funding), which currently holds substantially all of our assets. We are the managing member of SH Funding and hold approximately 99% of its membership units as of March 31, 2011. We manage all business aspects of SH Funding, including the sale and purchase of hotels, the investment in these hotels and the financing of SH Funding and its assets.

Throughout this Management s Discussion and Analysis of Financial Condition and Results of Operations section, references to we , our , and us are references to SHR together, except as the context otherwise requires, with its consolidated subsidiaries, including SH Funding (the Company).

When presenting the dollar equivalent amount for any amounts expressed in a foreign currency, the dollar equivalent amount has been computed based on the exchange rate on the date of the transaction or the exchange rate prevailing on March 31, 2011, as applicable, unless otherwise noted.

Key Indicators of Operating Performance

We evaluate the operating performance of our business using a variety of operating and other information that includes financial information prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) such as total revenues, operating income (loss), net income (loss), and earnings per share, as well as other non-GAAP financial information. In addition, we use other information that may not be financial in nature, including statistical information and comparative data. We use this information to measure the performance of individual hotels, groups of hotels, and/or our business as a whole. Key indicators that we evaluate include average daily occupancy, average daily rate (ADR), revenue per available room (RevPAR), and Total RevPAR, which are more fully discussed under Factors Affecting Our Results of Operations *Revenues.* We also evaluate Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), Comparable EBITDA, Funds from Operations (FFO), FFO-Fully Diluted, and Comparable FFO as supplemental measures to GAAP performance measures. We provide a more detailed discussion of the non-GAAP financial measures under Non-GAAP Financial Measures.

Outlook

We expect RevPAR and occupancy gains experienced in the latter part of 2010 and first quarter of 2011 to continue throughout 2011, driven by improved demand from both group and transient business. The lodging industry began its recovery near the end of the first quarter of 2010, after one of the worst downturns in its history. Luxury demand, in which our portfolio has the highest concentration of assets, has experienced positive RevPAR growth beginning with the week of February 20, 2010, following 96 consecutive weeks of negative RevPAR growth.

The first quarter of 2011 represented the fifth consecutive quarter of demand growth and fourth consecutive quarter of RevPAR growth and profit margin expansion for our North American portfolio. Excluding the hotels acquired this year, occupancy increased by 5.5 percentage points, driven by a 7.8% increase in group room nights and a 10.1% increase in transient room nights compared to the three months ended March 31, 2010. ADR at our hotels increased 2.7% in the quarter, primarily as a result of a 3.3% increase in group rate. We continued to see a more active corporate customer with corporate transient demand up 20.0% with a rate increase of 4.3%. For the quarter, RevPAR increased 11.9% and Total RevPAR increased 10.7%.

RevPAR growth at our European hotels was 2.9% in the first quarter of 2011, or 1.5% on constant U.S. dollars basis.

As we assess lodging supply/demand dynamics looking forward, we are optimistic about the prospects for a robust and sustained recovery, particularly in the markets where we own assets. Group bookings pace remains our best forward indicator of demand. Definite group room nights for 2011 are up 12.1% compared to the same time last year and are booked at 1.7% higher rates. New supply remains very well contained in our markets and the current significant gap between hotel trading values and replacement costs bodes favorably for very limited supply growth into the future.

During the lodging downturn we implemented hotel specific contingency plans designed to reduce costs and maximize efficiency at each hotel. These include, but are not limited to, adjusting variable labor, eliminating fixed labor, and reducing the hours of room service operations and other food and beverage outlets. We believe the cost structures of our hotels have been fundamentally redesigned to sustain many of the cost reductions, even during periods of rising lodging demand. Therefore, we are optimistic that improving lodging demand will lead to increases in average rate and drive significant profit margin expansion throughout our portfolio.

Factors Affecting Our Results of Operations

Acquisition and Sale of Interests in Hotel Properties.

On April 6, 2011, we sold our leasehold interest in the Paris Marriott hotel for consideration of 29.2 million ($41.6 million). As part of the transaction, we received 10.1 million ($14.5 million) of an additional 11.6 million ($16.6 million) owed related to the release of a security deposit and other closing adjustments for total proceeds of approximately 40.8 million ($58.2 million). This property s assets and liabilities have been classified as held for sale as of March 31, 2011 and December 31, 2010, and the results of operations for this property have been classified as discontinued operations for all periods presented.

On March 11, 2011, we acquired the Four Seasons Silicon Valley and the Four Seasons Jackson Hole hotels in exchange for an aggregate of 15.2 million shares of our common stock at a price of $6.08 per share based on our March 11, 2011 common share closing price, or approximately $92.4 million.

On February 4, 2011 we completed a recapitalization transaction that changed our ownership interest in the Hotel del Coronado. See Off-Balance Sheet Arrangements *Hotel and North Beach Ventures* for further description of this transaction.

On December 15, 2010, we sold the InterContinental Prague hotel for approximate consideration of 106.1 million ($141.4 million). The consideration included the assignment of the hotel s third party debt and the interest rate swap liability related to the third party indebtedness. Net proceeds from the sale, after prorations, were approximately $3.6 million. The results of operations for this property have been classified as discontinued operations for all periods presented.

Total Portfolio and Same Store Asset Definitions. We define our Total Portfolio as properties that we wholly or partially own or lease and whose operations are included in our consolidated operating results. The Total Portfolio excludes all sold properties and assets held for sale included in discontinued operations.

We present certain information about our hotel operating results on a comparable hotel basis, which we refer to as our Same Store analysis. We define our Same Store Assets as those hotels (a) that are owned or leased by us, and whose operations are included in our consolidated operating results and (b) for which we reported operating results throughout the entire reporting periods presented.

Our Same Store Assets for purposes of the comparison of the three months ended March 31, 2011 and 2010 exclude the Four Seasons Silicon Valley, the Four Seasons Jackson Hole, the Hotel del Coronado, which we account for using the equity method of accounting, and all sold properties and assets held for sale included in discontinued operations.

We present these Same Store Asset results because we believe that doing so provides useful information for evaluating the period-to-period performance of our hotels and facilitates comparisons with other hotel REITs and hotel owners. In particular, these measures assist in distinguishing whether increases or decreases in revenues and/or expenses are due to operations of the Same Store Assets or from acquisition or disposition activity.

Revenues. Substantially all of our revenue is derived from the operation of our hotels. Specifically, our revenue for the three months ended March 31, 2011 and 2010 consisted of:

	Total Portfolio		Same Store Assets	
	% of Total Revenues		% of Total Revenues	
	2011	2010	2011	2010
Revenues:				
Rooms	52.1%	51.9%	52.3%	51.9%
Food and beverage	35.8%	35.1%	36.0%	35.1%
Other hotel operating revenue	11.4%	12.2%	11.0%	12.2%
Lease revenue	0.7%	0.8%	0.7%	0.8%
Total revenues	100.0%	100.0%	100.0%	100.0%

Rooms revenue. Occupancy and ADR are the major drivers of rooms revenue.

Food and beverage revenue. Occupancy, local catering and banquet events are the major drivers of food and beverage revenue.

Other hotel operating revenue. Other hotel operating revenue consists primarily of cancellation fees, spa, telephone, parking, golf course, Internet access, space rentals, retail and other guest services and is also driven by occupancy.

Lease revenue. We sublease our interest in the Marriott Hamburg to a third party and earn annual base rent plus additional rent contingent on the hotel meeting performance thresholds.

Changes in our revenues are most easily explained by performance indicators that are used in the hotel real estate industry:

- average daily occupancy;
- ADR;
- RevPAR, which is the product of ADR and average daily occupancy, but does not capture food and beverage revenue or other hotel operating revenue; and
- Total RevPAR, which captures rooms revenue, food and beverage revenue and other hotel operating revenue.

We generate a significant portion of our revenue from two broad categories of customers, transient and group.

Our transient customers include individual or group business and leisure travelers that occupy less than 10 rooms per night. Transient customers accounted for approximately 53.5% and 53.0% of the rooms sold during the three months ended March 31, 2011 and 2010, respectively. We divide our transient customers into the following subcategories:

- Transient Leisure This category generates the highest room rates and includes travelers that receive published rates offered to the general public that do not have access to negotiated or discounted rates.
- Transient Negotiated This category includes travelers, who are typically associated with companies and organizations that generate high volumes of business, that receive negotiated rates that are lower than the published rates offered to the general public.

Our group customers include groups of 10 or more individuals that occupy 10 or more rooms per night. Group customers accounted for approximately 46.5% and 47.0% of the rooms sold during the three months ended March 31, 2011 and 2010, respectively. We divide our group customers into the following subcategories:

- Group Association This category includes group bookings related to national and regional association meetings and conventions.
- Group Corporate This category includes group bookings related to corporate business.
- Group Other This category generally includes group bookings related to social, military, education, religious, fraternal and youth and amateur sports teams.

Fluctuations in revenues, which, for our domestic hotels, tend to correlate with changes in the United States gross domestic product (U.S. GDP), are driven largely by general economic and local market conditions as well as general health and safety concerns, which in turn affect levels of business and leisure travel. Guest demographics also affect our revenues. The U.S. GDP continued to improve during the first quarter of 2011 leading to increased hotel demand over prior year. The increase in demand has come from both

our Transient and our Group categories. However, total demand is still well below levels reached before the recent economic downturn; therefore, the ADR for our hotels remains depressed.

In addition to economic conditions, supply is another important factor that can affect revenues. Room rates and occupancy tend to fall when supply increases unless the supply growth is offset by an equal or greater increase in demand. One reason we target upper upscale and luxury hotels in select urban and resort markets, including major business centers and leisure destinations, is because they tend to be in locations that have greater supply constraints such as lack of available land, high development costs, long development and entitlement lead times and brand trade area restrictions that prevent the addition of a certain brand or brands in close proximity. Nevertheless, our hotels are not insulated from competitive pressures and our hotel operators will lower room rates to compete more aggressively for guests in periods when occupancy declines.

