CONEXANT SYSTEMS INC
Form 10-Q
February 11, 2009

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

FORM 10-Q

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

For the Quarterly Period Ended January 2, 2009

OR

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

Commission file number: 000-24923

CONEXANT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**25-1799439**
(State of incorporation)	(I.R.S. Employer Identification No.)

4000 MacArthur Boulevard
Newport Beach, California 92660-3095
(Address of principal executive offices) (Zip code)
(949) 483-4600
(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 þ No o

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

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

(Do not check if a smaller reporting company)

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

As of January 30, 2009, there were 49,759,643 shares of the registrant s common stock outstanding.

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FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements within the meaning of the federal securities laws. Any statements that do not relate to historical or current facts or matters are forward-looking statements. You can identify some of the forward-looking statements by the use of forward-looking words, such as may, will, could, project, believe, anticipate, expect, estimate, continue, potential, plan, forecasts, and the like, the negatives of su expressions, or the use of future tense. Statements concerning current conditions may also be forward-looking if they imply a continuation of current conditions. Examples of forward-looking statements include, but are not limited to, statements concerning:

- our beliefs, subject to the qualifications expressed, regarding the sufficiency of our existing sources of liquidity and cash to fund our operations, research and development, anticipated capital expenditures and our working capital needs for at least the next 12 months and that we will be able to repatriate cash from our foreign operations on a timely and cost effective basis and that we will be able to sustain the recoverability of our goodwill, intangible and tangible long-term assets.
- expectations that we will have sufficient capital needed to remain in business and repay our indebtedness as it becomes due;
- expectation that we will be able to continue to meet NASDAQ listing requirements;
- expectations regarding the market share of our products, growth in the markets we serve and our market opportunities;
- expectations regarding price and product competition;
- continued demand and future growth in demand for our products in the communications, PC and consumer markets we serve;
- our plans and expectations regarding the transition of our semiconductor products to smaller line width geometries;
- our product development plans;
- our expectation that our largest customers will continue to account for a substantial portion of our revenue;
- expectations regarding our contractual obligations and commitments;
- expectation that we will be able to protect our products and services with proprietary technology and intellectual property protection;
- expectation that we will be able to meet our lease obligations (and other financial commitments); and
- expectation that we will be able to continue to rely on third party manufacturers to manufacture, assemble and test our products to meet our customers demands.

Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. You are urged to carefully review the disclosures we make concerning risks and other factors that may affect our business and operating results, including those made in Part II, Item 1A of this Quarterly Report on Form 10-Q, and any of those made in our other reports filed with the Securities and Exchange Commission. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this document. We do not intend, and undertake no obligation, to publish revised

forward-looking statements to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events.

CONEXANT SYSTEMS, INC.
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PART I. FINANCIAL INFORMATION
ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

CONEXANT SYSTEMS, INC. AND SUBSIDIARIES
Condensed Consolidated Balance Sheets
(unaudited, in thousands, except par value)

	January 2, 2009	October 3, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 110,327	$ 105,883
Restricted cash	20,500	26,800
Receivables, net of allowances of $868 and $834	40,514	48,997
Inventories, net	26,014	36,439
Other current assets	40,885	38,537
Total current assets	238,240	256,656
Property, plant and equipment, net	21,332	24,912
Goodwill	111,360	110,412
Intangible assets, net	9,910	14,971
Other assets	39,010	39,452
Total assets	$ 419,852	$ 446,403
LIABILITIES AND SHAREHOLDERS DEFICIT		
Current liabilities:		
Current portion of long-term debt	$	$ 17,707
Short-term debt	32,868	40,117
Accounts payable	22,783	34,894
Accrued compensation and benefits	11,952	14,989
Other current liabilities	41,829	44,385
Total current liabilities	109,432	152,092
Long-term debt	391,400	373,693
Other liabilities	71,985	57,352
Total liabilities	572,817	583,137
Commitments and contingencies (Note 6)		
Shareholders deficit:		
Preferred and junior preferred stock		
Common stock, $0.01 par value: 100,000 shares authorized; 49,665 and 49,601 shares issued and outstanding	497	496
Additional paid-in capital	4,746,395	4,744,140

Accumulated deficit	(4,896,894)	(4,879,208)
Accumulated other comprehensive loss	(2,884)	(2,083)
Shareholder notes receivable	(79)	(79)
Total shareholders deficit	(152,965)	(136,734)
Total liabilities and shareholders deficit	$ 419,852	$ 446,403

See accompanying notes to condensed consolidated financial statements.

