

DiamondRock Hospitality Co
Form 10-Q
November 06, 2018

Table of Contents

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

FORM 10-Q

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

For the quarterly period ended September 30, 2018

OR

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

Commission file number 001-32514

DIAMONDROCK HOSPITALITY COMPANY

(Exact Name of Registrant as Specified in Its Charter)

Maryland

(State of Incorporation)

20-1180098

(I.R.S. Employer Identification No.)

2 Bethesda Metro Center, Suite 1400, Bethesda, Maryland 20814

(Address of Principal Executive Offices)

(Zip Code)

(240) 744-1150

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Emerging growth company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The registrant had 207,920,844 shares of its \$0.01 par value common stock outstanding as of November 6, 2018.

Table of Contents
INDEX

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (unaudited):</u>	
<u>Condensed Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u>	<u>1</u>
Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2018 and 2017	<u>2</u>
Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and 2017	<u>3</u>
<u>Notes to the Condensed Consolidated Financial Statements</u>	<u>5</u>
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>19</u>
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	<u>35</u>
<u>Item 4. Controls and Procedures</u>	<u>35</u>
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	<u>36</u>
<u>Item 1A. Risk Factors</u>	<u>36</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>36</u>
<u>Item 3. Defaults Upon Senior Securities</u>	<u>36</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>36</u>
<u>Item 5. Other Information</u>	<u>36</u>
<u>Item 6. Exhibits</u>	<u>37</u>

Table of Contents

PART I. FINANCIAL INFORMATION

Item I. Financial Statements

DIAMONDROCK HOSPITALITY COMPANY

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

(unaudited)

	September 30, 2018	December 31, 2017
ASSETS		
Property and equipment, net	\$ 2,802,889	\$ 2,692,286
Restricted cash	42,624	40,204
Due from hotel managers	100,613	86,621
Favorable lease assets, net	46,216	26,690
Prepaid and other assets	16,330	71,488
Cash and cash equivalents	169,654	183,569
Total assets	\$ 3,178,326	\$ 3,100,858
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Mortgage and other debt, net of unamortized debt issuance costs	\$ 633,139	\$ 639,639
Term loans, net of unamortized debt issuance costs	298,498	298,153
Total debt	931,637	937,792
Deferred income related to key money, net	11,838	14,307
Unfavorable contract liabilities, net	73,977	70,734
Deferred ground rent	91,957	86,614
Due to hotel managers	64,879	74,213
Dividends declared and unpaid	26,648	25,708
Accounts payable and accrued expenses	61,177	57,845
Total liabilities	1,262,113	1,267,213
Stockholders' Equity:		
Preferred stock, \$0.01 par value; 10,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, \$0.01 par value; 400,000,000 shares authorized; 207,840,943 and 200,306,733 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	2,078	2,003
Additional paid-in capital	2,157,968	2,061,451
Accumulated deficit	(243,833)	(229,809)
Total stockholders' equity	1,916,213	1,833,645
Total liabilities and stockholders' equity	\$ 3,178,326	\$ 3,100,858

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

- 1-

Table of Contents

DIAMONDROCK HOSPITALITY COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Revenues:				
Rooms	\$165,750	\$167,990	\$469,786	\$483,305
Food and beverage	42,922	42,651	135,286	140,191
Other	12,146	12,845	35,225	39,472
Total revenues	220,818	223,486	640,297	662,968
Operating Expenses:				
Rooms	41,779	41,945	117,972	120,411
Food and beverage	29,047	30,794	88,202	93,324
Management fees	6,099	5,356	15,542	18,317
Other hotel expenses	78,731	77,769	241,437	228,036
Depreciation and amortization	26,369	25,083	77,304	75,031
Impairment losses	—	2,357	—	2,357
Hotel acquisition costs	—	(245)) —	2,028
Corporate expenses	4,521	6,109	22,139	19,199
Business interruption insurance income	(8,227)) —	(16,254)) —
Gain on property insurance settlement	(1,730)) —	(1,730)) —
Total operating expenses, net	176,589	189,168	544,612	558,703
Operating profit	44,229	34,318	95,685	104,265
Interest and other income, net	(621)) (372)) (1,428)) (923)
Interest expense	10,233	9,692	30,384	28,790
Loss on early extinguishment of debt	—	—	—	274
Total other expenses, net	9,612	9,320	28,956	28,141
Income before income taxes	34,617	24,998	66,729	76,124
Income tax expense	(3,174)) (3,375)) (2,939)) (9,019)
Net income	\$31,443	\$21,623	\$63,790	\$67,105
Earnings per share:				
Basic earnings per share	\$0.15	\$0.11	\$0.31	\$0.33
Diluted earnings per share	\$0.15	\$0.11	\$0.31	\$0.33

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

- 2-

Table of Contents

DIAMONDROCK HOSPITALITY COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$63,790	\$67,105
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	77,304	75,031
Corporate asset depreciation as corporate expenses	161	56
Loss on early extinguishment of debt	—	274
Non-cash ground rent	5,316	4,756
Amortization of debt issuance costs	1,384	1,489
Impairment losses	—	42,264
Estimated recovery of impairment losses from insurance	—	(39,907)
Amortization of favorable and unfavorable contracts, net	(1,474)	(1,434)
Amortization of deferred income related to key money	(2,469)	(3,040)
Stock-based compensation	4,104	4,769
Changes in assets and liabilities:		
Prepaid expenses and other assets	25,489	(560)
Due to/from hotel managers	(21,436)	(11,369)
Accounts payable and accrued expenses	(2,215)	7,975
Net cash provided by operating activities	149,954	147,409
Cash flows from investing activities:		
Hotel capital expenditures	(76,753)	(76,821)
Hotel acquisitions	(119,537)	(93,795)
Purchase deposits	(2,000)	—
Proceeds from property insurance	30,742	—
Net used in investing activities	(167,548)	(170,616)
Cash flows from financing activities:		
Scheduled mortgage debt principal payments	(9,947)	(9,094)
Proceeds from sale of common stock, net	92,715	—
Repayments of mortgage debt	—	(170,368)
Proceeds from senior unsecured term loan	—	200,000
Draws on senior unsecured credit facility	85,000	—
Repayments of senior unsecured credit facility	(85,000)	—
Payment of financing costs	—	(1,579)
Payment of cash dividends	(76,520)	(75,451)
Repurchase of common stock	(149)	(529)
Net cash provided by (used in) financing activities	6,099	(57,021)
Net decrease in cash, cash equivalents, and restricted cash	(11,495)	(80,228)
Cash, cash equivalents, and restricted cash at beginning of period	223,773	289,164
Cash, cash equivalents, and restricted cash at end of period	\$212,278	\$208,936

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

- 3-

Table of Contents

DIAMONDROCK HOSPITALITY COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - (CONTINUED)

(in thousands)

(unaudited)

Supplemental Disclosure of Cash Flow Information:

	Nine Months Ended September 30,	
	2018	2017
Cash paid for interest	\$28,462	\$27,183
Cash paid for income taxes	\$2,198	\$2,688
Non-cash Investing and Financing Activities:		
Unpaid dividends	\$26,648	\$25,627
Loan assumed in hotel acquisition	\$2,943	\$—

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

	September 30, December 31,	
	2018	2017
Cash and cash equivalents	\$ 169,654	\$ 183,569
Restricted cash (1)	42,624	40,204
Total cash, cash equivalents, and restricted cash	\$ 212,278	\$ 223,773

(1) Restricted cash primarily consists of reserves for replacement of furniture and fixtures held by our hotel managers and cash held in escrow pursuant to lender requirements.

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

- 4-

Table of Contents

DIAMONDROCK HOSPITALITY COMPANY

Notes to the Condensed Consolidated Financial Statements
(Unaudited)

1. Organization

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

As of September 30, 2018, we owned 30 hotels with 9,949 guest rooms, located in the following markets: Atlanta, Georgia; Boston, Massachusetts (2); Burlington, Vermont; Charleston, South Carolina; Chicago, Illinois (2); Denver, Colorado (2); Fort Lauderdale, Florida; Fort Worth, Texas; Huntington Beach, California; Key West, Florida (2); New York, New York (4); Phoenix, Arizona; Salt Lake City, Utah; San Diego, California; San Francisco, California; Sedona, Arizona (2); Sonoma, California; South Lake Tahoe, California; Washington D.C. (2); St. Thomas, U.S. Virgin Islands; and Vail, Colorado. As of September 30, 2018, the Frenchman's Reef & Morning Star Marriott Beach Resort (“Frenchman's Reef”) is closed as a result of damage incurred from Hurricanes Irma and Maria in September 2017.

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

2. Summary of Significant Accounting Policies

Basis of Presentation

We have condensed or omitted certain information and footnote disclosures normally included in financial statements presented in accordance with U.S. generally accepted accounting principles, or U.S. GAAP, in the accompanying unaudited condensed consolidated financial statements. We believe the disclosures made are adequate to prevent the information presented from being misleading. However, the unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto as of and for the year ended December 31, 2017, included in our Annual Report on Form 10-K filed on February 27, 2018.

In our opinion, the accompanying unaudited condensed consolidated financial statements reflect all adjustments necessary to present fairly our financial position as of September 30, 2018, the results of our operations for the three and nine months ended September 30, 2018 and 2017, and the cash flows for the nine months ended September 30, 2018 and 2017. Interim results are not necessarily indicative of full-year performance because of the impact of seasonal and short-term variations.

Our financial statements include all of the accounts of the Company and its subsidiaries in accordance with U.S. GAAP. All intercompany accounts and transactions have been eliminated in consolidation. If the Company determines that it has an interest in a variable interest entity within the meaning of the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 810, Consolidation, the Company will consolidate the entity when it is determined to be the primary beneficiary of the entity. The Operating Partnership meets the criteria of a variable interest entity. The Company is the primary beneficiary and, accordingly, we consolidate the Operating Partnership.

Use of Estimates

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

Property and Equipment

Table of Contents

Following the adoption of Accounting Standards Update (“ASU”) No. 2017-01, investments in hotel properties, land, land improvements, building and furniture, fixtures and equipment and identifiable intangible assets are generally accounted for as asset acquisitions and recorded at relative fair value based upon total accumulated cost of the acquisition. Direct acquisition-related costs are capitalized as a component of the acquired assets. Property and equipment purchased after the hotel acquisition date is recorded at cost. Replacements and improvements are capitalized, while repairs and maintenance are expensed as incurred. Upon the sale or retirement of a fixed asset, the cost and related accumulated depreciation are removed from the Company’s accounts and any resulting gain or loss is included in the statements of operations.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 5 to 40 years for buildings, land improvements, and building improvements and 1 to 10 years for furniture, fixtures and equipment. Leasehold improvements are amortized over the shorter of the lease term or the useful lives of the related assets.

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

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

Revenue Recognition

Revenues from operations of the hotels are recognized when the goods or services are provided, and thereby the performance obligations are satisfied. Revenues consist of room sales, food and beverage sales, and other hotel department revenues, such as telephone, parking, gift shop sales and resort fees. Room revenue is generated through contracts with customers whereby the customer agrees to pay a daily rate for the right to use a hotel room. Our contract performance obligations are fulfilled at the end of the day that the customer is provided the room and revenue is recognized daily at the contract rate. Food and beverage revenue is generated through contracts with customers whereby the customer agrees to pay a contract rate for restaurant dining services or banquet services. Our contract performance obligations are fulfilled at the time that the food and beverage is provided to the customer or when the banquet facilities and related dining amenities are provided to the customer. We recognize food and beverage revenue upon the fulfillment of the contract with the customer. Other revenues are recognized at the point in time or over the time period that goods or services are provided to the customer. Certain ancillary services are provided by third parties and we assess whether we are the principal or agent in these arrangements. If we are the agent, revenue is recognized based upon the commission earned from the third party. If we are the principal, we recognize revenue based upon the gross sales price. Certain of our hotels have retail spaces, restaurants or other spaces which we lease to third parties. Lease revenue is recognized on a straight-line basis over the life of the lease and included in other operating revenues

in our condensed consolidated statements of operations.

Hotel operating revenues are disaggregated on the face of the condensed consolidated statements of operations into the categories of room revenue, food and beverage revenue, and other revenue to demonstrate how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows.

The following table provides information about trade receivables and contract liabilities (in thousands):

	September 30, December	
	2018	31, 2017
Trade receivables (1)	\$ 46,455	\$ 32,316
Advance deposits as deferred revenue (2)	14,104	14,754

(1)Included within due from hotel managers on the accompanying condensed consolidated balance sheets.

(2)Included within due to hotel managers on the accompanying condensed consolidated balance sheets.

Table of Contents

Advance deposits are provided when a customer or group of customers provides a deposit for a future stay or banquet event at our hotels. Advance deposits are converted to revenue when the services are provided to the customer or when a customer with a noncancelable reservation fails to arrive for part or all of the reservation. Conversely, advance deposits are generally refundable upon guest cancellation of the related reservation within an established period of time prior to the reservation.