For purposes of calculating our Total Portfolio RevPAR for the three months ended March 31, 2011 and 2010, we exclude unconsolidated affiliates, discontinued operations, and the Marriott Hamburg because we sublease the operations of the hotel and only record lease revenue. Same Store Assets RevPAR is calculated in the same manner as Total Portfolio RevPAR but also excludes the Four Seasons Silicon Valley and the Four Seasons Jackson Hole for the three months ended March 31, 2011. These methods for calculating RevPAR each period is consistently applied through the remainder of this Management s Discussion and Analysis of Financial Condition and Results of Operations and should be taken into consideration wherever RevPAR results are disclosed.

Hotel Operating Expenses. Our hotel operating expenses for the three months ended March 31, 2011 and 2010 consisted of the costs and expenses to provide hotel services, including:

	Total Portfolio % of Total Hotel Operating Expenses		Same Store Assets % of Total Hotel Operating Expenses	
	2011	**2010**	**2011**	**2010**
Hotel Operating Expenses:				
Rooms	18.7%	18.6%	18.9%	18.7%
Food and beverage	32.3%	30.7%	32.4%	30.8%
Other departmental expenses	35.6%	36.1%	35.6%	36.2%
Management fees	4.0%	4.4%	4.0%	4.4%
Other hotel expenses	9.4%	10.2%	9.1%	9.9%
Total hotel operating expenses	100.0%	100.0%	100.0%	100.0%

Rooms expense. Occupancy is a major driver of rooms expense, which has a significant correlation with rooms revenue.

Food and beverage expense. Occupancy, local catering and banquet events are the major drivers of food and beverage expense, which has a significant correlation with food and beverage revenue.

Other departmental expenses. Other departmental expenses consist of general and administrative, marketing, repairs and maintenance, utilities and expenses related to earning other operating revenue.

Management fees. We pay base and incentive management fees to our hotel operators. Base management fees are computed as a percentage of revenue. Incentive management fees are incurred when operating profits exceed levels prescribed in our management agreements.

Other hotel expenses. Other hotel expenses consist primarily of insurance costs and property taxes.

Salaries, wages and related benefits are included within the categories of hotel operating expenses described above and represented approximately 48.9% and 48.0% of the Total Portfolio total hotel operating expenses for the three months ended March 31, 2011 and 2010, respectively.

Most categories of variable operating expenses, such as utilities and certain labor such as housekeeping, fluctuate with changes in occupancy. Increases in RevPAR attributable to increases in occupancy are accompanied by increases in most categories of variable operating costs and expenses while increases in RevPAR attributable to increases in ADR typically only result in increases in limited categories of operating costs and expenses, such as management fees charged by our operators, which are based on hotel revenues. Thus, changes in ADR have a more significant impact on operating margins.

Lease expense. As a result of the sale and leaseback transactions applicable to the Marriott Hamburg hotel, we recorded lease expense in our statements of operations. In conjunction with the sale and leaseback transaction, we also recorded a deferred gain. Net lease expense includes an offset for the amortization of the deferred gain of $0.1 million for each of the three months ended March 31, 2011 and 2010.

Corporate expenses. Corporate expenses include payroll and related costs, professional fees, travel expenses and office rent.

Recent Events. In addition to the acquisition and sale of interests in hotel properties noted above, we expect that the following events will cause our future results of operations to differ from our historical performance:

Common Stock. On March 11, 2011, we issued 8.0 million shares of our common stock to an affiliate of the seller of the Four Seasons Silicon Valley and Four Seasons Jackson Hole hotels in a private placement at a price of $6.25 per share for approximate net proceeds of $49.7 million after expenses. These proceeds were used to repay existing indebtedness under the bank credit facility.

On May 19, 2010, we completed a public offering of 75.9 million shares of common stock at a price of $4.60 per share. After discounts, commissions, and expenses, we raised net proceeds of approximately $331.8 million. These proceeds were used to fund the cash tender offer of the 3.50% Exchangeable Senior Notes due 2012 (Exchangeable Notes) and repay existing indebtedness under the bank credit facility.

Amendment to Bank Credit Facility. On February 23, 2011, we exercised our option to extend the maturity date of the bank credit facility from March 9, 2011 to March 9, 2012 and entered into the fourth amendment to the bank credit facility. This amendment reduced the maximum facility size from $400.0 million to $350.0 million, increased our maximum availability based on the performance of the borrowing base properties, and decreased the maximum corporate leverage ratio, as defined in the loan agreement, from 80.0% to 70.0%. See Liquidity and Capital Resources for further detail regarding the bank credit facility.

Termination and De-Designation of Cash Flow Hedges. On February 11, 2011, we paid approximately $4.2 million to terminate three interest rate swaps with a combined notional amount of $125.0 million. Amounts previously recorded in accumulated OCL related to these swaps will be reclassified into earnings over the life of the swaps.

In May and June 2010, we paid approximately $7.2 million to terminate five interest rate swaps with a combined notional amount of $300.0 million. In addition, based on changes in the forecasted levels of LIBOR-based debt, we de-designated one interest rate swap as a cash flow hedge. Amounts previously recorded in accumulated OCL related to this swap will be reclassified into earnings over the life of the swap and subsequent changes in the market value of the interest swap will be recorded in earnings.

Sale of Interest in BuyEfficient. On January 21, 2011, we sold our 50.0% interest in BuyEfficient for $9.0 million and recognized a gain of $2.6 million.

Cash Tender Offer of Exchangeable Notes. On May 10, 2010, we announced a cash tender offer to purchase any and all of the Exchangeable Notes outstanding. On June 7, 2010, we completed the tender offer and accepted for purchase, at par, $180.0 million of the principal amount of our outstanding Exchangeable Notes. The aggregate consideration for the Exchangeable Notes accepted for purchase was approximately $181.2 million, which included accrued and unpaid interest of approximately $1.2 million.

Loan Modifications. On May 5, 2010, we refinanced the loans secured by the Fairmont Chicago and Westin St. Francis hotels. Prior to the refinancing, the two loans included a $220.0 million loan secured by the Westin St. Francis hotel and a $123.8 million loan secured by the Fairmont Chicago hotel. The refinanced loans are cross-collateralized with a total principal amount of $317.8 million, allocated $220.0 million to the Westin St. Francis and $97.8 million to the Fairmont Chicago. Principal of $26.0 million related to the Fairmont Chicago was repaid at the time of the refinancing. The loans were converted from LIBOR-based variable-rate loans to fixed-rate loans with interest payable monthly at an annual interest rate of 6.09%. The maturities of the loans have been extended until 2017.

Comparison of Three Months Ended March 31, 2011 to Three Months Ended March 31, 2010

Operating Results

The following table presents the operating results for the three months ended March 31, 2011 and 2010, including the amount and percentage change in these results between the two periods of our Total Portfolio and Same Store Assets (in thousands, except operating data).

	Total Portfolio				Same Store Assets			
	2011	2010	Change ($) Favorable/ (Unfavorable)	Change (%) Favorable/ (Unfavorable)	2011	2010	Change ($) Favorable/ (Unfavorable)	Change (%) Favorable/ (Unfavorable)
Revenues:								
Rooms	$ 91,470	$ 80,890	$ 10,580	13.1%	$ 89,631	$ 80,890	$ 8,741	10.8%
Food and beverage	62,882	54,699	8,183	15.0%	61,651	54,699	6,952	12.7%
Other hotel operating revenue	19,973	19,100	873	4.6%	18,824	19,100	(276)	(1.4)%
Lease revenue	1,215	1,187	28	2.4%	1,215	1,187	28	2.4%
Total revenues	175,540	155,876	19,664	12.6%	171,321	155,876	15,445	9.9%
Operating Costs and Expenses:								
Hotel operating expenses	142,439	129,691	(12,748)	(9.8)%	139,017	129,328	(9,689)	(7.5)%
Lease expense	1,196	1,195	(1)	(0.1)%	1,196	1,195	(1)	(0.1)%
Depreciation and amortization	30,605	34,043	3,438	10.1%	29,882	33,668	3,786	11.2%
Corporate expenses	14,477	6,060	(8,417)	(138.9)%	-	-	-	-
Total operating costs and expenses	188,717	170,989	(17,728)	(10.4)%	170,095	164,191	(5,904)	(3.6)%
Operating (loss) income	(13,177)	(15,113)	1,936	12.8%	$ 1,226	$ (8,315)	$ 9,541	114.7%
Interest expense, net	(19,516)	(21,355)	1,839	8.6%				
Equity in losses of unconsolidated affiliates	(1,600)	(560)	(1,040)	(185.7)%				
Foreign currency exchange gain (loss)	139	(451)	590	130.8%				
Other income, net	3,925	232	3,693	1,591.8%				
Loss before income taxes and discontinued operations	(30,229)	(37,247)	7,018	18.8%				
Income tax benefit	1,648	837	811	96.9%				
Loss from continuing operations	(28,581)	(36,410)	7,829	21.5%				
Income from discontinued operations, net of tax	162	1,799	(1,637)	(91.0)%				
Net loss	(28,419)	(34,611)	6,192	17.9%				
Net loss attributable to the noncontrolling interests in SHR s operating partnership	138	442	(304)	(68.8)%				
Net loss attributable to the noncontrolling interests in consolidated affiliates	595	1,599	(1,004)	(62.8)%				
Net loss attributable to SHR	$ (27,686)	$ (32,570)	$ 4,884	15.0%				
Reconciliation of Same Store Assets Operating Income (Loss) to Operating Loss:								
Same Store Assets operating income (loss)					$ 1,226	$ (8,315)	$ 9,541	114.7%

Corporate expenses			(14,477)	(6,060)	(8,417)	(138.9)%
Corporate depreciation and amortization			(369)	(375)	6	1.6%
Non-Same Store Assets operating income (loss)			443	(363)	806	222.0%
Operating loss			$ (13,177)	$ (15,113)	$ 1,936	12.8%
Operating Data (1):						
Number of hotels	16	14	14	14		
Number of rooms	7,005	6,681	6,681	6,681		

(1) Operating data includes the leasehold interest in the Marriott Hamburg and excludes unconsolidated affiliates and properties included in discontinued operations.

We entered into an agreement to sell our leasehold interest in the Paris Marriott hotel in the fourth quarter of 2010, and subsequently closed on the disposition on April 6, 2011, and have classified the hotel s assets and liabilities as held for sale. We sold the InterContinental Prague hotel during the fourth quarter of 2010. The results of operations for these sold hotels are included in income from discontinued operations, net of tax for the three months ended March 31, 2011 and 2010.

Rooms. For the Total Portfolio, rooms revenue increased $10.6 million, or 13.1%, for the three months ended March 31, 2011 from the three months ended March 31, 2010. RevPAR from our Total Portfolio for the three months ended March 31, 2011 increased by 11.8% from the three months ended March 31, 2010. The components of RevPAR from our Total Portfolio for the three months ended March 31, 2011 and 2010 are summarized as follows:

	Three Months Ended March 31,	
	2011	**2010**
Occupancy	66.22%	61.39%
ADR	$237.86	$229.59
RevPAR	$157.51	$140.94

The increase in Total Portfolio rooms revenue includes $1.9 million of additional rooms revenue generated by two newly acquired hotels, the Four Seasons Silicon Valley and the Four Seasons Jackson Hole. Our Same Store Assets contributed to an $8.7 million increase in rooms revenue, which is more fully explained below as part of our rooms revenue Same Store Assets analysis.

For the Same Store Assets, rooms revenue increased $8.7 million, or 10.8%. RevPAR from our Same Store Assets for the three months ended March 31, 2011 increased by 10.8% from the three months ended March 31, 2010. The components of RevPAR from our Same Store Assets for the three months ended March 31, 2011 and 2010 are summarized as follows:

	Three Months Ended March 31,	
	2011	**2010**
Occupancy	66.23%	61.39%
ADR	$235.79	$229.59
RevPAR	$156.17	$140.94

The 10.8% increase in RevPAR for the Same Store Assets resulted from the combination of a 2.7% increase in ADR and a 4.8 percentage-point increase in occupancy. Rooms revenue increased across most of our Same Store Assets for the three months ended March 31, 2011 when compared to the three months ended March 31, 2010 due to improving market conditions compared to the first quarter of 2010. Hotels that had significant increases in rooms revenue include the Fairmont Chicago, Hyatt Regency La Jolla, Westin St. Francis, and the InterContinental Chicago hotels, which had increases of 36.7%, 32.9%, 28.4%, and 24.8%, respectively. These hotels had higher group demand and improved ADR resulting from significant increases in corporate group demand and business generated by citywide events. The Four Seasons Punta Mita Resort was the only hotel that experienced a significant decrease in rooms revenue due to declining demand resulting from safety concerns in Mexico.

Food and Beverage. Food and beverage revenue increased $8.2 million, or 15.0%, for the Total Portfolio when comparing the three months ended March 31, 2011 to the three months ended March 31, 2010. The increase in Total Portfolio food and beverage revenue includes $1.2 million of additional revenue generated by the newly acquired Four Seasons Silicon Valley and Four Seasons Jackson Hole hotels and an increase of $7.0 million, or 12.7%, generated by the Same Store Assets. The primary factor increasing food and beverage revenue at the Same Store Assets was an increase in group occupancy, which generated higher banquet revenue when compared to prior year. In addition, the Four Seasons Washington, D.C. hotel had strong social catering demand and improved revenues at its restaurant, and the Westin St. Francis hotel had increased revenues resulting from a change in the terms of a restaurant agreement.

Hotel Operating Expenses. The following table presents the components of our hotel operating expenses for the three months ended March 31, 2011 and 2010, including the amount and percentage changes in these expenses between the two periods (in thousands):

	Total Portfolio				Same Store Assets			
	2011	2010	Change($) Favorable/ (Unfavorable)	Change (%) Favorable/ (Unfavorable)	2011	2010	Change($) Favorable/ (Unfavorable)	Change (%) Favorable/ (Unfavorable)
Hotel operating expenses:								
Rooms	$ 26,627	$ 24,161	$ (2,466)	(10.2)%	$ 26,129	$ 24,161	$ (1,968)	(8.1)%
Food and beverage	46,007	39,805	(6,202)	(15.6)%	45,092	39,805	(5,287)	(13.3)%
Other departmental expenses	50,673	46,825	(3,848)	(8.2)%	49,488	46,825	(2,663)	(5.7)%
Management fees	5,774	5,672	(102)	(1.8)%	5,627	5,672	45	0.8%
Other hotel expenses	13,358	13,228	(130)	(1.0)%	12,681	12,865	184	1.4%
Total hotel operating expenses	$ 142,439	$ 129,691	$ (12,748)	(9.8)%	$ 139,017	$ 129,328	$ (9,689)	(7.5)%

For the Total Portfolio, hotel operating expenses increased by $12.7 million, or 9.8%, which includes approximately $3.1 million of expenses related to the newly acquired Four Seasons Silicon Valley and Four Seasons Jackson Hole hotels and an increase of $9.7 million, or 7.5%, related to the hotel operating expenses of the Same Store Assets. For the Same Store Assets, hotel operating expense were impacted by $5.7 million higher payroll costs resulting from higher occupancy at the hotels; $1.6 million higher food and beverage costs due to increased food and beverage consumption and the change in terms of a restaurant agreement at the Westin St. Francis; and $0.7 million higher credit card and travel agent commissions, which increased due to higher occupancy and rates.

Depreciation and Amortization. For the Total Portfolio, depreciation and amortization decreased $3.4 million, or 10.1%, for the three months ended March 31, 2011 when compared to the three months ended March 31, 2010. There was a decrease in depreciation expense of $3.8 million for the Same Store Assets, which was offset by $0.4 million increase in depreciation expense due to newly acquired hotels. Depreciation was lower for the Same Store Assets due to certain furniture, fixtures and equipment balances becoming fully depreciated in late 2010. In addition, in the fourth quarter of 2010, we impaired certain assets at the Fairmont Scottsdale hotel, which has decreased depreciation expense at that hotel subsequent to the impairment.

Corporate Expenses. Corporate expenses increased $8.4 million, or 138.9%, for the three months ended March 31, 2011 when compared to the same period in 2010. These expenses consist primarily of payroll and related costs, professional fees, travel expenses and office rent. The increase in corporate expenses is due to an $8.7 million increase in the charge related to the Value Creation Plan. See Item 1. Financial Statements 10. Share-Based Employee Compensation Plans Value Creation Plan for further description of this plan. This expense is directly related to our market capitalization and increased during the quarter as a result of continued volatility in our stock price and the issuance of 23.2 million shares of our common stock. Corporate expenses also increased by $1.1 million due to costs related to the recapitalization of the Hotel del Coronado and the acquisition of the Four Seasons Silicon Valley and Four Seasons Jackson Hole hotels. These increases were partially offset by decreases in salaries and wages, which primarily relates to a non-recurring severance payment in 2010.

Interest Expense, Net. The $1.8 million, or 8.6%, decrease in interest expense, net for the three months ended March 31, 2011 when compared to the three months ended March 31, 2010 was primarily due to:

a $6.9 million decrease attributable to lower average borrowings,

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a $3.6 million decrease in expense related to the mark to market of certain interest rate swaps,

a $0.5 million decrease in the amortization of deferred financing costs, and

a $0.1 million increase in capitalized interest, partially offset by

a $9.2 million increase due to the net impact of higher average interest rates offset by a decrease in amortization of interest rate swap costs, and

a $0.1 million decrease in interest income.

The components of interest expense, net for the three months ended March 31, 2011 and 2010 are summarized as follows (in thousands):

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Mortgages and other debt	$ (16,874)	$ (8,127)
Bank credit facility	(862)	(2,138)
Exchangeable Notes	-	(1,575)
Amortization of Exchangeable Notes discount	-	(1,106)
Amortization of deferred financing costs	(1,280)	(1,811)
Amortization of interest rate swap costs	(5,130)	(7,625)
Mark to market of certain interest rate swaps	4,366	731
Interest income	32	151
Capitalized interest	232	145
Total interest expense, net	$ (19,516)	$ (21,355)

The weighted average debt outstanding for the three months ended March 31, 2011 and 2010 amounted to $1.2 billion and $1.5 billion, respectively. At March 31, 2011, including the effect of interest rate swaps, approximately 100.0% of our total debt had fixed interest rates.

Equity in Losses of Unconsolidated Affiliates. The following tables present equity in losses and certain components included in the calculation of equity in losses resulting from our unconsolidated affiliates.