Earnings Per Share

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

Stock-based Compensation

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

Income Taxes

We account for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in earnings during the period in which the new rate is enacted. However, deferred tax assets are recognized only to the extent that it is more likely than not that they will be realized based on consideration of all available evidence, including the future reversals of existing taxable temporary differences, future projected taxable income and tax planning strategies. Valuation allowances are provided if, based upon the weight of the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

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

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

We had no accruals for tax uncertainties as of September 30, 2018 and December 31, 2017.

Fair Value Measurements

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

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

Intangible Assets and Liabilities

- 7 -

Table of Contents

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

Accounting for Impact of Natural Disasters

Assets destroyed or damaged as a result of natural disasters or other involuntary events are written off or reduced in carrying value to their salvage value. When recovery of all or a portion of the amount of property damage loss or other covered expenses through insurance proceeds is demonstrated to be probable, a receivable is recorded and offsets the loss or expense up to the amount of the total loss or expense. No gain is recorded until all contingencies related to the insurance claim have been resolved. Income resulting from business interruption insurance is not recognized until all contingencies related to the insurance recoveries are resolved.

In September 2017, Hurricanes Irma and Maria caused significant damage to Frenchman's Reef and the Havana Cabana Key West. We are pursuing an insurance claim for the remediation of property damage and business interruption at Frenchman's Reef. During the third quarter of 2018, we settled an insurance claim for the remediation of property damage and business interruption at the Havana Cabana Key West for \$8.3 million, net of deductibles. We received \$32.5 million and \$85.0 million of insurance proceeds under these hurricane claims during the three and nine months ended September 30, 2018, respectively. Additionally, during the third quarter of 2018, we settled an insurance claim for smoke damage and business interruption at The Lodge at Sonoma related to the 2017 wildfires in Northern California for \$1.3 million, net of deductibles.

For the three months ended September 30, 2018, we recognized \$8.2 million in business interruption insurance income on our accompanying condensed consolidated statement of operations. For the nine months ended September 30, 2018, we recognized \$16.3 million of business interruption insurance income on our accompanying condensed consolidated statement of operations, which is net of \$2.9 million of expense reimbursements from insurance recorded within other hotel expenses on our accompanying condensed consolidated statement of operations.

The following table summarizes the business interruption insurance income by impacted hotel property (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2018		September 30, 2017	
Frenchman's Reef	\$ 5,680	\$ —	—\$12,965	\$ —
Havana Cabana Key West	1,925	—	2,137	—
The Lodge at Sonoma	622	—	1,152	—
Total	\$ 8,227	\$ —	—\$16,254	\$ —

For both the three and nine months ended September 30, 2018, we recognized a \$1.7 million gain related to the settlement of the property damage insurance claim at the Havana Cabana Key West.

Recently Issued Accounting Pronouncements

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business, which clarifies the definition of a business to assist entities with evaluating whether transactions should be accounted for as acquisitions of assets or business combinations. As a result of the standard, we anticipate that the majority of our hotel acquisitions will be considered asset purchases as opposed to business combinations. However, the determination will be made on a transaction-by-transaction basis and we do not expect the determination to materially change the recognition of the assets and liabilities acquired. This standard is effective for annual periods beginning after December 15, 2017. We adopted ASU No. 2017-01 effective January 1, 2018. This standard will be applied on a prospective basis and, therefore, it does not affect the accounting for any of our transactions prior to January 1, 2018. Refer to Note 9 for more information about our two hotel property acquisitions during the nine months ended September 30, 2018, which were both asset purchases.

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, which requires that the statement of cash flows explain the change during the period in the total cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. This standard is effective for annual periods beginning after December 15, 2017. We adopted ASU No. 2016-18 effective January 1, 2018. The adoption of ASU No. 2016-18 changed the

Table of Contents

presentation of the statement of cash flows for the Company and we utilized a retrospective transition method for each period presented within financial statements for periods subsequent to the date of adoption. Restricted cash reserves are included with cash and cash equivalents on our consolidated statements of cash flows for all periods presented. There was no impact to the condensed consolidated statements of income or the condensed consolidated balance sheets.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which clarifies and provides specific guidance on eight cash flow classification issues with an objective to reduce the current diversity in practice. This standard is effective for annual periods beginning after December 15, 2017. We adopted ASU No. 2016-15 effective January 1, 2018 and it did not have an impact on our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which affects virtually all aspects of an entity's revenue recognition. The new standard sets forth five prescribed steps to determine the timing and amount of revenue to be recognized to appropriately depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which deferred the effectiveness of ASU No. 2014-09 to reporting periods beginning after December 15, 2017 and permitted early application for annual reporting periods beginning after December 15, 2016. We adopted the new standard effective January 1, 2018 under the cumulative effect transition method. No adjustment was recorded to the Company's opening balance of retained earnings on January 1, 2018 as there was no impact to net income for the Company.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which primarily changes the lessee's accounting for operating leases by requiring recognition of lease right-of-use assets and lease liabilities. This standard is effective for annual reporting periods beginning after December 15, 2018, with early adoption permitted. The primary impact of the new standard will be to the treatment of our ground leases, which represent a majority of all of our operating lease payments. We are continuing to evaluate the effect of ASU 2016-02 on our consolidated financial statements and related disclosures.

3. Property and Equipment

Property and equipment as of September 30, 2018 and December 31, 2017 consists of the following (in thousands):

	September 30, December 31,	
	2018	2017
Land	\$ 617,695	\$ 602,879
Land improvements	7,994	7,994
Buildings and site improvements	2,555,547	2,414,216
Furniture, fixtures and equipment	469,141	423,987
Construction in progress	18,673	31,906
	3,669,050	3,480,982
Less: accumulated depreciation	(866,161)	(788,696)
	\$ 2,802,889	\$ 2,692,286

As of September 30, 2018 and December 31, 2017, we had accrued capital expenditures of \$17.8 million and \$11.7 million, respectively.

4. Favorable Lease Assets

In connection with the acquisition of certain hotels, we have recognized intangible assets for favorable leases. Our favorable lease assets, net of accumulated amortization of \$3.2 million and \$2.7 million as of September 30, 2018 and December 31, 2017, respectively, consist of the following (in thousands):

- 9-

Table of Contents

	September 30, December 31,	
	2018	2017
Westin Boston Waterfront Hotel Ground Lease	\$ 17,480	\$ 17,643
Hotel Palomar Phoenix Ground Lease	19,838	—
Orchards Inn Sedona Annex Sublease	8,799	8,925
Lexington Hotel New York Tenant Leases	99	122
	\$ 46,216	\$ 26,690

Favorable lease assets are recorded at the acquisition date and are generally amortized using the straight-line method over the remaining non-cancelable term of the lease agreement. We recorded \$0.2 million and \$0.1 million of amortization expense, respectively, for the three months ended September 30, 2018 and 2017. We recorded \$0.5 million and \$0.3 million of amortization expense, respectively, for the nine months ended September 30, 2018 and 2017.

In connection with our acquisition of the Hotel Palomar Phoenix on March 1, 2018, we recorded a \$20.0 million favorable lease asset. We determined the value using a discounted cash flow of the favorable difference between the contractual lease payments and estimated market rents. The market rents were estimated with the assistance of a third-party valuation firm and the discount rate was estimated using a risk adjusted rate of return. See Note 9 for further discussion of this favorable lease asset.

5. Capital Stock

Common Shares

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

We have an “at-the-market” equity offering program (the “Current ATM Program”), pursuant to which we may issue and sell shares of our common stock from time to time, having an aggregate offering price of up to \$200 million. Prior to the implementation of the Current ATM Program, the Company had a \$200 million ATM program (the “Prior ATM Program”), which is no longer active. During the nine months ended September 30, 2018, we sold 7,472,946 shares of common stock at an average price of \$12.56 for net proceeds of \$92.9 million under the Prior ATM Program. We did not sell any shares of common stock during the three months ended September 30, 2018, and the full amount remains available under the Current ATM Program.

Our board of directors has approved a share repurchase program authorizing us to repurchase up to \$150 million in shares of our common stock. Repurchases under this program are made in open market or privately negotiated transactions as permitted by federal securities laws and other legal requirements. This authority may be exercised from time to time and in such amounts as market conditions warrant, and subject to regulatory considerations. The timing, manner, price and actual number of shares repurchased depends on a variety of factors including stock price, corporate and regulatory requirements, market conditions, and other corporate liquidity requirements and priorities. The share repurchase program may be suspended or terminated at any time without prior notice. On November 2, 2018, our board of directors increased the authorization under the share repurchase program from \$150 million to \$250 million. We have not repurchased any shares of our common stock during 2018 and we have full capacity remaining under our share repurchase program.

Dividends

We have paid the following dividends to holders of our common stock during 2018 as follows:

Payment Date	Record Date	Dividend per Share
January 12, 2018	December 29, 2017	\$ 0.125
April 12, 2018	March 29, 2018	\$ 0.125
July 12, 2018	June 29, 2018	\$ 0.125
October 12, 2018	September 28, 2018	\$ 0.125

Preferred Shares

- 10-

Table of Contents

We are authorized to issue up to 10 million shares of preferred stock, \$0.01 par value per share. Our board of directors is required to set for each class or series of preferred stock the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications, and terms or conditions of redemption. As of September 30, 2018 and December 31, 2017, there were no shares of preferred stock outstanding.

Operating Partnership Units

Holders of Operating Partnership units have certain redemption rights, which would enable them to cause the Operating Partnership to redeem their units in exchange for cash per unit equal to the market price of our common stock, at the time of redemption, or, at our option, for shares of our common stock on a one-for-one basis. The number of shares issuable upon exercise of these redemption rights will be adjusted upon the occurrence of stock splits, mergers, consolidations or similar pro-rata share transactions, which otherwise would have the effect of diluting the ownership interests of the limited partners or our stockholders.

As of September 30, 2018 and December 31, 2017, there were no Operating Partnership units held by unaffiliated third parties.

On September 6, 2018, we entered into a contribution agreement with the Operating Partnership and an unrelated third party (the "Contributor") under which the Contributor agreed to contribute its interest in a resort hotel in California to the Operating Partnership in exchange for approximately \$150 million in a combination of cash and newly issued common limited partnership interests in the Operating Partnership ("OP units") at an agreed-upon value. The Contributor has elected to receive a maximum of approximately 1.2 million OP units at \$11.76 per unit and the remaining amount in cash. The transaction is expected to close in the fourth quarter of 2018, following the satisfaction of closing conditions. Upon closing, the Contributor's OP units will create a noncontrolling interest in the Operating Partnership. We will remain the sole general partner of the Operating Partnership.

6. Stock Incentive Plans

We are authorized to issue up to 6,082,664 shares of our common stock under our 2016 Equity Incentive Plan (the "2016 Plan"), of which we have issued or committed to issue 846,517 shares as of September 30, 2018. In addition to these shares, additional shares of common stock could be issued in connection with the performance stock unit awards as further described below. The 2016 Plan replaced the 2004 Stock Option and Incentive Plan, as amended (the "2004 Plan"). We no longer make share grants and issuances under the 2004 Plan, although awards previously made under the 2004 Plan that are outstanding will remain in effect in accordance with the terms of that plan and the applicable award agreements.

Restricted Stock Awards

Restricted stock awards issued to our officers and employees generally vest over a three-year period from the date of the grant based on continued employment. We measure compensation expense for the restricted stock awards based upon the fair market value of our common stock at the date of grant. Compensation expense is recognized on a straight-line basis over the vesting period and is included in corporate expenses in the accompanying condensed consolidated statements of operations. A summary of our restricted stock awards from January 1, 2018 to September 30, 2018 is as follows:

Number of Shares	Weighted- Average Grant
------------------------	-------------------------------

Edgar Filing: DiamondRock Hospitality Co - Form 10-Q

		Date Fair Value
Unvested balance at January 1, 2018	630,962	\$ 10.66
Granted	349,091	10.19
Vested	(287,148)	11.02
Forfeited	(51,061)	10.44
Unvested balance at September 30, 2018	641,844	\$ 10.25

The remaining share awards are expected to vest as follows: 310,117 shares during 2019, 215,368 shares during 2020, and 116,359 during 2021. As of September 30, 2018, the unrecognized compensation cost related to restricted stock awards was \$4.8 million and the weighted-average period over which the unrecognized compensation expense will be recorded is approximately 23 months. We recorded \$0.2 million and \$0.8 million of compensation expense related to restricted stock awards for the three months ended September 30, 2018 and 2017, respectively. We recorded \$2.3 million of compensation expense related to restricted stock awards for each of the nine months ended September 30, 2018 and 2017.

Table of Contents

In the first quarter of 2018, we recorded \$0.6 million of compensation expense related to the accelerated vesting of awards in connection with the departure of our former Chief Financial Officer. In the third quarter of 2018, we entered into a settlement agreement with our former Chief Financial Officer, in which he forfeited certain of his equity awards. Accordingly, in the third quarter of 2018 we reversed \$0.5 million of compensation expense previously recorded in the first quarter of 2018.