Three months ended March 31, 2011 (in thousands):

	New Hotel Venture (1)	Hotel / North Beach Ventures (2)	Four Seasons RCPM	Total
Equity in (losses) earnings	$ (1,161)	$ (511)	$ 72	$ (1,600)
Depreciation and amortization	1,272	544	23	1,839
Interest expense	1,797	778	26	2,601
Income tax (benefit) expense	92	(669)	27	(550)

Three months ended March 31, 2010 (in thousands):

	Hotel / North Beach Venture	Four Seasons RCPM	BuyEfficient (3)	Total
Equity in (losses) earnings	$ (861)	$ 181	$ 120	$ (560)
Depreciation and amortization	1,991	14	-	2,005
Interest expense	1,844	22	-	1,866
Income tax (benefit) expense	(537)	68	-	(469)

(1) The New Hotel Venture is BSK Del Partners, L.P., the owner of the Hotel del Coronado as of February 4, 2011. See - Off-Balance Sheet Arrangements - *Hotel and North Beach Ventures* for further detail regarding the ownership of the Hotel del Coronado.

(2) These ventures include SHC KSL Partners, LP (Hotel Venture), the owner of the Hotel del Coronado through February 3, 2011, and HdC North Beach Development, LLLP (North Beach Venture), the owner of a residential condominium-hotel development adjacent to the hotel. See - Off-Balance Sheet Arrangements *Hotel and North Beach Ventures* for further detail regarding the ownership of the Hotel del Coronado.

(3) On January 21, 2011, we sold our 50.0% interest in BuyEfficient for $9.0 million.

We recorded $1.6 million of equity in losses during the three months ended March 31, 2011, which is a $1.0 million increase in losses from the $0.6 million equity in losses recorded during the three months ended March 31, 2010. The increase in losses is primarily due to legal costs incurred as part of the Hotel del Coronado recapitalization, a higher interest rate on the new loan secured as part of the recapitalization, and the sale of BuyEfficient.

Foreign Currency Exchange Gain (Loss). We recorded a foreign currency exchange gain of $0.1 million during the three months ended March 31, 2011, which is a $0.6 million increase from the $0.5 million foreign currency exchange loss recorded in the same period in the prior year. The change was primarily related to changing foreign exchange rates related to a GBP-denominated loan associated with the Marriott London Grosvenor Square and working capital at certain foreign hotel properties.

Other Income, Net. Other income, net includes asset management fee income, non-income related state, local and franchise taxes, as well as miscellaneous income and expenses. The increase in income of $3.7 million for the three months ended March 31, 2011 when compared to the prior year is primarily due to a $2.6 million gain we recognized on the sale of our interest in BuyEfficient and $1.3 million in financing and other fees we received related to the Hotel del Coronado.

Income Tax Benefit. Our income tax benefit increased to $1.6 million during the three months ended March 31, 2011 from $0.8 million during the three months ended March 31, 2010. The change in income taxes primarily relates to a decrease in current tax expense at the Four Seasons Punta Mita Resort resulting from a decline in earnings at the hotel.

Income from Discontinued Operations, Net of Tax. We entered into an agreement to sell our leasehold interest in the Paris Marriott hotel in the fourth quarter of 2010 and have classified the hotel s assets and liabilities as held for sale. We sold the InterContinental Prague hotel during the fourth quarter of 2010. The results of operations of these hotels were reclassified as discontinued operations for the periods presented.

The income from discontinued operations, net of tax of $0.2 million for the three months ended March 31, 2011 consisted of the operating results of the Paris Marriott hotel and a $0.3 million state tax refund related to the Hyatt Regency Phoenix hotel, which we sold in 2008. The income from discontinued operations, net of tax, of $1.8 million for the three months ended March 31, 2010 primarily consisted of the operating results of the Paris Marriott and the InterContinental Prague hotels.

Net Loss Attributable to the Noncontrolling Interests in SHR s Operating Partnership. We record net loss or income attributable to noncontrolling interests in SHR s operating partnership based on the percentage of SH Funding we do not own. Net loss attributable to noncontrolling interests in SHR s operating partnership decreased by $0.3 million when compared to prior year. This change was due to the decrease in net loss recognized during the three months ended March 31, 2011 when compared to the three months ended March 31, 2010. Additionally, our ownership percentage of SH Funding increased when compared to prior year due to the issuance of shares of common stock for the acquisition of the Four Seasons Silicon Valley and Four Seasons Jackson Hole hotels in March 2011 and for common stock offerings in March 2011 and May 2010.

Net Loss Attributable to the Noncontrolling Interests in Consolidated Affiliates. We record net loss or income attributable to noncontrolling interests in consolidated affiliates for the non-ownership interests in hotels that are partially owned by us. Net loss attributable to noncontrolling interests in consolidated affiliates decreased by $1.0 million for the three months ended March 31, 2011 when compared to the same period in the prior year due to lower combined net losses of our consolidated affiliates.

Liquidity and Capital Resources

Our short-term liquidity requirements consist primarily of funds necessary to pay for operating expenses and other expenditures. Historically, we have satisfied our short-term liquidity requirements through our existing working capital, cash provided by operations, and our bank credit facility. On February 23, 2011, we exercised our option to extend the maturity date of the bank credit facility to March 9, 2012 and entered into the fourth amendment to our bank credit facility. This fourth amendment decreased the size of the facility from $400.0 million to $350.0 million but increased our maximum availability under the bank credit facility due to changes in financial calculations and continues to provide sufficient borrowing capacity to meet our short-term liquidity requirements during 2011. As of March 31, 2011, we were in compliance with our financial and other restrictive covenants contained in the bank credit facility.

Our available capacity under the bank credit facility and compliance with financial covenants in future periods will depend substantially on the financial results of our hotels, and in particular, the operating results and appraised values of the borrowing base assets, which include the Four Seasons Punta Mita Resort, the Four Seasons Washington, D.C., the Marriott Lincolnshire, and the Ritz-Carlton Laguna Niguel hotels. As of May 5, 2011, the outstanding borrowings and letters of credit in the aggregate were $0.5 million.

In the second quarter of 2010, we completed a common stock offering and raised net proceeds of approximately $331.8 million. These proceeds were used to fund our tender offer for Exchangeable Notes and repay existing indebtedness under the bank credit facility. In the fourth quarter of 2010, we sold the InterContinental Prague for net sales proceeds of $3.6 million, in which the buyer assumed the mortgage debt and related interest rate swap liability. On March 11, 2011 we acquired the Four Seasons Silicon Valley and the Four Seasons Jackson Hole hotels in exchange for an aggregate of 15.2 million shares of our common stock at a price of $6.08 per share based on our March 11, 2011 common share closing price and concurrently privately placed and issued an additional 8.0 million shares of our stock to an affiliate of the seller of the two hotels at a price of $6.25 per share. The proceeds from the concurrent private placement were used to repay existing indebtedness under the bank credit facility. On April 6, 2011, we sold our leasehold interest in the Paris Marriott hotel for consideration of 29.2 million ($41.6 million) and received an additional 10.1 million ($14.5 million) related to a security deposit that was released back to us and other closing adjustments. We expect to receive an additional 1.5 million ($2.1 million) within six months of the close date. We believe that the measures we have taken as described above should be sufficient to satisfy our liquidity needs for the next 12 months.

In February 2009, our board of directors elected to suspend the quarterly dividend to holders of Series A, B and C Cumulative Redeemable Preferred Stock as a measure to preserve liquidity. Factors contributing to this decision were the declining economic environment for hotel operations, no projected taxable distribution requirement for 2009 under the REIT rules, and uncertainty regarding operating cash flows in 2009. Elimination of preferred dividends equates to approximately $7.7 million in cash flow savings each quarter. In November 2008, our board of directors elected to suspend the quarterly dividend to holders of shares of our common stock beginning in the fourth quarter of 2008. As of March 31, 2011, unpaid cumulative dividends totaled $69.5 million.

Capital expenditures for the three months ended March 31, 2011 and 2010 amounted to $9.6 million and $7.7 million, respectively. Included in the 2011 and 2010 amounts were $0.2 million and $0.1 million of capitalized interest, respectively. For the remainder of the year ended December 31, 2011, we expect to spend approximately $40.7 million on hotel property and equipment replacement projects in accordance with hotel management or lease agreements and up to approximately $16.4 million on owner-funded projects.

Bank credit facility. On February 23, 2011, we exercised our option to extend the maturity date of the bank credit facility to March 9, 2012 and entered into the fourth amendment to our bank credit facility. The following summarizes key financial terms and conditions of the bank credit facility, as amended:

- the maximum facility size was reduced to $350.0 million from $400.0 million;

- maximum availability is now determined by the lesser of 1.2 times (previously 1.3 times) debt service coverage on the borrowing base assets (based on the trailing 12 months net operating income for these assets divided by a 7.0% (previously 8.0%) debt constant on the balance outstanding under the bank credit facility, as defined in the loan agreement) or a 55.0% (previously 45.0%) advance rate against the appraised value of the borrowing base assets; and

- maximum corporate leverage, as defined in the loan agreement, decreased to 70.0% from 80.0%.

Prior to the fourth amendment in February 2011, we entered into the third amendment to our bank credit facility in February 2009. The following summarizes key financial terms and conditions of the bank credit facility that were not impacted by the fourth amendment mentioned above:

- interest rate on the facility is LIBOR plus a margin of 3.75% in the case of each LIBOR loan and base rate plus a margin of 2.75% in the case of each base rate loan and a commitment fee of 0.50% per annum based on the unused revolver balance;

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

- minimum corporate fixed charge coverage of 1.15 times;

- minimum tangible net worth, as defined in the agreement, of $600.0 million, excluding goodwill and currency translation adjustments;

- default in payment, when due, of indebtedness of the consolidated group (other than with respect to certain non-domestic entities which do not own property in North America) in excess of $25.0 million, or a default which has the effect of causing such indebtedness to become due or payable prior to maturity, would be an event of default; and

- restrictions on our ability to pay dividends. Such restrictions include:

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

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

Notwithstanding the dividend restriction described above, for so long as the Company qualifies, or has taken all other actions necessary to qualify as a REIT, SH Funding may authorize, declare and pay quarterly cash dividends to the Company when and to the extent necessary for the Company to distribute cash dividends to its shareholders generally in an aggregate amount not to exceed the minimum amount necessary for the Company to maintain its tax status as a REIT, unless SH Funding receives notice of any monetary event of default or other material event of default.

Other terms and conditions exist including provisions to release assets from the borrowing base and limitations on our ability to incur costs for discretionary capital programs. Under the agreement, SH Funding has a letter of credit sub-facility of $75.0 million, which is secured by the bank credit facility. Letters of credit reduce the borrowing capacity under the facility.

Mortgages and other debt payable. The following table summarizes our outstanding debt and scheduled maturities, related to mortgages and other debt payable as of March 31, 2011, excluding amounts outstanding under the back credit facility (in thousands):

	Balance as of March 31, 2011	Remainder of 2011	2012	2013	2014	2015	Thereafter
Mortgages payable							
Fairmont Scottsdale, LIBOR plus 0.56% (1)	$ 180,000	$ 180,000	$ -	$ -	$ -	$ -	$ -
InterContinental Chicago, LIBOR plus 1.06% (1)	121,000	121,000	-	-	-	-	-
InterContinental Miami, LIBOR plus 0.73% (1)	90,000	90,000	-	-	-	-	-
Loews Santa Monica Beach Hotel, LIBOR plus 0.63%	118,250	-	118,250	-	-	-	-
Ritz-Carlton Half Moon Bay, LIBOR plus 0.67%	76,500	-	76,500	-	-	-	-
Hyatt Regency La Jolla, LIBOR plus 1.00%	97,500	-	97,500	-	-	-	-
Marriott London Grosvenor Square, 3-month GBP LIBOR plus 1.10% (2)	118,982	1,653	3,305	114,024	-	-	-
Fairmont Chicago, 6.09% (2)	97,750	-	2,583	2,745	2,917	3,099	86,406
Westin St. Francis, 6.09% (2)	220,000	-	5,814	6,178	6,564	6,976	194,468
Total mortgages payable	1,119,982	392,653	303,952	122,947	9,481	10,075	280,874
Other debt (3)	1,476	-	-	1,476	-	-	-
Total mortgages and other debt payable	$ 1,121,458	$ 392,653	$ 303,952	$ 124,423	$ 9,481	$ 10,075	$ 280,874

(1) We are currently working to restructure, refinance or extend these loans.

(2) These loan agreements require maintenance of financial covenants, all of which we were in compliance with at March 31, 2011.

(3) The North Beach Venture (see Off-Balance Sheet Arrangements) assumed the mortgage loan on a hotel-condominium unit, which accrues interest at an annual fixed rate of 5.0% and is secured by the hotel-condominium unit.

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

Historically, we have satisfied our long-term liquidity requirements through various sources of capital, including our existing working capital, cash provided by operations, sales of properties, long-term property mortgage indebtedness, bank credit facilities, issuance of senior unsecured debt instruments and through the issuance of additional equity securities. Credit markets have improved and access to mortgage and corporate level debt is more readily available. However, the capital markets continue to be fragile and there are no guarantees our maturing debt will be readily refinanced. Our ability to raise funds through the issuance of equity securities is dependent upon, among other things, general market conditions for both REITs in general and us specifically, including market perceptions regarding the Company.

On May 19, 2010, we completed a public offering of 75.9 million shares of common stock at a price of $4.60 per share and raised net proceeds of approximately $331.8 million. In addition, on March 11, 2011, we issued 8.0 million shares of common stock in a private placement at a price of $6.25 per share and raised net proceeds of approximately $49.7 million and concurrently issued 15.2 million shares of common stock at an issuance price of $6.08 based on our March 11, 2011 common share closing price to acquire the Four Seasons Silicon Valley and Four Seasons Jackson Hole hotels for $92.4 million. We will continue to analyze which source of capital is most advantageous to us at any particular point in time, but equity and debt financing may not be consistently available to us on terms that are attractive or at all.

Equity Securities

As of March 31, 2011, we had 1,670,348 RSUs outstanding, of which 436,611 were vested. In addition, we had 669,797 options to purchase shares of SHR common stock (Options) outstanding.

The following table presents the changes in our issued and outstanding shares of common stock and operating partnership units (OP Units) since December 31, 2010 (excluding RSUs):

	Common Shares	OP Units Represented by Noncontrolling Interests	Total
Outstanding at December 31, 2010	151,305,314	954,571	152,259,885
RSUs redeemed for shares of our common stock	192,243	-	192,243
OP Units redeemed for shares of our common stock	101,110	(101,110)	-
Common stock issued	23,200,000	-	23,200,000
Outstanding at March 31, 2011	174,798,667	853,461	175,652,128

Cash Flows

Operating Activities. Net cash provided by operating activities was $3.7 million for the three months ended March 31, 2011 compared to $11.1 million for the three months ended March 31, 2010. Cash flows from operations decreased from 2010 to 2011 primarily due to working capital changes.

Investing Activities. Net cash used in investing activities was $40.1 million for the three months ended March 31, 2011 compared to $12.6 million for the three months ended March 31, 2010. The significant investing activities during these periods are summarized below:

We sold our 50.0% interest in BuyEfficient for $9.0 million during the three months ended March 31, 2011.

We paid $57.4 million related to the recapitalization of the Hotel and North Beach Ventures during the three months ended March 31, 2011.

We acquired unrestricted cash of $30.6 million through the recapitalization of the Hotel and North Beach Ventures and acquisition of the Four Seasons Silicon Valley and Four Seasons Jackson Hole during the three months ended March 31, 2011.

We disbursed $9.6 million and $7.7 million during the three months ended March 31, 2011 and 2010, respectively, for capital expenditures primarily related to room renovations and food and beverage facilities.

Financing Activities. Net cash provided by financing activities was $21.6 million for the three months ended March 31, 2011 compared to net cash used in financing activities of $16.0 million for the three months ended March 31, 2010. The significant financing activities during these periods are summarized below:

We received proceeds from a common stock offering, net of offering costs of approximately $49.7 million during the three months ended March 31, 2011.

During the three months ended March 31, 2011, we made net payments of $21.0 million under our bank credit facility. During the three months ended March 31, 2010, we had net borrowings of $17.0 million under our bank credit facility.

During the three months ended March 31, 2011 and 2010, we made payments of $1.6 million and $4.9 million, respectively, on mortgages and other debt.

We paid $3.9 million and $27.9 million to terminate and buy down interest rate swaps during the three months ended March 31, 2011 and 2010, respectively.

Dividend Policy

We generally intend to distribute each year substantially all of our taxable income (which does not necessarily equal net income as calculated in accordance with GAAP) to our shareholders so as to comply with REIT provisions of the Tax Code. If necessary for REIT qualification purposes, we may need to distribute any taxable income in cash or by a special dividend. Our dividend policy is subject to revision at the discretion of our board of directors. All distributions will be made at the discretion of our board of directors and will depend on our taxable income, our financial condition, our maintenance of REIT status and other factors as our board of directors deems relevant.

For the three months ended March 31, 2011, our board of directors has continued the suspension of the quarterly dividend to holders of shares of our common and preferred stock as a measure to preserve liquidity due to the economic environment for hotel operations, no projected taxable distribution requirement and pending debt maturities. Based on our current forecasts, we would not be required to make any distributions during 2011 in order to maintain our REIT status. The board of directors will continue to evaluate the dividend policy in light of the REIT provisions of the Tax Code, restrictions under the bank credit facility, and the economic climate.

Contractual Obligations

The following table summarizes our future payment obligations and commitments as of March 31, 2011 (in thousands):

	Payments Due by Period				
	Total	Less than 1 year [1]	1 to 3 years	4 to 5 years	More than 5 years
Long-term debt obligations [2]	$ 1,128,458	$ 392,653	$ 444,856	$ 20,781	$ 270,168
Interest on long-term debt obligations [3]	261,780	51,925	156,280	46,767	6,808
Operating lease obligations ground leases and office space	9,878	503	2,101	1,478	5,796
Operating leases Marriott Hamburg	99,703	3,885	15,538	10,359	69,921
Construction contracts	8,440	8,440	-	-	-
Total	$ 1,508,259	$ 457,406	$ 618,775	$ 79,385	$ 352,693

(1) These amounts represent obligations that are due within fiscal year 2011.
(2) Long-term debt obligations include our mortgages and other debt and bank credit facility.
(3) Interest on variable-rate debt obligations is calculated based on the variable rates at March 31, 2011 and includes the effect of our interest rate swaps.

Reserve Funds for Capital Expenditures

We maintain each of our hotels in excellent condition and in conformity with applicable laws and regulations and in accordance with the agreed upon requirements in our management agreements with our preferred operators.

We are obligated to maintain reserve funds for capital expenditures at the majority of our hotels (including the periodic replacement or refurbishment of furniture, fixtures and equipment) as determined pursuant to the management agreements with our preferred operators. As of March 31, 2011, $16.7 million was in restricted cash reserves for future capital expenditures. Generally, our agreements with hotel operators require us to reserve funds at amounts ranging between 4.0% and 5.0% of the individual hotel s annual revenues and require the funds to be set aside in restricted cash. Expenditures are capitalized as incurred and depreciation begins when the related asset is placed in service. Any unexpended amounts will remain our property upon termination of the management and operating contracts.