Performance Stock Units

Performance stock units (“PSUs”) are restricted stock units that vest three years from the date of grant. Each executive officer is granted a target number of PSUs (the “PSU Target Award”). For the PSUs issued in 2015 and vesting in 2018, the actual number of shares of common stock issued to each executive officer is subject to the achievement of certain levels of total stockholder return relative to the total stockholder return of a peer group of publicly traded lodging REITs over a three-year performance period. There will be no payout of shares of our common stock if our total stockholder return falls below the 30th percentile of the total stockholder returns of the peer group. The maximum number of shares of common stock issued to an executive officer is equal to 150% of the PSU Target Award and is earned if our total stockholder return is equal to or greater than the 75th percentile of the total stockholder returns of the peer group. For the PSUs issued in 2016 and vesting in 2019, the calculation of total stockholder return relative to the total stockholder return of a peer group over a three-year performance period remained in effect for 75% of the number of PSUs to be earned in the performance period. The remaining 25% is determined based on achieving improvement in market share for each of our hotels over the three-year performance period based on a report prepared for each hotel by STR Global, a well-recognized and universally accepted benchmarking service for the hospitality industry. For the PSUs issued in 2017 and 2018 and vesting in 2020 and 2021, respectively, the calculation of total stockholder return relative to the total stockholder return of a peer group over a three-year performance period applies to 50% of the number of PSUs to be earned in the performance period. The remaining 50% is determined based on achieving improvement in market share for each of our hotels over the three-year performance period.

We measure compensation expense for the PSUs based upon the fair market value of the award at the grant date. Compensation expense is recognized on a straight-line basis over the three-year performance period and is included in corporate expenses in the accompanying condensed consolidated statements of operations. The grant date fair value of the portion of the PSUs based on our relative total stockholder return is determined using a Monte Carlo simulation performed by a third-party valuation firm. The grant date fair value of the portion of the PSUs based on improvement in market share for each of our hotels is the closing price of our common stock on the grant date.

On March 2, 2018, our board of directors granted 264,509 PSUs to our executive officers. The grant date fair value of the portion of the PSUs based on our relative total stockholder return was \$9.52 using the assumptions of volatility of 26.9% and a risk-free rate of 2.40%. The grant date fair value of the portion of the PSUs based on hotel market share was \$10.18, the closing stock price of our common stock on such date. On April 2, 2018, our board of directors granted 28,602 PSUs to our new Chief Financial Officer. The grant date fair value of the portion of the PSUs based on our relative total stockholder return was \$9.00 using the assumptions of volatility of 26.9% and a risk-free rate of 2.37%. The grant date fair value of the portion of the PSUs based on hotel market share was \$10.32, the closing stock price of our common stock on such date.

A summary of our PSUs from January 1, 2018 to September 30, 2018 is as follows:

Number of Target Units	Weighted- Average Grant Date Fair
---------------------------------	--

Edgar Filing: DiamondRock Hospitality Co - Form 10-Q

		Value
Unvested balance at January 1, 2018	785,797	\$ 10.42
Granted	293,111	9.82
Additional units from dividends	26,068	11.13
Vested (1)	(218,514)	11.98
Forfeited	(113,668)	9.86
Unvested balance at September 30, 2018	772,794	\$ 11.18

(1) The number of shares of common stock earned for the PSUs vested in 2018 was equal to 51.75% of the PSU Target Award.

The remaining target units are expected to vest as follows: 245,055 units during 2019, 228,521 units during 2020 and 299,218 units during 2021. The number of shares earned upon vesting is subject to the attainment of the performance goals described above. As of September 30, 2018, the unrecognized compensation cost related to the PSUs was \$3.7 million and is expected to be recognized on a straight-line basis over a weighted average period of 24 months.

- 12-

Table of Contents

We recorded a net \$0.4 million reversal of compensation expense related to the PSUs for the three months ended September 30, 2018, due primarily to a reversal of \$1.0 million of previously recorded compensation expense related to the forfeiture of PSU awards of our former Chief Financial Officer. We recorded \$0.6 million of compensation expense related to the PSUs for the three months ended September 30, 2017. We recorded \$1.3 million and \$1.8 million, respectively, of compensation expense related to the PSUs for the nine months ended September 30, 2018 and 2017. The compensation expense for the nine months ended September 30, 2018 includes a net reversal of \$0.4 million of compensation expense due to the forfeiture of our former Chief Financial Officer's PSUs.

7. Earnings Per Share

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

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Numerator:				
Net income	\$31,443	\$ 21,623	\$63,790	\$ 67,105
Denominator:				
Weighted-average number of common shares outstanding—basic	208,758,920	200,834,910	204,520,620	200,767,104
Effect of dilutive securities:				
Unvested restricted common stock	221,018	173,557	212,051	170,612
Shares related to unvested PSUs	617,074	415,933	617,074	415,933
Weighted-average number of common shares outstanding—diluted	209,597,012	201,424,400	205,349,745	201,353,649
Earnings per share:				
Basic earnings per share	\$0.15	\$ 0.11	\$0.31	\$ 0.33
Diluted earnings per share	\$0.15	\$ 0.11	\$0.31	\$ 0.33

8. Debt

The following table sets forth information regarding the Company's debt as of September 30, 2018 and December 31, 2017 (dollars in thousands):

Table of Contents

Loan	Interest Rate	Maturity Date	Principal Balance as of	
			September 30, 2018	December 31, 2017
Salt Lake City Marriott Downtown mortgage loan	4.25%	November 2020	\$55,600	\$ 56,717
Westin Washington D.C. City Center mortgage loan	3.99%	January 2023	63,269	64,833
The Lodge at Sonoma, a Renaissance Resort & Spa mortgage loan	3.96%	April 2023	27,849	28,277
Westin San Diego mortgage loan	3.94%	April 2023	63,761	64,859
Courtyard Manhattan / Midtown East mortgage loan	4.40%	August 2024	82,990	84,067
Renaissance Worthington mortgage loan	3.66%	May 2025	82,941	84,116
JW Marriott Denver at Cherry Creek mortgage loan	4.33%	July 2025	62,694	63,519
Boston Westin mortgage loan	4.36%	November 2025	195,382	198,046
New Market Tax Credit loan (1)	5.17%	December 2020	2,943	—
Unamortized debt issuance costs			(4,290)	(4,795)
Total mortgage and other debt, net of unamortized debt issuance costs			633,139	639,639
Unsecured term loan	LIBOR + 1.45% (2)	May 2021	100,000	100,000
Unsecured term loan	LIBOR + 1.45% (2)	April 2022	200,000	200,000
Unamortized debt issuance costs			(1,502)	(1,847)
Unsecured term loan, net of unamortized debt issuance costs			298,498	298,153
Senior unsecured credit facility	LIBOR + 1.50%	May 2020 (3)	—	—
Total debt, net of unamortized debt issuance costs			\$931,637	\$ 937,792
Weighted-Average Interest Rate	4.03%			

(1) Assumed in connection with the acquisition of the Hotel Palomar Phoenix in March 2018.

(2) The interest rate at September 30, 2018 was 3.55%.

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

Mortgage and Other Debt

We have incurred limited recourse, property specific mortgage debt secured by certain of our hotels. In the event of default, the lender may only foreclose on the secured assets; however, in the event of fraud, misapplication of funds or other customary recourse provisions, the lender may seek payment from us. As of September 30, 2018, eight of our 30 hotels were secured by mortgage debt.

Our mortgage debt contains certain property specific covenants and restrictions, including minimum debt service coverage ratios that trigger “cash trap” provisions as well as restrictions on incurring additional debt without lender consent. As of September 30, 2018, we were in compliance with the financial covenants of our mortgage debt.

On March 1, 2018, in connection with our acquisition of the Hotel Palomar in Phoenix, Arizona, we assumed a \$2.9 million loan originated under a qualified New Market Tax Credit program. The loan is interest-only and bears an annual fixed interest rate equal to 5.17%. The loan matures on December 6, 2020.

Senior Unsecured Credit Facility

- 14-

Table of Contents

We are party to a senior unsecured credit facility with a capacity up to \$300 million. The maturity date is May 2020 and may be extended for an additional year upon the payment of applicable fees and the satisfaction of certain customary conditions. The facility also includes an accordion feature to expand up to \$600 million, subject to lender consent. The interest rate on the facility is based upon LIBOR, plus an applicable margin based upon the Company's leverage ratio, as follows:

Leverage Ratio	Applicable Margin
Less than or equal to 35%	1.50 %
Greater than 35% but less than or equal to 45%	1.65 %
Greater than 45% but less than or equal to 50%	1.80 %
Greater than 50% but less than or equal to 55%	2.00 %
Greater than 55%	2.25 %

In addition to the interest payable on amounts outstanding under the facility, we were required to pay an amount equal to 0.20% of the unused portion of the facility if the average usage of the facility was greater than 50% or 0.30% of the unused portion of the facility if the average usage of the facility was less than or equal to 50%.

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

	Covenant	Actual at September 30, 2018
Maximum leverage ratio (1)	60%	23.8%
Minimum fixed charge coverage ratio (2)	1.50x	4.25x
Minimum tangible net worth (3)	\$1.98 billion	\$2.74 billion
Secured recourse indebtedness	Less than 45% of Total Asset Value	20.4%

Leverage ratio is net indebtedness, as defined in the credit agreement, divided by total asset value, defined in the (1) credit agreement as the value of our owned hotels based on hotel net operating income divided by a defined capitalization rate.

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

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

As of September 30, 2018, we had no borrowings outstanding under the facility and the Company's leverage ratio was 23.8%. Accordingly, interest on our borrowings under the facility will be based on LIBOR plus 150 basis points for the following quarter. We incurred interest and unused credit facility fees on the facility of \$0.3 million for each of the three months ended September 30, 2018 and 2017. We incurred interest and unused credit facility fees on the facility of \$1.0 million and \$0.7 million for the nine months ended September 30, 2018 and 2017, respectively.

Unsecured Term Loans

Edgar Filing: DiamondRock Hospitality Co - Form 10-Q

We are party to two five-year unsecured term loans. The financial covenants of the term loans are consistent with the covenants on our senior unsecured credit facility, which are described above. The interest rate on each of the term loans is based on a pricing grid ranging from 145 to 220 basis points over LIBOR, as follows:

Leverage Ratio	Applicable Margin
Less than or equal to 35%	1.45 %
Greater than 35% but less than or equal to 45%	1.60 %
Greater than 45% but less than or equal to 50%	1.75 %
Greater than 50% but less than or equal to 55%	1.95 %
Greater than 55%	2.20 %

As of September 30, 2018, the Company's leverage ratio was 23.8%. Accordingly, interest on our borrowings under the term loans will be based on LIBOR plus 145 basis points for the following quarter. We incurred interest on the term loans of \$2.7 million

- 15-

Table of Contents

and \$2.1 million for the three months ended September 30, 2018 and 2017, respectively. We incurred interest on the term loans of \$7.6 million and \$4.2 million for the nine months ended September 30, 2018 and 2017, respectively.

On October 18, 2018, we entered into a new five-year \$50 million unsecured term loan. There are currently no outstanding borrowings on the term loan. The term loan will be funded upon closing of the pending acquisition of a resort hotel in California. The financial covenants of the term loan are consistent with the covenants on our other unsecured term loans and our senior unsecured credit facility. The interest rate is based on a pricing grid ranging from 140 to 220 basis points over LIBOR, as follows:

Leverage Ratio	Applicable Margin
Less than or equal to 25%	1.40 %
Greater than 25% but less than or equal to 35%	1.45 %
Greater than 35% but less than or equal to 45%	1.55 %
Greater than 45% but less than or equal to 50%	1.75 %
Greater than 50% but less than or equal to 55%	1.95 %
Greater than 55%	2.20 %

9. Acquisitions

On March 1, 2018, we acquired the 77-room Landing Resort & Spa in South Lake Tahoe, California, for a total contractual purchase price of \$42 million. The acquisition was funded with corporate cash. The acquisition is accounted for as an acquisition of assets; accordingly, our direct acquisition costs of \$0.5 million were capitalized. Upon acquisition of the hotel, we entered into a new management agreement with Two Roads Hospitality for an initial term of five years. The management agreement provides for a base management fee of 1.5% of gross revenues through 2020 and 1.75% of gross revenues for the remainder of the term. The management agreement also provides for an incentive management fee of 15% of hotel operating profit above an owner's priority, determined in accordance with the terms of the management agreement. The incentive management fee is capped at 1% of gross revenues for each year. The management agreement also specifies a corporate marketing contribution of 1% of gross revenues.

On March 1, 2018, we acquired the 242-room Hotel Palomar in Phoenix, Arizona, for a total contractual purchase price of \$80 million. The acquisition was funded with corporate cash. In connection with the acquisition, we assumed a \$2.9 million loan under a qualified New Market Tax Credit program. Refer to Note 8 for additional information about the loan. The acquisition is accounted for as an acquisition of assets; accordingly, our direct acquisition costs of \$0.3 million were capitalized. We assumed the existing management agreement with Kimpton Hotel and Restaurant Group. The management agreement provides for a base management fee of 3.5% of gross revenues. The management agreement also provides for an incentive management fee of 20% of hotel operating profit above an owner's priority, determined in accordance with the terms of the management agreement. The incentive management fee is capped at 1.5% of gross revenues for each year.