Off-Balance Sheet Arrangements

Hotel and North Beach Ventures

Prior to February 4, 2011, we had 45.0% ownership interests in the Hotel Venture, the then owner of the Hotel del Coronado in San Diego, California, and the North Beach Venture, the owner of an adjacent residential condominium-hotel development. We accounted for our investments in the Hotel and North Beach Ventures under the equity method of accounting. Our investment in the Hotel and North Beach Ventures amounted to $7.8 million as of December 31, 2010. We recognized equity in losses related to the Hotel and North Beach Ventures of $0.5 million for the period from January 1, 2011 through February 3, 2011 and $0.9 million for the three months ended March 31, 2010. We earned asset management, development and financing fees under agreements with the Hotel and North Beach Ventures. We recognized income of 55.0% of these fees, representing the percentage of the Hotel and North Beach Ventures not owned by us.

The Hotel Venture obtained $610.0 million of non-recourse mortgage and mezzanine debt financings and a $20.0 million non-recourse revolving credit facility, which were secured by, among other things, a mortgage on the Hotel del Coronado. In December 2010, the Hotel Venture purchased a $37.5 million mezzanine layer of the debt structure for a discounted payoff of $13.0 million. The remaining principal on the mortgage and mezzanine debt financings and revolving credit facility had a maturity date of January 7,

2011. On January 7, 2011, the Hotel Venture obtained an extension of the maturity date to February 9, 2011.

On February 4, 2011, the Hotel and North Beach Ventures completed a recapitalization (the Transaction) through a series of contemporaneous transactions. Under the terms of the Transaction, we acquired the ownership interest of an existing member of the Hotel and North Beach Ventures, and, along with the remaining members of the Hotel Venture, formed a partnership, BSK Del Partners, L.P. (New Hotel Venture) with an unaffiliated third party, an affiliate of Blackstone Real Estate Advisors VI L.P. (Blackstone), to own the Hotel del Coronado. As part of the Transaction, we contributed $57.4 million of cash drawn from our bank credit facility to fund our contribution. This payment included the purchase of the existing member s ownership in the Hotel and North Beach Ventures and is net of a $1.7 million financing fee earned as part of the Transaction. The Hotel Venture contributed substantially all of the assets and liabilities to the New Hotel Venture. The New Hotel Venture then settled all contributed debts outstanding by paying balances off in full or agreeing to convert debt to equity. In connection with the Transaction, we also acquired our partner s interest in HdC DC Corporation, a taxable corporation, with assets of $25.6 million and an existing deferred tax liability of approximately $48.6 million. As a result of the Transaction, we recorded an equity method investment of $97.6 million. Pursuant to the terms of the Transaction, Blackstone will be the general partner of the New Hotel Venture with a 60.0% ownership interest and we will be a limited partner with an indirect 34.3% ownership interest. Our investment in the New Hotel Venture amounted to $96.5 million as of March 31, 2011. Our equity in losses of the New Hotel Venture was $1.2 million for the three months ended March 31, 2011.

The New Hotel Venture secured $425.0 million of five-year debt financing at a weighted average rate of LIBOR plus 480 basis points, subject to a 1.0% LIBOR floor. After the third year of the loan, the final two one-year extensions require payment to the lender of a 25 basis point extension fee. Additionally, the New Hotel Venture purchased a two-year 2.0% LIBOR cap, which was required by the loan.

We continue to act as asset manager and earn a quarterly asset management fee equal to 1.0% of gross revenue, certain development fees, and when applicable, an incentive fee equal to one-third of the incentive fee paid to the hotel operator under the hotel management agreement. As part of the New Hotel Venture with Blackstone, the remaining members of the Hotel Venture will earn a profit-based incentive fee of 20.0% of all distributions of the New Hotel Venture that exceed both a 20.0% internal rate of return and two times return on invested equity.

Four Seasons RCPM

We own a 31.0% interest in and act as asset manager for a venture with two unaffiliated parties that is developing the Four Seasons RCPM, a luxury vacation home product sold in fractional ownership interests on the property adjacent to our Four Seasons Punta Mita Resort hotel in Mexico. We account for this investment under the equity method of accounting. At March 31, 2011and December 31, 2010, our investment in the unconsolidated affiliate amounted to $4.0 million. Our equity in earnings of the unconsolidated affiliate was $0.1 million and $0.2 million for the three months ended March 31, 2011 and 2010, respectively.

BuyEfficient

We owned a 50.0% interest in an electronic purchasing platform venture called BuyEfficient with an unaffiliated third party. This platform allows members to procure food, operating supplies, furniture, fixtures and equipment. We accounted for this investment under the equity method of accounting. At December 31, 2010, our investment in the unconsolidated affiliate amounted to $6.3 million. Our equity in earnings of the unconsolidated affiliate was $0.1 million for the three months ended March 31, 2010. On January 21, 2011, we sold our 50.0% interest in this venture for $9.0 million.

Related Party Transactions

We have in the past engaged in and currently engage in transactions with related parties. See Item 1. Financial Statements 11. Related Party Transactions for a discussion of our transactions with related parties.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities.

We evaluate our estimates on an ongoing basis. We base our estimates on historical experience, information that is currently available to us and on various other assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect the most significant judgments and estimates used in the preparation of our consolidated financial statements.

Impairment

Long-Lived Assets. We review our long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, 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 our analysis of fair value, we use discounted cash flow analysis to estimate the fair value of our properties taking into account each property s expected cash flow from operations, holding period and proceeds from disposing of the property. In addition to the discounted cash flow analysis, management also considers external independent appraisals to estimate fair value. The analysis and appraisals used by management are consistent with those used by a market participant. The factors addressed in determining estimated proceeds from disposition include anticipated operating cash flow in the year of disposition, terminal capitalization rate and selling price per room. Judgment is required in determining the discount rate applied to estimated cash flows, growth rate of the properties, the need for capital expenditures, as well as specific market and economic conditions. Additionally, the classification of assets as held for sale requires the recording of assets at their net realizable value which can affect the amount of impairment recorded.

There were no indicators of potential impairment during the three months ended March 31, 2011, and we did not record any non-cash long-lived asset impairment charges. However, if deterioration in economic and market conditions occurs, it may present a potential for impairment charges on our hotel properties subsequent to March 31, 2011. Any such adjustments could be material, but will be non-cash.

Goodwill. We review goodwill for impairment at least annually as of December 31 and whenever circumstances or events indicate potential impairment. Goodwill has an indefinite useful life that should not be amortized but should be reviewed annually for impairment, or more frequently if events or changes in circumstances indicate that goodwill might be impaired. The measurement of impairment of goodwill consists of two steps. In the first step, we compare the fair value of each reporting unit, which in our case is each hotel property, to its carrying value. In the second step of the impairment test, the impairment loss is determined by comparing the implied fair value of goodwill to the recorded amount of goodwill. The activities in the second step include hypothetically allocating the fair value of the reporting unit used in step one to all of the assets and liabilities, including all intangible assets, even if no intangible assets are currently recorded, of that reporting unit as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the price paid to acquire the reporting unit.

There were no indicators of potential impairment during the three months ended March 31, 2011, and we did not record any non-cash goodwill impairment charges. However, if deterioration in economic and market conditions occurs, it may present a potential for impairment charges on our hotel properties with goodwill subsequent to March 31, 2011. Any such adjustments could be material, but will be non-cash.

Investment in Unconsolidated Affiliates. A series of operating losses of an investee or other factors may indicate that a decrease in value of a company s investment in unconsolidated affiliates has occurred which is other-than-temporary. Accordingly, the investment in each of the unconsolidated affiliates is evaluated periodically and as deemed necessary for recoverability and valuation declines that are other-than-temporary. If the investment is other than temporarily impaired, the investment is written down to its estimated fair value. Also taken into consideration when testing for impairment is the value of the underlying real estate investments, the ownership and distribution preferences and limitations and rights to sell and repurchase of its ownership interests. There were no other-than-temporary declines in value of investments in unconsolidated affiliates during the three months ended March 31, 2011. However, if deterioration in economic and market conditions occurs, it may present a potential for other-than-temporary declines in value subsequent to March 31, 2011. Any such adjustments could be material, but will be non-cash.

Acquisition Related Assets and Liabilities. Accounting for the acquisition of a hotel property as a purchase transaction requires an allocation of the purchase price to the assets acquired and the liabilities assumed in the transaction at their respective estimated fair values. The most difficult estimations of individual fair values are those involving long-lived assets, such as property and equipment and intangible assets. We use all available information to make these fair value determinations and, for hotel acquisitions, engage an independent valuation specialist to assist in the fair value determination of the acquired long-lived assets. Due to inherent subjectivity in determining the estimated fair value of long-lived assets, we believe that the recording of acquired assets and liabilities is a critical accounting policy. We acquired two hotel properties during the three months ended March 31, 2011.

Depreciation and Amortization Expense. Depreciation expense is based on the estimated useful life of our assets. The life of the assets is based on a number of assumptions, including cost and timing of capital expenditures to maintain and refurbish the asset, as well as specific market and economic conditions. While management believes its estimates are reasonable, a change in the estimated lives could affect depreciation expense and net income or the gain or loss on the sale of any of the assets.

Derivative Instruments and Hedging Activities. Derivative instruments and hedging activities require management to make judgments on the nature of its derivatives and their effectiveness as hedges. These judgments determine if the changes in fair value of the derivative instruments are reported in our consolidated statements of operations as a component of net income or as a component of comprehensive income and as a component of equity on our consolidated balance sheets. While management believes its judgments are reasonable, a change in a derivative s effectiveness as a hedge could affect expenses, net income and equity.