We lease the surface and air rights of the hotel property pursuant to a ground lease with the City of Phoenix. We own the building improvements fee simple. The ground lease expires in 2085, including all extension options. As lessee of government property, we are subject to a Government Property Lease Excise Tax ("GPLET") under Arizona state statute in lieu of ad valorem real estate taxes through the end of the term of the ground lease. We reviewed the terms of the ground lease and GPLET agreement and concluded that the terms of the ground lease are favorable to us compared with a typical market ground lease. Accordingly, we recorded a \$20.0 million favorable ground lease asset that will be amortized over the remaining term of the ground lease, including all extension options.

We assumed an agreement previously made with the lessee of the subsurface parking facility under the hotel, which requires us to pay 50% of the lessee's lease payments to the landlord—the City of Phoenix. The agreement is coterminous with the underlying subsurface ground lease, which expires in 2085, including all extensions at the lessee's option. We reviewed the terms of the parking agreement and concluded that the terms are unfavorable to us compared with a typical market parking agreement. Accordingly, we recorded a \$4.6 million unfavorable agreement liability that will be amortized over the remaining term of the parking agreement, including all extension options.

The following table summarizes the relative fair value of the assets acquired and liabilities assumed in our acquisitions (in thousands):

- 16-

Table of Contents

	The Landing Resort & Spa	Hotel Palomar Phoenix
Land	\$14,816	\$—
Building and improvements	24,351	59,703
Furnitures, fixtures and equipment	3,346	5,207
Total fixed assets	42,513	64,910
Favorable ground lease asset	—	20,012
Unfavorable contract liability	—	(4,644)
New Market Tax Credit loan assumption	—	(2,943)
Other assets and liabilities, net	(658)	497
Total	\$41,855	\$77,832

10. Fair Value of Financial Instruments

The fair value of certain financial assets and liabilities and other financial instruments as of September 30, 2018 and December 31, 2017, in thousands, is as follows:

	September 30, 2018		December 31, 2017	
	Carrying Amount (1)	Fair Value	Carrying Amount (1)	Fair Value
Debt	\$931,637	\$922,418	\$937,792	\$942,529

(1) The carrying amount of debt is net of unamortized debt issuance costs.

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

11. Commitments and Contingencies

Litigation

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

On August 13, 2018, the Company brought suit against certain of its property insurers in St. Thomas, U.S. Virgin Islands, over the amount of the coverage the insurers owe as a result of the damage caused to Frenchman's Reef by Hurricanes Irma and Maria. On September 28, 2018, certain of the Company's property insurers brought a similar suit against the Company in New York seeking a declaration that the insurers do not owe the full amount of the

Company's claim. Notwithstanding the litigation, the Company and its insurers continue to engage in discussions and negotiation regarding the Company's claim.

Other Matters

As previously reported, in February 2016, the Company was notified by the franchisor of one of its hotels that as a result of low guest satisfaction scores, the Company was in default under the franchise agreement for that hotel. The Company continues to proactively work with the franchisor and the manager of the hotel and has developed and executed a plan aimed to improve guest satisfaction scores. To date, the guest satisfaction scores have improved so that the Company is no longer in default under the franchise agreement. However, if the guest satisfaction scores were to decrease again, the franchisor may again notify the Company that it is in default under the franchise agreement and that the franchisor is reserving all of its rights under the franchise agreement, including the right to terminate the franchise agreement in the future.

- 17-

Table of Contents

While the Company continues to work diligently with the franchisor and manager to maintain the guest satisfaction scores at a level such that the Company does not fall back into default, no assurance can be given that the Company will be successful. If the Company is not successful, the franchisor may seek to terminate the franchise agreement and assert a claim it is owed a termination fee, including a payment for liquidated damages, which could result in a material adverse effect on the Company's business, financial condition or results of operation.

- 18-

Table of Contents

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

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and includes this statement for purposes of complying with these safe harbor provisions. These forward-looking statements are generally identifiable by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project" or similar expressions, whether in the negative or affirmative. Forward-looking statements are based on management's current expectations and assumptions and are not guarantees of future performance. Factors that may cause actual results to differ materially from current expectations include, but are not limited to, the risks discussed herein and the risk factors discussed from time to time in our periodic filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended December 31, 2017 as updated by our Quarterly Reports on Form 10-Q. Accordingly, there is no assurance that the Company's expectations will be realized. Except as otherwise required by the federal securities laws, the Company

disclaims any obligations or undertaking to publicly release any updates or revisions to any forward-looking statement contained in this report to reflect events, circumstances or changes in expectations after the date of this report.

Some of the risks and uncertainties that may cause our actual results, performance or achievements to differ materially from those expressed or implied by forward-looking statements include, among others, the following:

- negative changes in the economy, including, but not limited to, a reversal of current job growth trends, an increase in unemployment or a decrease in corporate earnings and investment;
- increased competition in the lodging industry and from alternative lodging channels or third party internet intermediaries in the markets in which we own properties;
- failure to effectively execute our long-term business strategy and successfully identify and complete acquisitions;
- risks and uncertainties affecting hotel renovations and management (including, without limitation, construction delays, increased construction costs, disruption in hotel operations and the risks associated with our franchise agreements);
- risks associated with the availability and terms of financing and the use of debt to fund acquisitions and renovations or refinance existing indebtedness, including the impact of higher interest rates on the cost and/or availability of financing;
- risks associated with the lodging industry overall, including, without limitation, an increase in alternative lodging channels, decreases in the frequency of business travel and increases in operating costs;
- risks associated with natural disasters;
- estimated costs and duration of renovation or restoration projects and estimated insurance recoveries;
- costs of compliance with government regulations, including, without limitation, the Americans with Disabilities Act;
- potential liability for uninsured losses and environmental contamination;
- risks associated with security breaches through cyber-attacks or otherwise, as well as other significant disruptions of our information technologies and systems, which support our operations and our hotel managers;
- risks associated with our potential failure to qualify as a REIT under the Internal Revenue Code of 1986, as amended;
- possible adverse changes in tax and environmental laws; and
- risks associated with our dependence on key personnel whose continued service is not guaranteed.

Overview

DiamondRock Hospitality Company is a lodging-focused Maryland corporation operating as a real estate investment trust ("REIT"). As of September 30, 2018, we owned a portfolio of 30 premium hotels and resorts that contain 9,949 guest rooms located in 21 different markets in North America and the U.S. Virgin Islands. As of September 30, 2018, the 502-room Frenchman's Reef & Morning Star Marriott Beach Resort ("Frenchman's Reef") is closed as a result of damage incurred from Hurricanes Irma and Maria in September 2017.

As an owner, rather than an operator, of lodging properties, we receive all of the operating profits or losses generated by our hotels after the payment of fees due to hotel managers, which are calculated based on the revenues and profitability of each hotel.

Our vision is to be a highly professional public lodging REIT that delivers long-term returns for our stockholders which exceed long-term returns generated by our peers. Our goal is to deliver long-term stockholder returns through a combination of dividends and enduring capital appreciation. Our strategy is to utilize disciplined capital allocation, focus on high quality lodging properties in North American markets with superior growth prospects and high barriers-to-entry, aggressively asset manage those hotels, and employ conservative amounts of leverage.

Table of Contents

Our primary business is to acquire, own, asset manage and renovate premium hotel properties in the United States. Our portfolio is concentrated in key gateway cities and destination resort locations. Each of our hotels is managed by a third party—either an independent operator or a brand operator, such as Marriott International, Inc.

We critically evaluate each of our hotels to ensure that we own a portfolio of hotels that conforms to our vision, supports our mission and corresponds with our strategy. On a regular basis, we analyze our portfolio to identify opportunities to invest capital in certain projects or market non-core assets for sale in order to increase our portfolio quality. We are committed to a conservative capital structure with prudent leverage. We regularly assess the availability and affordability of capital in order to maximize stockholder value and minimize enterprise risk. In addition, we are committed to following sound corporate governance practices and to being open and transparent in our communications with our stockholders.

Key Indicators of Financial Condition and Operating Performance

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

• Occupancy percentage;

• Average Daily Rate (or ADR);

• Revenue per Available Room (or RevPAR);

• Earnings Before Interest, Income Taxes, Depreciation and Amortization (or EBITDA), Earnings Before Interest, Income Taxes, Depreciation and Amortization for real estate (or EBITDAre), and Adjusted EBITDA; and

• Funds From Operations (or FFO) and Adjusted FFO.

Occupancy, ADR and RevPAR are commonly used measures within the hotel industry to evaluate operating performance. RevPAR, which is calculated as the product of ADR and occupancy percentage, is an important statistic for monitoring operating performance at the individual hotel level and across our business as a whole. We evaluate individual hotel RevPAR performance on an absolute basis with comparisons to budget and prior periods, as well as on a company-wide and regional basis. ADR and RevPAR include only room revenue. Room revenue comprised approximately 73% of our total revenues for the nine months ended September 30, 2018 and is dictated by demand, as measured by occupancy percentage, pricing, as measured by ADR, and our available supply of hotel rooms.

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

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

Our Hotels

The following table sets forth certain operating information for the nine months ended September 30, 2018 for each of our hotels.

- 20-

Table of Contents

Property (1)	Location	Number of Rooms	Occupancy (%)	ADR(\$)	RevPAR(\$)	% Change from 2017 RevPAR (2)
Chicago Marriott Downtown	Chicago, Illinois	1,200	73.6 %	\$ 228.45	\$ 168.23	5.5 %
Westin Boston Waterfront Hotel	Boston, Massachusetts	793	76.5 %	250.51	191.56	(4.9)%
Lexington Hotel New York	New York, New York	725	89.7 %	236.54	212.28	(0.4)%
Salt Lake City Marriott Downtown	Salt Lake City, Utah	510	73.3 %	174.07	127.67	(3.6)%
Renaissance Worthington	Fort Worth, Texas	504	74.8 %	188.71	141.08	2.7 %
Westin San Diego	San Diego, California	436	84.3 %	193.20	162.94	(5.5)%
Westin Fort Lauderdale Beach Resort	Fort Lauderdale, Florida	432	82.7 %	199.24	164.73	(1.4)%
Westin Washington, D.C. City Center	Washington, D.C.	410	88.7 %	204.56	181.40	(6.2)%
Hilton Boston Downtown	Boston, Massachusetts	403	88.0 %	298.92	262.93	4.9 %
Vail Marriott Mountain Resort & Spa	Vail, Colorado	344	60.8 %	294.81	179.23	(15.3)%
Marriott Atlanta Alpharetta	Atlanta, Georgia	318	69.5 %	173.66	120.74	(5.9)%
Courtyard Manhattan/Midtown East	New York, New York	321	93.7 %	246.82	231.21	5.4 %
The Gwen Chicago	Chicago, Illinois	311	82.3 %	254.98	209.79	31.0 %
Hilton Garden Inn Times Square Central	New York, New York	282	97.6 %	239.27	233.61	6.1 %
Bethesda Marriott Suites	Bethesda, Maryland	272	65.6 %	179.28	117.69	(8.4)%
Hilton Burlington	Burlington, Vermont	258	81.8 %	190.99	156.29	6.4 %
Hotel Palomar Phoenix (3)	Phoenix, Arizona	242	75.8 %	179.63	136.09	(0.1)%
JW Marriott Denver at Cherry Creek	Denver, Colorado	196	82.3 %	253.12	208.40	(2.0)%
Courtyard Manhattan/Fifth Avenue	New York, New York	189	89.9 %	259.44	233.13	5.1 %
Sheraton Suites Key West	Key West, Florida	184	87.8 %	252.38	221.61	(3.6)%
The Lodge at Sonoma, a Renaissance Resort & Spa	Sonoma, California	182	72.2 %	309.25	223.31	5.3 %
Courtyard Denver Downtown	Denver, Colorado	177	84.1 %	198.12	166.55	(1.1)%
Renaissance Charleston	Charleston, South Carolina	166	84.9 %	255.55	216.86	11.7 %
Shorebreak Hotel	Huntington Beach, California	157	78.9 %	261.64	206.52	10.8 %
Havana Cabana Key West (4)	Key West, Florida	106	75.3 %	173.57	130.64	(19.3)%
Hotel Rex (5)	San Francisco, California	94	81.6 %	204.18	166.71	(11.6)%
L'Auberge de Sedona	Sedona, Arizona	88	74.8 %	587.68	439.54	11.2 %
The Landing Resort & Spa (3)	South Lake Tahoe, California	77	63.9 %	330.90	211.57	(0.9)%
Orchards Inn Sedona	Sedona, Arizona	70	75.6 %	249.32	188.59	5.8 %
TOTAL/WEIGHTED AVERAGE		9,447	79.8 %	\$ 231.31	\$ 184.58	(0.6)%

(1) Frenchman's Reef closed on September 6, 2017 due to Hurricane Irma and remains closed. Accordingly, there is no operating information for the nine months ended September 30, 2018.