If the notional amount of the derivative instruments exceeds the forecasted LIBOR-based debt, an over-hedged position results. To alleviate the over-hedged position, the derivative instruments may be terminated and/or de-designated as hedges. Future changes to our overall floating rate debt could have implications to our overall hedging position. On February 11, 2011, we paid approximately $4.2 million to terminate three interest rate swaps with a combined notional amount of $125.0 million. We terminated these swaps to address an over-hedged position that would have resulted when our final $100.0 million forward starting swap became effective on February 15, 2011. Depending on the capital markets and the availability of floating rate debt, the remaining swap portfolio may need to be reassessed in the future for additional terminations.

Disposal of Long-Lived Assets. We classify assets as held for sale in accordance with GAAP. Assets identified as held for sale are reclassified on our balance sheet and the related results of operations are reclassified as discontinued operations on our statement of operations. While these classifications do not have an effect on total assets, net equity or net income, they affect the classifications within each statement. Additionally, a determination to classify an asset as held for sale affects depreciation expense as long-lived assets are not depreciated while classified as held for sale. We classified the Paris Marriott s assets and liabilities as held for sale as of March 31, 2011 and December 31, 2010.

Seasonality

The lodging business is seasonal in nature, and we experience some seasonality in our business. Revenues for hotels in tourist areas, those with significant group business, and in areas driven by greater climate changes are generally seasonal. Quarterly revenues also may be adversely affected by events beyond our control, such as extreme weather conditions, terror attacks or alerts, airline strikes, economic factors and other considerations affecting travel.

The Marriott domestic hotels report their results of operations using a fiscal year consisting of thirteen four-week periods. As a result, for our domestic Marriott branded property, for all years presented, the first three quarters consist of 12 weeks each and the fourth quarter consists of 16 weeks.

To the extent that cash flows from operations are insufficient during any quarter, due to temporary or seasonal fluctuations in revenues, we may have to enter into short-term borrowings to pay operating expenses and make distributions to our stockholders.

New Accounting Guidance

In December 2010, the Financial Accounting Standards Board issued new guidance that amends the criteria for performing the second step of the goodwill impairment test for reporting units with zero or negative carrying amounts and requires performing the second step if qualitative factors indicate that it is more likely than not that a goodwill impairment exists. We adopted the new guidance on January 1, 2011, and determined that it did not have a material impact on our financial statements.

Non-GAAP Financial Measures

We present five non-GAAP financial measures that we believe are useful to management and investors as key measures of our operating performance: FFO; FFO - Fully Diluted; Comparable FFO; EBITDA; and Comparable EBITDA. Amounts presented in accordance with our definitions of FFO, FFO - Fully Diluted, Comparable FFO, EBITDA, and Comparable EBITDA may not be comparable to similar measures disclosed by other companies, since not all companies calculate these non-GAAP measures in the same manner. FFO, FFO - Fully Diluted, Comparable FFO, EBITDA, and Comparable EBITDA should not be considered as an alternative measure of our net loss or operating performance. FFO, FFO - Fully Diluted, Comparable FFO, EBITDA, and Comparable EBITDA may include funds that may not be available for our discretionary use due to functional requirements to conserve funds for capital expenditures and property acquisitions and other commitments and uncertainties. Although we believe that FFO, FFO - Fully Diluted, Comparable FFO, EBITDA, and Comparable EBITDA can enhance the understanding of our financial condition and results of operations, these non-GAAP financial measures, when viewed individually, are not necessarily better indicators of any trend as compared to comparable GAAP measures such as net loss attributable to SHR common shareholders. In addition, adverse economic and market conditions might negatively impact our cash flow. We have provided a quantitative reconciliation of FFO, FFO - Fully Diluted, Comparable FFO, EBITDA, and Comparable EBITDA to the most directly comparable GAAP financial performance measure, which is net loss attributable to SHR common shareholders.

EBITDA and Comparable EBITDA

EBITDA represents net loss attributable to SHR common shareholders excluding: (i) interest expense, (ii) income taxes, including deferred income tax benefits and expenses applicable to our foreign subsidiaries and income taxes applicable to sale of assets; and (iii) depreciation and amortization. EBITDA also excludes interest expense, income taxes and depreciation and amortization of our unconsolidated affiliates. EBITDA is presented on a full participation basis, which means we have assumed conversion of all redeemable noncontrolling interests of our operating partnership into our common stock and includes preferred dividends. We believe this treatment of noncontrolling interests provides more useful information for management and our investors and appropriately considers our current capital structure. We also present Comparable EBITDA, which eliminates the effect of realizing deferred gains on our sale leasebacks, as well as the effect of gains or losses on sales of assets, early extinguishment of debt, impairment losses, foreign currency exchange gains or losses and certain other charges that are highly variable from year to year.

We believe EBITDA and Comparable EBITDA are useful to management and investors in evaluating our operating performance because they provide management and investors with an indication of our ability to incur and service debt, to satisfy general operating expenses, to make capital expenditures and to fund other cash needs or reinvest cash into our business. We also believe they help management and investors meaningfully evaluate and compare the results of our operations from period to period by removing the impact of our asset base (primarily depreciation and amortization) from our operating results. Our management also uses EBITDA and Comparable EBITDA as measures in determining the value of acquisitions and dispositions.

The following table provides a reconciliation of net loss attributable to SHR common shareholders to Comparable EBITDA (in thousands):

	Three Months Ended March 31,	
	2011	**2010**
Net loss attributable to SHR common shareholders	$ (35,407)	$ (40,291)
Depreciation and amortization continuing operations	30,605	34,043
Depreciation and amortization discontinued operations	-	1,814
Interest expense continuing operations	19,548	21,506
Interest expense discontinued operations	-	3,186
Income taxes continuing operations	(1,648)	(837)
Income taxes discontinued operations	359	59
Noncontrolling interests	(138)	(442)
Adjustments from consolidated affiliates	(1,329)	(1,482)
Adjustments from unconsolidated affiliates	3,890	3,402
Preferred shareholder dividends	7,721	7,721
EBITDA	23,601	28,679
Realized portion of deferred gain on sale leaseback continuing operations	(53)	(54)
Realized portion of deferred gain on sale leaseback discontinued operations	(1,152)	(1,165)
Gain on sale of assets continuing operations	(2,640)	-
(Gain) loss on sale of assets discontinued operations	(14)	612
Foreign currency exchange (gain) loss continuing operations	(139)	451
Foreign currency exchange gain discontinued operations	(58)	(6,519)
Adjustment for Value Creation Plan	9,181	506
Comparable EBITDA	$ 28,726	$ 22,510

FFO, FFO-Fully Diluted, and Comparable FFO

We compute FFO in accordance with standards established by the National Association of Real Estate Investment Trusts, or NAREIT, which adopted a definition of FFO in order to promote an industry-wide standard measure of REIT operating performance. NAREIT defines FFO as net income (or loss) (computed in accordance with GAAP) excluding losses or gains from sales of depreciable property plus real estate-related depreciation and amortization, and after adjustments for our portion of these items related to unconsolidated affiliates. We also present FFO - Fully Diluted, which is FFO plus income or loss on income attributable to redeemable noncontrolling interests of our operating partnership. We also present Comparable FFO, which is FFO - Fully Diluted excluding the impact of any gains or losses on early extinguishment of debt, impairment losses, foreign currency exchange gains or losses and certain other charges that are highly variable from year to year.

We believe that the presentation of FFO, FFO - Fully Diluted and Comparable FFO provides useful information to management and investors regarding our results of operations because they are measures of our ability to fund capital expenditures and expand our business. In addition, FFO is widely used in the real estate industry to measure operating performance without regard to items such as depreciation and amortization.

The following table provides a reconciliation of net loss attributable to SHR common shareholders to Comparable FFO (in thousands):

	Three Months Ended March 31,	
	2011	**2010**
Net loss attributable to SHR common shareholders	$ (35,407)	$ (40,291)
Depreciation and amortization continuing operations	30,605	34,043
Depreciation and amortization discontinued operations	-	1,814
Corporate depreciation	(299)	(304)
Gain on sale of assets continuing operations	(2,640)	-
(Gain) loss on sale of assets discontinued operations	(14)	612
Realized portion of deferred gain on sale leaseback continuing operations	(53)	(54)
Realized portion of deferred gain on sale leaseback discontinued operations	(1,152)	(1,165)
Deferred tax expense on realized portion of deferred gain on sale leasebacks	359	363
Noncontrolling interests adjustments	(157)	(480)
Adjustments from consolidated affiliates	(1,561)	(1,966)
Adjustments from unconsolidated affiliates	1,839	2,004
FFO	(8,480)	(5,424)
Redeemable noncontrolling interests	19	38
FFO Fully Diluted	(8,461)	(5,386)
Non-cash mark to market of interest rate swaps	(4,366)	-
Foreign currency exchange (gain) loss continuing operations	(139)	451
Foreign currency exchange gain, net of tax discontinued operations	(58)	(6,526)
Adjustment for Value Creation Plan	9,181	506
Comparable FFO	$ (3,843)	$ (10,955)

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Interest Rate Risk

Our future income, cash flows and fair values relevant to financial instruments are dependent upon prevailing market interest rates. Market risk refers to the risk of loss from adverse changes in market prices and interest rates. Our outstanding debt, after considering the effect of interest rate swaps, has a fixed interest rate. We use derivative financial instruments to manage, or hedge, interest rate risks related to our borrowings, from lines of credit to medium- and long-term financings. We generally require that hedging derivative instruments be effective in reducing the interest rate risk exposure that they are designed to hedge. We do not use derivatives for trading or speculative purposes and only enter into contracts with major financial institutions based on their credit rating and other factors. We use methods which incorporate standard market conventions and techniques such as discounted cash flow analysis and option pricing models to determine fair value. All methods of estimating fair value result in general approximation of value and such value may or may not actually be realized.