(2) The percentage change from 2017 RevPAR reflects the comparable period in 2017 to our 2018 ownership period for our 2018 and 2017 acquisitions.

(3) The hotel was acquired on March 1, 2018. The operating statistics reflect the period from March 1, 2018 to September 30, 2018.

(4) The hotel closed on September 6, 2017 due to Hurricane Irma and reopened in April 2018. Accordingly, the operating information reported for the nine months ended September 30, 2018 only includes operations beginning in April 2018.

(5) The hotel closed on September 4, 2018 for a comprehensive renovation. Accordingly, the operating information reported for the nine months ended September 30, 2018 only includes operations through the closure date.

Highlights

Hotel Acquisitions. In March 2018, we acquired the 77-room Landing Resort & Spa in South Lake Tahoe, California, for a total contractual purchase price of \$42 million, and the 242-room Hotel Palomar in Phoenix, Arizona, for a total contractual purchase price of \$80 million.

Pending Resort Acquisition. In September 2018, we entered into a contribution agreement under which an unrelated third party has agreed to contribute its interest in a resort hotel in California in exchange for approximately \$150 million of consideration, in a combination of cash and newly issued operating partnership units. The acquisition is expected to close in the fourth quarter of 2018, following the satisfaction of closing conditions.

Table of Contents

Update on Insurance Claims

As previously disclosed, we have insurance claims resulting from hurricanes that impacted Frenchman's Reef and the Havana Cabana Key West in 2017, as well as from the 2017 wildfires in Northern California that impacted The Lodge at Sonoma. The Company is insured for up to \$361 million for each covered event, subject to certain deductibles and other conditions.

Frenchman's Reef. The hotel was significantly damaged by last year's hurricanes and is expected to remain closed into 2020. We submitted our insurance claim during the first quarter of 2018 and are continuing to work diligently with our insurance carriers and the U.S. Virgin Islands government to evaluate all alternatives to ensure the best outcome for our shareholders. During the three and nine months ended September 30, 2018, we recognized \$5.7 million and \$13.0 million, respectively, of business interruption income under the insurance claim.

Havana Cabana Key West. We completed a comprehensive renovation and re-positioning of the hotel in connection with the remediation of substantial wind and water-related damage from Hurricane Irma. The hotel reopened as the Havana Cabana Key West in April 2018. In July 2018, we settled our insurance claim for the property damage and business interruption for \$8.3 million, net of deductibles. During the three and nine months ended September 30, 2018, we recognized \$1.9 million and \$2.1 million, respectively, of business interruption income. During each of the three and nine months ended September 30, 2018, we recognized a \$1.7 million gain on the property damage insurance settlement.

The Lodge at Sonoma. In July 2018, we settled our insurance claim for smoke damage and business interruption for \$1.3 million, net of deductibles. During the three and nine months ended September 30, 2018, we recognized \$0.6 million and \$1.2 million, respectively, of business interruption income related to The Lodge at Sonoma.

In total, we have recognized \$8.2 million and \$16.3 million of business interruption income for the three and nine months ended September 30, 2018, respectively.

Results of Operations

Comparison of the Three Months Ended September 30, 2018 to the Three Months Ended September 30, 2017

Revenue. Revenue consists primarily of the room, food and beverage and other operating revenues from our hotels, as follows (dollars in millions):

	Three Months Ended September 30,		% Change
	2018	2017	
Rooms	\$ 165.8	\$ 168.0	(1.3)%
Food and beverage	42.9	42.7	0.5 %
Other	12.1	12.8	(5.5)%
Total revenues	\$ 220.8	\$ 223.5	(1.2)%

Our total revenues decreased \$2.7 million from \$223.5 million for the three months ended September 30, 2017 to \$220.8 million for the three months ended September 30, 2018. This decrease includes amounts that are not comparable quarter-over-quarter as follows:

\$11.2 million decrease from Frenchman's Reef, which was closed on September 6, 2017 due to Hurricane Irma and remained closed through the end of the third quarter of 2018.

- \$0.3 million increase from the Havana Cabana Key West, which was closed on September 6, 2017 due to Hurricane Irma and re-opened in April 2018.

\$3.9 million increase from The Landing Resort & Spa, which was acquired on March 1, 2018.

\$4.1 million increase from the Hotel Palomar Phoenix, which was acquired on March 1, 2018.

\$0.7 million decrease from Hotel Rex, which closed beginning September 4, 2018 for renovations.

Excluding these non-comparable amounts, our total revenues increased \$0.9 million, or 0.4%.

Table of Contents

The following are key hotel operating statistics for the three months ended September 30, 2018 and 2017. The 2017 amounts reflect the period in 2017 comparable to our ownership period in 2018 for the Hotel Palomar Phoenix and The Landing Resort & Spa and exclude the results from Frenchman's Reef and the Havana Cabana Key West, due to the closure of these hotels for all or a portion of the periods presented, and Hotel Rex beginning September 4, 2017, due to the renovation closure on September 4, 2018.

	Three Months Ended September 30,		
	2018	2017	% Change
Occupancy %	82.4	84.9	(2.5)%
ADR	\$233.14	\$227.91	2.3 %
RevPAR	\$192.07	\$193.45	(0.7)%

Food and beverage revenues increased \$0.3 million from the three months ended September 30, 2017, which includes amounts that are not comparable quarter-over-quarter as follows:

- \$3.3 million decrease from Frenchman's Reef, which was closed on September 6, 2017 due to Hurricane Irma and remained closed through the end of the third quarter of 2018.

- \$0.1 million increase from the Havana Cabana Key West, which was closed on September 6, 2017 due to Hurricane Irma and re-opened in April 2018.

\$1.4 million increase from The Landing Resort & Spa, which was acquired on March 1, 2018.

\$1.6 million increase from the Hotel Palomar Phoenix, which was acquired on March 1, 2018.

Excluding these non-comparable amounts, food and beverage revenues increased \$0.5 million, or 1.2%, primarily due to an increase in restaurant and room service revenues.

Excluding non-comparable amounts, other revenues, which primarily represent spa, parking, resort fees and attrition and cancellation fees, increased by \$0.8 million, primarily due to an increase in resort fees and rents and commissions, partially offset by a decrease in parking and attrition and cancellation revenue.

Hotel operating expenses. The operating expenses consisted of the following (dollars in millions):

	Three Months Ended September 30,		
	2018	2017	% Change (B)/W
Rooms departmental expenses	\$41.8	\$41.9	(0.2)%
Food and beverage departmental expenses	29.0	30.8	(5.8)
Other departmental expenses	2.6	3.1	(16.1)
General and administrative	18.2	19.2	(5.2)
Utilities	5.6	6.5	(13.8)
Repairs and maintenance	8.0	8.8	(9.1)
Sales and marketing	15.7	15.2	3.3
Franchise fees	6.5	6.2	4.8
Base management fees	4.7	3.4	38.2

Edgar Filing: DiamondRock Hospitality Co - Form 10-Q

Incentive management fees	1.4	2.0	(30.0)
Property taxes	14.2	13.1	8.4
Other fixed charges	5.0	3.2	56.3
Ground rent—Contractual	1.2	1.0	20.0
Ground rent—Non-cash	1.8	1.5	20.0
Total hotel operating expenses	\$155.7	\$155.9	(0.1)%

Our hotel operating expenses decreased \$0.2 million from \$155.9 million for the three months ended September 30, 2017 to \$155.7 million for the three months ended September 30, 2018. The decrease in hotel operating expenses includes amounts that are not comparable quarter-over-quarter as follows:

- 23-

Table of Contents

\$9.6 million decrease from Frenchman's Reef, which was closed on September 6, 2017 due to Hurricane Irma and remained closed throughout the third quarter of 2018.

- \$0.4 million increase from the Havana Cabana Key West, which was closed on September 6, 2017 due to Hurricane Irma and re-opened in April 2018.

\$2.4 million increase from The Landing Resort & Spa, which was acquired on March 1, 2018.

\$3.6 million increase from the Hotel Palomar Phoenix, which was acquired on March 1, 2018.

\$0.2 million decrease from Hotel Rex, which closed beginning September 4, 2018 for renovations.

In connection with the change in hotel manager of the Courtyard Manhattan/Midtown East in August 2017, we recognized \$1.9 million of accelerated amortization of key money during the three months ended September 30, 2017. This amortization reduced base management fees during the three months ended September 30, 2017.

Excluding the accelerated amortization of key money and the non-comparable amounts detailed above, hotel operating expenses increased \$1.2 million, or 2.2%, from the three months ended September 30, 2017.

Depreciation and amortization. Depreciation and amortization is recorded on our hotel buildings over 40 years for the periods subsequent to acquisition. Depreciable lives of hotel furniture, fixtures and equipment are estimated as the time period between the acquisition date and the date that the hotel furniture, fixtures and equipment will be replaced. Our depreciation and amortization expense increased \$1.3 million, or 5.1%, from the three months ended September 30, 2017.

Corporate expenses. Corporate expenses principally consist of employee-related costs, including base payroll, bonus, restricted stock and severance. Corporate expenses also include corporate operating costs, professional fees and directors' fees. Our corporate expenses decreased \$1.6 million, or 26.0%, from \$6.1 million for the three months ended September 30, 2017 to \$4.5 million for the three months ended September 30, 2018 primarily due to the reversal of \$2.4 million of severance costs previously recorded in the first quarter of 2018, related to a settlement agreement in the third quarter of 2018 with our former Chief Financial Officer, partially offset by various increases, including professional fees, consulting fees, and employee compensation.

Business interruption insurance income. In September 2017, Hurricanes Irma and Maria caused significant damage to Frenchman's Reef and the Havana Cabana Key West. In October 2017, The Lodge at Sonoma was impacted by smoke infiltration due to the wildfires. These natural disasters resulted in lost revenue and additional expenses covered under our insurance policy. For the three months ended September 30, 2018, we recognized \$8.2 million of business interruption insurance income, which is in addition to the less than \$0.1 million of expense reimbursements from insurance recorded within other hotel expenses on our accompanying condensed consolidated statement of operations.

Gain on property insurance settlement. In July 2018, we settled our insurance claim for the property damage and business interruption related to the Havana Cabana Key West. Based on the settled insurance claim, we recognized a gain on insurance settlement of \$1.7 million, which represents proceeds received in excess of the impairment loss for property damage.

Interest expense. Our interest expense was \$10.2 million and \$9.7 million for the three months ended September 30, 2018 and 2017, respectively, and comprises the following (in millions):

Three
Months
Ended
September

	30,	
	2018	2017
Mortgage debt interest	\$6.7	\$6.9
Term loan interest	2.7	2.1
Credit facility interest and unused fees	0.3	0.2
Amortization of deferred financing costs and debt premium	0.5	0.5
	\$10.2	\$9.7

The increase in interest expense is primarily related to the increase in variable interest rates from 2017 to 2018, which caused an increase in interest expense on our two unsecured term loans.

Income taxes. We recorded income tax expense of \$3.2 million for the three months ended September 30, 2018 and an income tax expense of \$3.4 million for the three months ended September 30, 2017. The income tax expense for the three months ended September 30, 2018 includes \$2.4 million of income tax expense on the \$8.7 million pre-tax income of our taxable REIT subsidiaries (each, a "TRS") and \$0.8 million of income tax expense on the \$5.9 million pre-tax income of the TRS that owns Frenchman's Reef. The income tax expense for the three months ended September 30, 2017 includes \$3.4 million of income tax expense incurred

Table of Contents

on the \$8.4 million pre-tax income of our TRSs and \$0.1 million of state franchise taxes, offset by \$0.1 million of income tax benefit incurred on the \$1.5 million pre-tax loss of the TRS that owns Frenchman's Reef.

Comparison of the Nine Months Ended September 30, 2018 to the Nine Months Ended September 30, 2017

Revenue. Revenue consists primarily of the room, food and beverage and other operating revenues from our hotels, as follows (dollars in millions):

	Nine Months Ended September 30,		%
	2018	2017	Change
Rooms	\$469.8	\$483.3	(2.8)%
Food and beverage	135.3	140.2	(3.5)%
Other	35.2	39.5	(10.9)%
Total revenues	\$640.3	\$663.0	(3.4)%

Our total revenues decreased \$22.7 million from \$663.0 million for the nine months ended September 30, 2017 to \$640.3 million for the nine months ended September 30, 2018. This decrease includes amounts that are not comparable period-over-period as follows:

\$50.2 million decrease from Frenchman's Reef, which was closed on September 6, 2017 due to Hurricane Irma and remained closed through the end of the third quarter of 2018.

\$2.4 million decrease from the Havana Cabana Key West, which was closed on September 6, 2017 due to Hurricane Irma and re-opened in April 2018.

\$6.5 million increase from The Landing Resort & Spa, which was acquired on March 1, 2018.

\$12.1 million increase from the Hotel Palomar Phoenix, which was acquired on March 1, 2018.

\$3.2 million increase from the L'Auberge de Sedona, which was acquired on February 28, 2017.

\$1.0 million increase from the Orchards Inn Sedona, which was acquired on February 28, 2017.

\$0.7 million decrease from Hotel Rex, which closed beginning September 4, 2018 for renovations.

Excluding these non-comparable amounts our total revenues increased \$7.8 million, or 1.3%.

The following are key hotel operating statistics for the nine months ended September 30, 2018 and 2017. The 2017 amounts reflect the period in 2017 comparable to our ownership period in 2018 for the Hotel Palomar Phoenix, The Landing Resort & Spa, the L'Auberge de Sedona, and Orchards Inn Sedona, and exclude the results from Frenchman's Reef and the Havana Cabana Key West, due to the closure of these hotels for all or a portion of the periods presented, and Hotel Rex beginning September 4, 2017, due to the renovation closure on September 4, 2018.

	Nine Months Ended September 30,		%
	2018	2017	Change
Occupancy %	79.8	% 81.0	% (1.2)%
ADR	\$231.67	\$226.10	2.5 %
RevPAR	\$184.94	\$183.09	1.0 %

Food and beverage revenues decreased \$4.9 million from the nine months ended September 30, 2017, which includes amounts that are not comparable period-over-period as follows:

\$14.1 million decrease from Frenchman's Reef, which was closed on September 6, 2017 due to Hurricane Irma and remained closed through the end of the third quarter of 2018.

\$2.3 million increase from The Landing Resort & Spa, which was acquired on March 1, 2018.

\$4.6 million increase from the Hotel Palomar Phoenix, which was acquired on March 1, 2018.

\$0.8 million increase from the L'Auberge de Sedona, which was acquired on February 28, 2017.

\$0.5 million increase from the Orchards Inn Sedona, which was acquired on February 28, 2017.

Excluding these non-comparable amounts, food and beverage revenues increased \$1.0 million, or 0.8%, primarily due to an increase in restaurant and room service revenues.

Table of Contents

Excluding non-comparable amounts, other revenues, which primarily represent spa, parking, resort fees and attrition and cancellation fees, increased by \$1.7 million, or 5.4%, primarily due to an increase in resort fees, partially offset by a decrease in attrition and cancellation fees.

Hotel operating expenses. The operating expenses consisted of the following (dollars in millions):

	Nine Months Ended September 30,			% Change (B)/W
	2018	2017		
Rooms departmental expenses	\$118.0	\$120.4	(2.0)%
Food and beverage departmental expenses	88.2	93.3	(5.5)
Other departmental expenses	7.6	9.2	(17.4)
General and administrative	54.5	56.7	(3.9)
Utilities	15.6	18.6	(16.1)
Repairs and maintenance	23.9	26.3	(9.1)
Sales and marketing	45.9	44.6	2.9	
Franchise fees	19.3	17.3	11.6	
Base management fees	11.4	13.7	(16.8)
Incentive management fees	4.1	4.6	(10.9)
Property taxes	42.0	39.2	7.1	
Other fixed charges	13.2	8.5	55.3	
Severance costs	10.9	—	100.0	
Ground rent—Contractual	3.5	3.1	12.9	
Ground rent—Non-cash	5.1	4.6	10.9	
Total hotel operating expenses	\$463.2	\$460.1	0.7	%

Our hotel operating expenses increased \$3.1 million from \$460.1 million for the nine months ended September 30, 2017 to \$463.2 million for the nine months ended September 30, 2018. The increase in hotel operating expenses includes amounts that are not comparable period-over-period as follows:

• \$37.6 million decrease from Frenchman's Reef, which was closed on September 6, 2017 due to Hurricane Irma and remained closed through the end of the third quarter of 2018.

• \$0.2 million decrease from the Havana Cabana Key West, which was closed on September 6, 2017 due to Hurricane Irma and re-opened in April 2018.

• \$5.1 million increase from The Landing Resort & Spa, which was acquired on March 1, 2018.

• \$9.0 million increase from the Hotel Palomar Phoenix, which was acquired on March 1, 2018.

• \$2.8 million increase from the L'Auberge de Sedona, which was acquired on February 28, 2017.

• \$0.8 million increase from the Orchards Inn Sedona, which was acquired on February 28, 2017.

• \$0.2 million decrease from Hotel Rex, which closed beginning September 4, 2018 for renovations.

In connection with the termination of the hotel manager of Frenchman's Reef in February 2018, we recognized \$2.2 million of accelerated amortization of key money during the nine months ended September 30, 2018. This amortization reduced base management fees during the nine months ended September 30, 2018 and is included within the non-comparable decrease of hotel operating expenses. In connection with the change in hotel manager of the

Courtyard Manhattan/Midtown East in August 2017, we recognized \$1.9 million of accelerated amortization of key money during the nine months ended September 30, 2017. This amortization reduced base management fees during the nine months ended September 30, 2017.

For the nine months ended September 30, 2018, we incurred \$10.9 million of severance costs related to payments made to unionized employees under a voluntary buyout program that commenced during the first quarter of 2018 at the Lexington Hotel New York.

Excluding the severance costs, the accelerated amortization of key money, and the non-comparable amounts detailed above, hotel operating expenses increased \$12.5 million, or 3.0%, from the nine months ended September 30, 2017.

Depreciation and amortization. Depreciation and amortization is recorded on our hotel buildings over 40 years for the periods subsequent to acquisition. Depreciable lives of hotel furniture, fixtures and equipment are estimated as the time period between

- 26-

Table of Contents

the acquisition date and the date that the hotel furniture, fixtures and equipment will be replaced. Our depreciation and amortization expense increased \$2.3 million, or 3.0%, from the nine months ended September 30, 2017.

Hotel acquisitions costs. The acquisitions of The Landing Resort & Spa in South Lake Tahoe and the Hotel Palomar Phoenix are accounted for as an acquisition of assets. All direct acquisition related costs are capitalized as a component of acquired assets. Refer to Note 2 for additional information on the adoption of ASU No. 2017-01. We incurred \$2.0 million of hotel acquisition costs during the nine months ended September 30, 2017 associated with the acquisitions of L'Auberge de Sedona and Orchards Inn Sedona.

Corporate expenses. Corporate expenses principally consist of employee-related costs, including base payroll, bonus, restricted stock and severance. Corporate expenses also include corporate operating costs, professional fees and directors' fees. Our corporate expenses increased \$2.9 million, or 15.3%, from \$19.2 million for the nine months ended September 30, 2017 to \$22.1 million for the nine months ended September 30, 2018. The increase is due to various drivers, including an increase in professional fees, consulting fees, and employee compensation.

Business interruption insurance income. In September 2017, Hurricanes Irma and Maria caused significant damage to Frenchman's Reef and the Havana Cabana Key West. In October 2017, The Lodge at Sonoma was impacted by smoke infiltration due to the wildfires. These natural disasters resulted in lost revenue and additional expenses covered under our insurance policy. For the nine months ended September 30, 2018, we recognized \$16.3 million of business interruption insurance income, which is in addition to \$2.9 million of expense reimbursements from insurance recorded within other hotel expenses on our accompanying condensed consolidated statement of operations.

Gain on property insurance settlement. In July 2018, we settled our insurance claim for the property damage and business interruption related to the Havana Cabana Key West. Based on the settled insurance claim we recognized a gain on insurance settlement of \$1.7 million, which represents proceeds received in excess of the impairment loss for property damage.

Interest expense. Our interest expense was \$30.4 million and \$28.8 million for the nine months ended September 30, 2018 and 2017, respectively, and comprises the following (in millions):

	Nine Months Ended September 30, 2018 2017	
Mortgage debt interest	\$20.3	\$22.4
Term loan interest	7.6	4.2
Credit facility interest and unused fees	1.0	0.7
Amortization of deferred financing costs and debt premium	1.5	1.5
	\$30.4	\$28.8

The increase in interest expense is primarily related to the \$200 million unsecured term loan entered into in April 2017. This increase is partially offset by a decrease in mortgage debt interest expense, primarily related to the repayment of the mortgage loan secured by the Lexington Hotel New York in April 2017.

Income taxes. We recorded income tax expense of \$2.9 million for the nine months ended September 30, 2018 and an income tax expense of \$9.0 million for the nine months ended September 30, 2017. The income tax expense for the

nine months ended September 30, 2018 includes \$1.0 million of income tax expense on the \$3.9 million pre-tax income of our TRSs and \$1.9 million of income tax expense incurred on the \$14.3 million pre-tax income of the TRS that owns Frenchman's Reef. The income tax expense for the nine months ended September 30, 2017 includes \$8.4 million of income tax expense incurred on the \$20.7 million pre-tax income of our TRSs, \$0.2 million of state franchise taxes and \$0.4 million of income tax expense incurred on the \$6.3 million pre-tax income of the TRS that owns Frenchman's Reef.

Liquidity and Capital Resources

Our short-term liquidity requirements consist primarily of funds necessary to fund distributions to our stockholders to maintain our REIT status as well as to pay for operating expenses and capital expenditures directly associated with our hotels, funding of share repurchases under our share repurchase program, hotel acquisitions, costs to repair property damaged by natural disasters and scheduled debt payments of interest and principal. We currently expect that our available cash flows, which are generally provided through net cash from hotel operations, existing cash balances, equity issuances, proceeds from new financings and refinancings of maturing debt, insurance proceeds, proceeds from potential property dispositions, and, if necessary, short-term borrowings under our senior unsecured credit facility, will be sufficient to meet our short-term liquidity requirements.

Table of Contents

Some of our mortgage debt agreements contain “cash trap” provisions that are triggered when the hotel’s operating results fall below a certain debt service coverage ratio. When these provisions are triggered, all of the excess cash flow generated by the hotel is deposited directly into cash management accounts for the benefit of our lenders until a specified debt service coverage ratio is reached and maintained for a certain period of time. Such provisions do not allow the lender the right to accelerate repayment of the underlying debt.

Our long-term liquidity requirements consist primarily of funds necessary to pay for the costs of acquiring additional hotels, renovations, and other capital expenditures that need to be made periodically to our hotels, scheduled debt payments, debt maturities, redemption of operating partnership units and making distributions to our stockholders. We expect to meet our long-term liquidity requirements through various sources of capital, including cash provided by operations, borrowings, issuances of additional equity, including operating partnership units, and/or debt securities and proceeds from property dispositions. Our ability to incur additional debt is dependent upon a number of factors, including the state of the credit markets, our degree of leverage, the value of our unencumbered assets and borrowing restrictions imposed by existing lenders. Our ability to raise capital through the issuance of additional equity and/or debt securities is also dependent on a number of factors including the current state of the capital markets, investor sentiment and intended use of proceeds. We may need to raise additional capital if we identify acquisition opportunities that meet our investment objectives and require liquidity in excess of existing cash balances. Our ability to raise funds through the issuance of equity securities depends on, among other things, general market conditions for hotel companies and REITs and market perceptions about us.

Our Financing Strategy

Since our formation in 2004, we have been committed to a conservative capital structure with prudent leverage. The majority of our outstanding debt is fixed interest rate mortgage debt. We have a preference to maintain a significant portion of our portfolio as unencumbered assets in order to provide balance sheet flexibility. We expect that our strategy will enable us to maintain a balance sheet with an appropriate amount of debt throughout all phases of the lodging cycle. We believe that it is not prudent to increase the inherent risk of highly cyclical lodging fundamentals through the use of a highly leveraged capital structure.

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

We believe that we maintain a reasonable amount of debt. As of September 30, 2018, we had \$931.6 million of debt outstanding with a weighted average interest rate of 4.03% and a weighted average maturity date of approximately 4.9 years. We maintain balance sheet flexibility with no near-term debt maturities, no borrowings outstanding under our senior unsecured credit facility and 22 of our 30 hotels unencumbered by mortgage debt. We remain committed to our core strategy of maintaining a simple capital structure with conservative leverage.

Information about our financing activities is available in Note 8 to the accompanying condensed consolidated financial statements.

ATM Program

We have equity distribution agreements, as amended, with a number of sales agents to issue and sell, from time to time, shares of our common stock, par value \$0.01 per share, having an aggregate offering price of up to \$200 million (the "ATM Shares") under the Current ATM Program. Sales of the ATM Shares can be made in privately negotiated transactions and/or any other method permitted by law, including sales deemed to be an "at the market" offering, which includes sales made directly on the New York Stock Exchange or sales made to or through a market maker other than on an exchange. We have not sold any shares under the Current ATM Program. Actual future sales of the ATM Shares will depend upon a variety of factors, including but not limited to market conditions, the trading price of the Company's common stock and the Company's capital needs. We have no obligation to sell the ATM Shares under the Current ATM Program.

Prior to the implementation of the Current ATM Program, the Company had a \$200 million ATM program (the "Prior ATM Program"), which is no longer active. During the nine months ended September 30, 2018, we sold 7,472,946 shares of common stock at an average price of \$12.56 for net proceeds of \$92.9 million under the Prior ATM Program. We did not sell any shares of common stock during the three months ended September 30, 2018.