See Item 1. Financial Statements 9. Derivatives for information on our interest rate cap and swap agreements outstanding as of March 31, 2011.

As of March 31, 2011, our total outstanding mortgages and other debt and indebtedness under the bank credit facility totaled approximately $1.13 billion, of which approximately 100.0% was fixed-rate debt when including the effect of interest rate swaps.

Currency Exchange Risk

As we have international operations, currency exchange risk arises as a normal part of our business. In particular, we are subject to fluctuations due to changes in foreign exchange rates in the British pound, euro, and Mexican peso. We reduce this risk by transacting our international business in local currencies. In this manner, assets and liabilities are matched in the local currency, which reduces the need for dollar conversion. Generally, we do not enter into forward or option contracts to manage our currency exchange risk exposure applicable to net operating cash flows.

To manage the currency exchange risk applicable to equity positions in foreign hotels, we may use long-term mortgage debt denominated in the local currency. In addition, we may enter into forward or option contracts. We do not currently have any currency forward or option contracts.

Our exposure to foreign currency exchange rates relates primarily to our foreign hotels. For our foreign hotels, exchange rates impact the U.S. dollar value of our reported earnings, our investments in the hotels and the intercompany transactions with the hotels.

For the three months ended March 31, 2011, approximately 10.5% of our total revenues, were generated outside of the United States, with approximately 6.0% of total revenues generated from the Four Seasons Punta Mita Resort (which uses the Mexican peso), approximately 3.8% of total revenues generated from the Marriott London Grosvenor Square (which uses the British pound), and approximately 0.7% of total revenues generated from the Marriott Hamburg (which use the euro). As a result, fluctuations in the value of foreign currencies against the U.S. dollar may have a significant impact on our reported results. Revenues and expenses denominated in foreign currencies are translated into U.S. dollars at a weighted average exchange rate for the period. Consequently, as the value of the U.S. dollar changes relative to the currencies of these markets, our reported results vary.

If the U.S. dollar had weakened an additional 10.0% during the three months ended March 31, 2011, total revenues and operating income or loss would have changed from the amounts reported by (in millions):

	Mexican Peso	Euro	British Pound	Total
Increase in total revenues	$ 1.1	$ 0.1	$ 0.7	$ 1.9
Increase in operating income	$ 0.2	$ -	$ -	$ 0.2

Fluctuations in foreign currency exchange rates also impact the U.S. dollar amount of our shareholders equity. The assets and liabilities of our non-U.S. hotels are translated into U.S. dollars at exchange rates in effect at the end of the period. The resulting translation adjustments are recorded in shareholders equity as a component of accumulated other comprehensive loss. If the U.S. dollar had weakened by 10.0% as of

March 31, 2011, resulting translation adjustments recorded in shareholders equity would have decreased by approximately $2.4 million from the amounts reported.

ITEM 4. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

An evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act), as of the end of the period covered by this quarterly report on Form 10-Q was made under the supervision and with the participation of our management, including our chief executive officer and our chief financial officer. Based upon this evaluation, as of March 31, 2011, our chief executive officer and our chief financial officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and that information required to be disclosed by us in reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended March 31, 2011 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

We are not involved in any material litigation nor, to our knowledge, is any material litigation threatened against us, other than routine litigation arising in the ordinary course of business or which is expected to be covered by insurance.

ITEM 1A. RISK FACTORS.

There were no material changes from the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2010.

A copy of those risk factors, updated for this quarterly report on Form 10-Q, are attached as Exhibit 99.1 to this quarterly report on Form 10-Q.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

As previously disclosed, on March 11, 2011, the Company and certain of its affiliates closed on two concurrent transactions with certain affiliates of The Woodbridge Company Limited, a corporation amalgamated under the laws of Ontario (Woodbridge), pursuant to which (i) certain affiliates of Woodbridge sold to the Company, and the Company acquired, the hotels commonly known as the Four Seasons Jackson Hole and the Four Seasons Silicon Valley for an aggregate of 15,200,000 shares (the Property Purchase Shares) of the Company s common stock (the Common Stock), at an agreed to issuance price of $6.25 per share (the Hotels Transaction) and (ii) an affiliate of Woodbridge purchased from the Company, and the Company issued and sold to such Woodbridge affiliate, in a concurrent private offering (the PIPE Transaction and together with Hotels Transaction, the Transactions), an aggregate of 8,000,000 shares of Common Stock at a price of $6.25 per share (the Additional Shares and, together with the Property Purchase Shares, the Shares). The issuance of the Shares in connection with the Transactions was made in reliance upon the exemption from registration afforded by Section 4(2) of the Securities Act of 1933, as amended. The proceeds from the issuance of the Additional Shares were used to pay down the Company s bank credit facility.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

In February 2009, our board of directors elected to suspend the quarterly dividend beginning with the first quarter of 2009 to holders of shares of our 8.50% Series A Cumulative Preferred Stock, 8.25% Series B Cumulative Preferred Stock, and 8.25% Series C Cumulative Preferred Stock. Dividends on the preferred stock are cumulative. As of the date of the filing of this report, unpaid cumulative dividends on our preferred stock were $69,493,000.

ITEM 4. (REMOVED AND RESERVED).

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS.

The information in the Exhibit Index appearing after the signature page of this Form 10-Q is incorporated by reference.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	STRATEGIC HOTELS & RESORTS, INC.
May 5, 2011	By: /s/ Laurence S. Geller
	Laurence S. Geller
	President, Chief Executive Officer and
	Director
	(principal executive officer)
May 5, 2011	By: /s/ Diane M. Morefield
	Diane M. Morefield
	Executive Vice President and Chief Financial
	Officer
	(principal financial officer)

Exhibit Index

	Exhibit No.	Description of Exhibit
+	2.1	Purchase and Sale Agreement, dated February 24, 2011, by and among FS Jackson Hole Development Company LLC, East Palo Alto Hotel Development LLC, TWCL US, Inc., SHR Jackson Hole, LLC, SHR Palo Alto, LLC, Strategic Hotel Funding, L.L.C. and the Company *
	3.1.a	Articles of Amendment and Restatement of the Company (filed as Exhibit 3.1 to the Company s Amendment No. 3 to the Registration Statement on Form S-11 (File No. 333-112846), filed with the SEC on June 8, 2004 and incorporated herein by reference).
	3.1.b	Articles of Amendment relating to the Company s name change to Strategic Hotels & Resorts, Inc. (filed as Exhibit 3.1 to the Company s Current Report on Form 8-K (File No. 001-32223), filed with the SEC on March 15, 2006 and incorporated herein by reference).
	3.1.c	Articles of Amendment (filed as Exhibit 3.1 to the Company s Current Report on Form 8-K (File No. 001-32223), filed with the SEC on May 19, 2010 and incorporated herein by reference).
	3.1.d	Articles Supplementary relating to the 8.50% Series A Cumulative Redeemable Preferred Stock (filed as Exhibit 3.1 to the Company s Current Report on Form 8-K (File No. 001-32223), filed with the SEC on March 18, 2005 and incorporated herein by reference).
	3.1.e	Certificate of Correction relating to the 8.50% Series A Cumulative Redeemable Preferred Stock (filed as Exhibit 3.2 to the Company s Current Report on Form 8-K (File No. 001-32223), filed with the SEC on March 18, 2005 and incorporated herein by reference).
	3.1.f	Articles Supplementary relating to the 8.25% Series B Cumulative Redeemable Preferred Stock (filed as Exhibit 3.5 to the Company s Form 8-A (File No. 001-32223), filed with the SEC on January 13, 2006 and incorporated herein by reference).
	3.1.g	Articles Supplementary relating to the 8.25% Series C Cumulative Redeemable Preferred Stock (filed as Exhibit 3.1 to the Company s Current Report on Form 8-K (File No. 001-32223), filed with the SEC on April 21, 2006 and incorporated herein by reference).
	3.1.h	Articles Supplementary relating to the Series D Junior Participating Preferred Stock (filed as Exhibit 3.1 to the Company s Form 8-K (File No. 001-32223), filed with the SEC on November 18, 2008 and incorporated herein by reference).
	3.1.i	Articles Supplementary relating to the Series D Junior Participating Preferred Stock (filed as Exhibit 3.2 to the Company s Current Report on Form 8-K (File No. 001-32223), filed with the SEC on May 19, 2010 and incorporated herein by reference).
	3.2	By-Laws of the Company (filed as Exhibit 3.2 to the Company s Current Report on Form 8-K (File No. 001-32223), filed with the SEC on November 18, 2008 and incorporated herein by reference).
	10.1	Stock Transfer Restriction and Registration Rights Agreement, dated as of March 11, 2011, by and among the Company, WJH Holdings Inc. and WPA Hotel Holdings Inc. (filed as Exhibit 10.1 to the Company s Current Report on Form 8-K (File No. 001-32223), filed with the SEC on March 16, 2011 and incorporated

herein by reference).

+	10.2	Fourth Amendment to Credit Agreement, dated February 23, 2011, by and among Strategic Hotel Funding, L.L.C., Deutsche Bank Trust Company Americas as administrative agent and various financial institutions.
+	31.1	Certification of Laurence S. Geller, Chief Executive Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
+	31.2	Certification of Diane M. Morefield, Chief Financial Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
+	32.1	Certification of Laurence S. Geller, Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
+	32.2	Certification of Diane M. Morefield, Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
+	99.1	Forward-Looking Information and Risk Factors.

+ Filed herewith

* Certain schedules to this exhibit have been omitted pursuant to Item 601(b)(2) of Regulation S-K. The Company agrees to furnish supplementally copies of any of the omitted schedules to the Securities and Exchange Commission upon request.