Share Repurchase Program

- 28-

Table of Contents

As of September 30, 2018, we had a \$150 million share repurchase program authorizing us to repurchase shares of our common stock. On November 2, 2018, our board of directors increased the authorization under the share repurchase program from \$150 million to \$250 million. Information about our share repurchase program is found in Note 5 to the accompanying condensed consolidated financial statements. We have not repurchased any shares of our common stock during 2018 and we have full capacity remaining under our share repurchase program.

Short-Term Borrowings

Other than borrowings under our senior unsecured credit facility, discussed below, we do not utilize short-term borrowings to meet liquidity requirements.

Senior Unsecured Credit Facility

We are party to a \$300 million senior unsecured credit facility expiring in May 2020. The credit facility may be extended for an additional year upon the payment of applicable fees and the satisfaction of certain customary conditions. Information about our senior unsecured credit facility is found in Note 8 to the accompanying condensed consolidated financial statements. As of September 30, 2018, we had no borrowings outstanding under our senior unsecured credit facility.

Unsecured Term Loans

We are party to a \$100 million unsecured term loan expiring in May 2021 and a \$200 million unsecured term loan expiring in April 2022. On October 18, 2018, we closed on a new five-year \$50 million unsecured term loan. There are currently no outstanding borrowings on the new term loan. Information about our unsecured term loans is found in Note 8 to the accompanying condensed consolidated financial statements.

Sources and Uses of Cash

Our principal sources of cash are net cash flow from hotel operations and borrowings under mortgage debt, term loans, and our senior unsecured credit facility, proceeds from equity issuances, proceeds from potential hotel dispositions, and proceeds from insurance claims. Our principal uses of cash are acquisitions of hotel properties, debt service, debt maturities, capital expenditures, operating costs, corporate expenses, natural disaster remediation and repair costs, and dividends. As of September 30, 2018, we had \$169.7 million of unrestricted corporate cash and \$42.6 million of restricted cash, as well as full borrowing capacity under our senior unsecured credit facility.

Our net cash provided by operations was \$150.0 million for the nine months ended September 30, 2018. Our cash from operations generally consists of the net cash flow from hotel operations and insurance proceeds related to our hotels impacted by natural disasters, offset by cash paid for corporate expenses and other working capital changes.

Our net cash used in investing activities was \$167.5 million for the nine months ended September 30, 2018, which consisted of \$119.5 million paid for the acquisitions of The Landing Resort & Spa and the Hotel Palomar Phoenix, capital expenditures at our hotels of \$76.8 million, and a \$2.0 million purchase deposit on a resort hotel in California, offset by \$30.7 million of insurance proceeds related to property casualty losses at our hotels impacted by Hurricanes Irma and Maria.

Our net cash provided by financing activities was \$6.1 million for the nine months ended September 30, 2018, which consisted of \$92.7 million of proceeds from the issuance of ATM Shares, offset by \$76.5 million of dividend payments, \$9.9 million of scheduled mortgage debt principal payments, and \$0.1 million paid to repurchase shares upon the vesting of restricted stock for the payment of tax withholding obligations.

We currently anticipate our significant sources of cash for the remainder of the year ending December 31, 2018 will be the net cash flow from hotel operations and funding of the new \$50 million unsecured term loan. We expect our uses of cash for the remainder of the year ending December 31, 2018 will be regularly scheduled debt service payments, capital expenditures, dividends, corporate expenses, and potential hotel acquisitions.

Dividend Policy

We intend to distribute to our stockholders dividends at least equal to our REIT taxable income to avoid paying corporate income tax and excise tax on our earnings (other than the earnings of our TRS, which are all subject to tax at regular corporate

- 29-

Table of Contents

rates) and to qualify for the tax benefits afforded to REITs under the Code. In order to qualify as a REIT under the Code, we generally must make distributions to our stockholders each year in an amount equal to at least:

- 90% of our REIT taxable income determined without regard to the dividends paid deduction and excluding net capital gains, plus

- 90% of the excess of our net income from foreclosure property over the tax imposed on such income by the Code, minus

- any excess non-cash income.

The timing and frequency of distributions will be authorized by our board of directors and declared by us based upon a variety of factors, including our financial performance, restrictions under applicable law and our current and future loan agreements, our debt service requirements, our capital expenditure requirements, the requirements for qualification as a REIT under the Code and other factors that our board of directors may deem relevant from time to time.

We have paid the following dividends to holders of our common stock during 2018:

Payment Date	Record Date	Dividend per Share
January 12, 2018	December 29, 2017	\$ 0.125
April 12, 2018	March 29, 2018	\$ 0.125
July 12, 2018	June 29, 2018	\$ 0.125
October 12, 2018	September 28, 2018	\$ 0.125

Capital Expenditures

The management and franchise agreements for each of our hotels provide for the establishment of separate property improvement funds to cover, among other things, the cost of replacing and repairing furniture, fixtures and equipment at our hotels and other routine capital expenditures. Contributions to the property improvement fund are calculated as a percentage of hotel revenues. In addition, we may be required to pay for the cost of certain additional improvements that are not permitted to be funded from the property improvement fund under the applicable management or franchise agreement. As of September 30, 2018, we have set aside \$36.5 million for capital projects in property improvement funds, which are included in restricted cash.

We expect to spend approximately \$135 million on capital improvements at our hotels in 2018. We spent approximately \$76.8 million on capital improvements at our hotels during the nine months ended September 30, 2018, primarily related to the substantial completion of the renovations at the Chicago Marriott Downtown, the Havana Cabana Key West, Bethesda Marriott Suites, Westin Boston Waterfront Hotel, Westin Fort Lauderdale Beach Resort, and the Vail Marriott Mountain Resort & Spa. Significant projects planned for the remainder of 2018 include:

- Hotel Rex: In connection with its addition to the Viceroy Collection, we commenced a comprehensive renovation and re-positioning of the hotel beginning in September 2018. The hotel will close for approximately four months during renovation and will reopen as the Hotel Emblem. The renovation is expected to be completed in time to take advantage of an expected strong 2019 lodging market in San Francisco.

- JW Marriott Denver: We expect to begin renovating the hotel's guest rooms, public space and meeting rooms in the fourth quarter of 2018, with the majority of the work occurring in 2019. The renovation is expected to secure

the hotel's position as one of the top luxury hotels in the high-end Cherry Creek submarket of Denver.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Non-GAAP Financial Measures

We use the following non-GAAP financial measures that we believe are useful to investors as key measures of our operating performance: EBITDA, EBITDAre, Adjusted EBITDA, FFO and Adjusted FFO. These measures should not be considered in isolation or as a substitute for measures of performance in accordance with U.S. GAAP. EBITDA, EBITDAre, Adjusted EBITDA,

- 30-

Table of Contents

FFO and Adjusted FFO, as calculated by us, may not be comparable to other companies that do not define such terms exactly as the Company.

Use and Limitations of Non-GAAP Financial Measures

Our management and Board of Directors use EBITDA, EBITDAre, Adjusted EBITDA, FFO and Adjusted FFO to evaluate the performance of our hotels and to facilitate comparisons between us and other lodging REITs, hotel owners who are not REITs and other capital intensive companies. The use of these non-GAAP financial measures has certain limitations. These non-GAAP financial measures as presented by us, may not be comparable to non-GAAP financial measures as calculated by other real estate companies. These measures do not reflect certain expenses or expenditures that we incurred and will incur, such as depreciation, interest and capital expenditures. We compensate for these limitations by separately considering the impact of these excluded items to the extent they are material to operating decisions or assessments of our operating performance. Our reconciliations to the most comparable U.S. GAAP financial measures, and our consolidated statements of operations and cash flows, include interest expense, capital expenditures, and other excluded items, all of which should be considered when evaluating our performance, as well as the usefulness of our non-GAAP financial measures.

These non-GAAP financial measures are used in addition to and in conjunction with results presented in accordance with U.S. GAAP. They should not be considered as alternatives to operating profit, cash flow from operations, or any other operating performance measure prescribed by U.S. GAAP. These non-GAAP financial measures reflect additional ways of viewing our operations that we believe, when viewed with our U.S. GAAP results and the reconciliations to the corresponding U.S. GAAP financial measures, provide a more complete understanding of factors and trends affecting our business than could be obtained absent this disclosure. We strongly encourage investors to review our financial information in its entirety and not to rely on a single financial measure.

EBITDA, EBITDAre and FFO

EBITDA represents net income (calculated in accordance with U.S. GAAP) excluding: (1) interest expense; (2) provision for income taxes, including income taxes applicable to sale of assets; and (3) depreciation and amortization. The Company computes EBITDAre in accordance with the National Association of Real Estate Investment Trusts ("Nareit") guidelines, as defined in its September 2017 white paper "Earnings Before Interest, Taxes, Depreciation and Amortization for Real Estate." EBITDAre represents net income (calculated in accordance with U.S. GAAP) adjusted for: (1) interest expense; (2) provision for income taxes, including income taxes applicable to sale of assets; (3) depreciation and amortization; (4) gains or losses on the disposition of depreciated property, including gains or losses on change of control; (5) impairment write-downs of depreciated property and of investments in unconsolidated affiliates caused by a decrease in value of depreciated property in the affiliate; and (6) adjustments to reflect the entity's share of EBITDAre of unconsolidated affiliates.

We believe EBITDA and EBITDAre are useful to an investor in evaluating our operating performance because they help investors evaluate and compare the results of our operations from period to period by removing the impact of our capital structure (primarily interest expense) and our asset base (primarily depreciation and amortization, and in the case of EBITDAre, impairment and gains or losses on dispositions of depreciated property) from our operating results. In addition, covenants included in our debt agreements use EBITDA as a measure of financial compliance. We also use EBITDA and EBITDAre as one measure in determining the value of hotel acquisitions and dispositions.

The Company computes FFO in accordance with standards established by the Nareit, which defines FFO as net income determined in accordance with U.S. GAAP, excluding gains or losses from sales of properties and impairment

losses, plus depreciation and amortization. The Company believes that the presentation of FFO provides useful information to investors regarding its operating performance because it is a measure of the Company's operations without regard to specified non-cash items, such as real estate depreciation and amortization and gains or losses on the sale of assets. The Company also uses FFO as one measure in assessing its operating results.

Adjustments to EBITDA and FFO

We adjust EBITDA and FFO when evaluating our performance because we believe that the exclusion of certain additional items described below provides useful supplemental information to investors regarding our ongoing operating performance and that the presentation of Adjusted EBITDA and Adjusted FFO, when combined with U.S. GAAP net income, EBITDA and FFO, is beneficial to an investor's complete understanding of our consolidated operating performance. We adjust EBITDA and FFO for the following items:

Table of Contents

Non-Cash Ground Rent: We exclude the non-cash expense incurred from the straight line recognition of rent from our ground lease obligations and the non-cash amortization of our favorable lease assets. We exclude these non-cash items because they do not reflect the actual rent amounts due to the respective lessors in the current period and they are of lesser significance in evaluating our actual performance for that period.

Non-Cash Amortization of Favorable and Unfavorable Contracts: We exclude the non-cash amortization of the favorable and unfavorable contracts recorded in conjunction with certain acquisitions because the non-cash amortization is based on historical cost accounting and is of lesser significance in evaluating our actual performance for that period.

Cumulative Effect of a Change in Accounting Principle: Infrequently, the Financial Accounting Standards Board promulgates new accounting standards that require the consolidated statement of operations to reflect the cumulative effect of a change in accounting principle. We exclude the effect of these adjustments, which include the accounting impact from prior periods, because they do not reflect the Company's actual underlying performance for the current period.

Gains or Losses from Early Extinguishment of Debt: We exclude the effect of gains or losses recorded on the early extinguishment of debt because these gains or losses result from transaction activity related to the Company's capital structure that we believe are not indicative of the ongoing operating performance of the Company or our hotels.

Hotel Acquisition Costs: We exclude hotel acquisition costs expensed during the period because we believe these transaction costs are not reflective of the ongoing performance of the Company or our hotels.

Severance Costs: We exclude corporate severance costs, or reversals thereof, incurred with the termination of corporate-level employees and severance costs incurred at our hotels related to lease terminations or structured severance programs because we believe these costs do not reflect the ongoing performance of the Company or our hotels.

Hotel Manager Transition Items: We exclude the transition items associated with a change in hotel manager because we believe these items do not reflect the ongoing performance of the Company or our hotels.

Other Items: From time to time we incur costs or realize gains that we consider outside the ordinary course of business and that we do not believe reflect the ongoing performance of the Company or our hotels. Such items may include, but are not limited to, the following: pre-opening costs incurred with newly developed hotels; lease preparation costs incurred to prepare vacant space for marketing; management or franchise contract termination fees; gains or losses from legal settlements; costs incurred related to natural disasters; and gains from insurance proceeds, other than income related to business interruption insurance.

In addition, to derive Adjusted FFO we exclude any fair value adjustments to debt instruments. We exclude these non-cash amounts because they do not reflect the underlying performance of the Company.

The following table is a reconciliation of our U.S. GAAP net income to EBITDA, EBITDAre and Adjusted EBITDA (in thousands):

Table of Contents

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	\$31,443	\$21,623	\$63,790	\$67,105
Interest expense	10,233	9,692	30,384	28,790
Income tax expense	3,174	3,375	2,939	9,019
Real estate related depreciation and amortization	26,369	25,083	77,304	75,031
EBITDA	71,219	59,773	174,417	179,945
Impairment losses	—	2,357	—	2,357
Gain on sale of hotel properties	—	—	—	—
EBITDAre	71,219	62,130	174,417	182,302
Non-cash ground rent	1,838	1,591	5,316	4,756
Non-cash amortization of favorable and unfavorable contracts, net	(495)	(478)	(1,474)	(1,434)
Hotel acquisition costs (1)	—	(245)	—	2,028
Hurricane-related costs (2)	1,690	1,493	3,005	1,493
Hotel manager transition and pre-opening items (3)	100	(1,362)	(1,699)	(1,362)
Loss on early extinguishment of debt	—	—	—	274
Severance costs (4)	(2,351)	—	11,691	—
Gain on property insurance settlement	(1,730)	—	(1,730)	—
Adjusted EBITDA	\$70,271	\$63,129	\$189,526	\$188,057

- (1) During the three months ended September 30, 2017, we recorded a refund of \$0.2 million of transfer taxes originally paid to the City and County of San Francisco in connection with our acquisition of the Hotel Rex.
- (2) Represents stabilization, cleanup, and other costs (such as professional fees and hotel labor) incurred at our hotels impacted by Hurricanes Irma or Maria that have not been or are not expected to be recovered by insurance. Three months ended September 30, 2018 consists of \$0.1 million related to manager transition costs at L'Auberge de Sedona and Orchards Inn Sedona and pre-opening costs related to the reopening of the Havana Cabana Key West and Hotel Rex. Nine months ended September 30, 2018 consists of (a) manager transition costs of \$0.1 million related to the Hotel Rex, L'Auberge de Sedona and Orchards Inn Sedona and (b) pre-opening costs of \$0.4 million related to the reopening of the Havana Cabana Key West and Hotel Rex, offset by \$2.2 million of
- (3) accelerated amortization of key money in connection with the termination of the Frenchman's Reef management agreement. Three and nine months ended September 30, 2017 consists of items related to the hotel manager change at the Courtyard Manhattan Midtown East as follows: (a) employee severance costs of approximately \$0.4 million, (b) transition costs of approximately \$0.1 million, offset by \$1.9 million of accelerated amortization of key money in connection with the termination of the management agreement with Marriott.

- Three months ended September 30, 2018 consists of the reversal of previously recorded compensation expense related to the forfeiture of certain equity awards of our former Chief Financial Officer, which is classified within corporate expenses on the condensed consolidated statements of operations. Nine months ended September 30,
- (4) 2018 consists of (a) \$10.9 million related to payments made to unionized employees under a voluntary buyout program at the Lexington Hotel New York, which are classified within other hotel expenses on the condensed consolidated statement of operations, and (b) \$0.8 million related to the departure of our former Chief Financial Officer, which is classified within corporate expenses on the condensed consolidated statement of operations.

The following table is a reconciliation of our U.S. GAAP net income to FFO and Adjusted FFO (in thousands):

- 33-

Table of Contents

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	\$31,443	\$21,623	\$63,790	\$67,105
Real estate related depreciation and amortization	26,369	25,083	77,304	75,031
Impairment losses	—	2,357	—	2,357
FFO	57,812	49,063	141,094	144,493
Non-cash ground rent	1,838	1,591	5,316	4,756
Non-cash amortization of favorable and unfavorable contracts, net	(495)	(478)	(1,474)	(1,434)
Hotel acquisition costs (1)	—	(245)	—	2,028
Hurricane-related costs (2)	1,690	1,493	3,005	1,493
Hotel manager transition and pre-opening items (3)	100	(1,362)	(1,699)	(1,362)
Gain on property insurance settlement	(1,730)	—	(1,730)	—
Loss on early extinguishment of debt	—	—	—	274
Severance costs (4)	(2,351)	—	11,691	—
Adjusted FFO	\$56,864	\$50,062	\$156,203	\$150,248

- (1) During the three months ended September 30, 2017, we recorded a refund of \$0.2 million of transfer taxes originally paid to the City and County of San Francisco in connection with our acquisition of the Hotel Rex.
- (2) Represents stabilization, cleanup, and other costs (such as professional fees and hotel labor) incurred at our hotels impacted by Hurricanes Irma or Maria that have not been or are not expected to be recovered by insurance. Three months ended September 30, 2018 consists of \$0.1 million related to manager transition costs at L'Auberge de Sedona and Orchards Inn Sedona and pre-opening costs related to the reopening of the Havana Cabana Key West and Hotel Rex. Nine months ended September 30, 2018 consists of (a) manager transition costs of \$0.1 million related to the Hotel Rex, L'Auberge de Sedona and Orchards Inn Sedona and (b) pre-opening costs of \$0.4 million related to the reopening of the Havana Cabana Key West and Hotel Rex, offset by \$2.2 million of
- (3) accelerated amortization of key money in connection with the termination of the Frenchman's Reef management agreement. Three and nine months ended September 30, 2017 consists of items related to the hotel manager change at the Courtyard Manhattan Midtown East as follows: (a) employee severance costs of approximately \$0.4 million, (b) transition costs of approximately \$0.1 million, offset by \$1.9 million of accelerated amortization of key money in connection with the termination of the management agreement with Marriott. Three months ended September 30, 2018 consists of the reversal of previously recorded compensation expense related to the forfeiture of certain equity awards of our former Chief Financial Officer, which is classified within corporate expenses on the condensed consolidated statements of operations. Nine months ended September 30,
- (4) 2018 consists of (a) \$10.9 million related to payments made to unionized employees under a voluntary buyout program at the Lexington Hotel New York, which are classified within other hotel expenses on the condensed consolidated statement of operations, and (b) \$0.8 million related to the departure of our former Chief Financial Officer, which is classified within corporate expenses on the condensed consolidated statement of operations.

Critical Accounting Policies

Our unaudited condensed consolidated financial statements have been prepared in conformity with U.S. GAAP, which requires management to make estimates and assumptions that affect the reported amount of assets and liabilities at the date of our financial statements and the reported amounts of revenues and expenses during the reporting period. While

we do not believe that the reported amounts would be materially different, application of these policies involves the exercise of judgment and the use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. We evaluate our estimates and judgments on an ongoing basis. We base our estimates on experience and on various other assumptions that we believe to be reasonable under the circumstances. All of our significant accounting policies, including certain critical accounting policies, are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017.

Investment in Hotels

Following the adoption of Accounting Standards Update No. 2017-01, acquired hotels, land improvements, building and furniture, fixtures and equipment and identifiable intangible assets are generally accounted for as asset acquisitions and recorded at relative fair value based upon the total accumulated cost of the acquisition. Direct acquisition-related costs are capitalized as a component of the acquired assets. Additions to property and equipment, including current buildings, improvements, furniture, fixtures and equipment are recorded at cost. Property and equipment are depreciated using the straight-line method over an estimated

Table of Contents

useful life of 5 to 40 years for buildings and land improvements and one to ten years for furniture and equipment. Identifiable intangible assets are typically related to contracts, including ground lease agreements and hotel management agreements, which are recorded at fair value. Above-market and below-market contract values are based on the present value of the difference between contractual amounts to be paid pursuant to the contracts acquired and our estimate of the fair market contract rates for corresponding contracts. Contracts acquired that are at market do not have significant value. We enter into a hotel management agreement at the time of acquisition and such agreements are generally based on market terms. Intangible assets are amortized using the straight-line method over the remaining non-cancelable term of the related agreements. In making estimates of fair values for purposes of allocating purchase price, we may utilize a number of sources that may be obtained in connection with the acquisition or financing of a property and other market data. Management also considers information obtained about each property as a result of its pre-acquisition due diligence in estimating the fair value of the tangible and intangible assets acquired.

We review our investments in hotels for impairment whenever events or changes in circumstances indicate that the carrying value of our investments in hotels may not be recoverable. Events or circumstances that may cause us to perform a review include, but are not limited to, adverse changes in the demand for lodging at our properties due to declining national or local economic conditions and/or new hotel construction in markets where our hotels are located. When such conditions exist, management performs an analysis to determine if the estimated undiscounted future cash flows from operations and the proceeds from the ultimate disposition of an investment in a hotel exceed the hotel's carrying value. If the estimated undiscounted future cash flows are less than the carrying amount of the asset, an adjustment to reduce the carrying value to the estimated fair market value is recorded and an impairment loss is recognized. Fair market value is estimated based on market data, estimated cash flows discounted at an appropriate rate, comparable sales information and other considerations requiring management to use its judgment in determining the assumptions used.

While our hotels have experienced improvement in certain key operating measures as the general economic conditions improve, the operating performance at certain of our hotels has not achieved our expected levels. As part of our overall capital allocation strategy, we assess underperforming hotels for possible disposition, which could result in a reduction in the carrying values of these properties.

Inflation

Operators of hotels, in general, possess the ability to adjust room rates daily to reflect the effects of inflation. However, competitive pressures may limit the ability of our management companies to raise room rates.

New Accounting Pronouncements Not Yet Implemented

See Note 2 to the accompanying condensed consolidated financial statements for additional information relating to recently issued accounting pronouncements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk includes risks that arise from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market sensitive instruments. In pursuing our business strategies, the primary market risk to which we are currently exposed, and, to which we expect to be exposed in the future, is interest rate risk. The face amount of our outstanding debt as of September 30, 2018 was \$937.4 million, of which \$300 million was variable rate. If market rates of interest on our variable rate debt fluctuate by 25 basis points, interest expense would increase or decrease, depending on rate movement, future earnings and cash flows, by \$0.8 million

annually.

Item 4. Controls and Procedures

The Company's management has evaluated, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")), as required by paragraph (b) of Rules 13a-15 and 15d-15 under the Exchange Act, and has concluded that as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective to give reasonable assurances that information we disclose in reports filed with the Securities and Exchange Commission is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There was no change in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act during the Company's most recent fiscal quarter that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

- 35-

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

On August 13, 2018, the Company brought suit against certain of its property insurers in St. Thomas, U.S. Virgin Islands, over the amount of the coverage the insurers owe as a result of the damage caused to Frenchman's Reef by Hurricanes Irma and Maria. On September 28, 2018, certain of the Company's property insurers brought a similar suit against the Company in New York seeking a declaration that the insurers do not owe the full amount of the Company's claim. Notwithstanding the litigation, the Company and its insurers continue to engage in discussions and negotiation regarding the Company's claim.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs (in thousands) (1)
July 1 - July 31, 2018	—	\$ —	—	\$ 150,000
August 1 - August 31, 2018	—	\$ —	—	\$ 150,000
September 1 - September 30, 2018	—	\$ —	—	\$ 150,000

(1) Represents amounts available under the Company's \$150 million share repurchase program. To facilitate repurchases, we make purchases pursuant to a trading plan under Rule 10b5-1 of the Exchange Act, which allows us to repurchase shares during periods when we otherwise may be prevented from doing so under insider trading

laws or because of self-imposed trading blackout periods. The share repurchase program may be suspended or terminated at any time without prior notice. On November 2, 2018, our board of directors increased the authorization under the share repurchase program from \$150 million to \$250 million. We have not repurchased any shares of our common stock during 2018 and we have full capacity remaining under our share repurchase program.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Table of Contents

Item 6. Exhibits

(a) Exhibits

The following exhibits are filed as part of this Form 10-Q:

Exhibit

- 10.1† Settlement Agreement between DiamondRock Hospitality Company, Sean Mahoney and RLJ Lodging Trust, dated as of July 16, 2018 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 6, 2018)
- 10.2 Amended and Restated Agreement of Limited Partnership of DiamondRock Hospitality Limited Partnership, dated as of August 28, 2018, by and among DiamondRock Hospitality Company and DiamondRock Hospitality, LLC (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on August 31, 2018)
- 31.1* Certification of Chief Executive Officer Required by Rule 13a-14(a) and Rule 15d-14(a) of the Exchange Act
- 31.2* Certification of Chief Financial Officer Required by Rule 13a-14(a) and Rule 15d-14(a) of the Exchange Act
- 32.1** Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Attached as Exhibit 101 to this report are the following materials from DiamondRock Hospitality Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2018 formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) the related notes to these condensed consolidated financial statements.

† Exhibit is a management contract or compensatory plan or arrangement

* Filed herewith

** Furnished herewith

Table of Contents

SIGNATURES

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

DiamondRock Hospitality Company

November 6, 2018

/s/ Jay L. Johnson
Jay L. Johnson
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

/s/ Briony R. Quinn
Briony R. Quinn
Senior Vice President and Treasurer
(Principal Accounting Officer)

- 38-