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CONEXANT SYSTEMS, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Operations
(unaudited, in thousands, except per share amounts)

	Fiscal Quarter Ended	
	January 2, 2009	December 28, 2007
Net revenues	$ 86,498	$ 145,933
Cost of goods sold [(1)]	40,348	63,812
Gross margin	46,150	82,121
Operating expenses:		
Research and development [(1)]	26,313	37,823
Selling, general and administrative [(1)]	19,483	20,014
Amortization of intangible assets	3,371	4,571
Gain on sale of intellectual property	(12,858)	
Special charges	10,209	4,349
Total operating expenses	46,518	66,757
Operating (loss) income	(368)	15,364
Interest expense	6,054	9,449
Other expense, net	2,295	5,345
(Loss) income from continuing operations before income taxes and (loss) gain on equity method investments	(8,717)	570
Provision for income taxes	912	862
Loss from continuing operations before (loss) gain on equity method investments	(9,629)	(292)
(Loss) gain on equity method investments	(846)	3,773
(Loss) income from continuing operations	(10,475)	3,481
Loss from discontinued operations, net of tax [(1)]	(7,214)	(12,699)
Net loss	$ (17,689)	$ (9,218)
(Loss) income per share from continuing operations basic and diluted	$ (0.21)	$ 0.07

Loss per share from discontinued operations basic and diluted	$	(0.15)	$	(0.26)
Net loss per share basic and diluted	$	(0.36)	$	(0.19)
Shares used in computing basic per-share computations		49,657		49,236
Shares used in computing diluted per-share computations		49,657		49,399

(1) These captions include non-cash employee stock-based compensation expense as follows (see Note 7):

	Fiscal quarter Ended			
	January 2, 2009		December 28, 2007	
Cost of goods sold	$	43	$	114
Research and development		511		1,612
Selling, general and administrative		1,819		958
Loss from discontinued operations, net of tax				600

See accompanying notes to condensed consolidated financial statements.

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CONEXANT SYSTEMS, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(unaudited, in thousands)

	Fiscal Quarter Ended	
	January 2, 2009	**December 28, 2007**
Cash flows from operating activities:		
Net loss	$ (17,689)	$ (9,218)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities, net of effects of acquisitions:		
Depreciation	2,649	5,709
Amortization of intangible assets	3,371	4,781
Asset impairments		130
Reversal of provision for bad debts, net		(95)
Charges for inventory provisions, net	340	2,598
Deferred income taxes	(171)	5,593
Stock-based compensation	2,373	3,284
Decrease in fair value of derivative instruments	988	8,160
Losses (gains) of equity method investments	846	(542)
Other-than-temporary impairment of marketable securities	2,635	
Gain on sale of intellectual property	(12,858)	
Other items, net	600	32
Changes in assets and liabilities:		
Receivables	8,483	9,274
Inventories	10,983	(323)
Accounts payable	(12,111)	(5,054)
Accrued expenses and other current liabilities	(4,458)	(21,765)
Accrued restructuring expenses	11,146	2,795
Other, net	(2,590)	3,387
Net cash (used in) provided by operating activities	(5,463)	8,746
Cash flows from investing activities:		
Purchases of property, plant and equipment	(181)	(1,614)
Payments for acquisitions	(1,953)	
Purchases of equity securities		(755)
Release of restricted cash	6,300	
Proceeds from sale of intellectual property, net of expenses of $132	14,548	
Net cash provided by (used in) investing activities	18,714	(2,369)
Cash flows from financing activities:		
Repayments of short-term debt, including debt costs of $651 and $818	(7,900)	(9,845)

Proceeds from issuance of common stock		4
Interest rate swap security deposit	(907)	
Net cash used in financing activities	(8,807)	(9,841)
Net increase (decrease) in cash and cash equivalents	4,444	(3,464)
Cash and cash equivalents at beginning of period	105,883	235,605
Cash and cash equivalents at end of period	$ 110,327	$ 232,141

See accompanying notes to condensed consolidated financial statements.

CONEXANT SYSTEMS, INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
(unaudited)

1. Description of Business

Conexant Systems, Inc. (Conexant or the Company) designs, develops and sells semiconductor system solutions, comprised of semiconductor devices, software and reference designs for use in broadband communications applications that enable high-speed transmission, processing and distribution of audio, video, voice and data to and throughout homes and business enterprises worldwide. The Company s access solutions connect people through personal communications access products, such as personal computers (PCs), to audio, video, voice and data services over wireless and wire line broadband connections as well as over dial-up Internet connections. The Company s central office solutions are used by service providers to deliver high-speed audio, video, voice and data services over copper telephone lines and optical fiber networks to homes and businesses around the globe. In addition, media processing products enable the capture, display, storage, playback and transfer of audio and video content in applications throughout home and small office environments. These solutions enable broadband connections and network content to be shared throughout a home or small office-home office environment using a variety of communications devices.

2. Basis of Presentation and Significant Accounting Policies

Interim Reporting The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in the Company s Annual Report on Form 10-K for the fiscal year ended October 3, 2008. The financial information presented in the accompanying statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the periods indicated. All such adjustments are of a normal recurring nature. The year-end condensed balance sheet data was derived from the audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Fiscal Periods The Company s fiscal year is the 52- or 53-week period ending on the Friday closest to September 30. In a 52-week year, each fiscal quarter consists of 13 weeks. The additional week in a 53-week year is added to the fourth quarter, making such quarter consist of 14 weeks. Fiscal 2009 is a 52-week year and fiscal 2008 consisted of 53 weeks.

Revenue Recognition The Company recognizes revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the sales price and terms are fixed and determinable, and (iv) the collection of the receivable is reasonably assured. These terms are typically met upon shipment of product to the customer. The majority of the Company s distributors have limited stock rotation rights, which allow them to rotate up to 10% of product in their inventory two times per year. The Company recognizes revenue to these distributors upon shipment of product to the distributor, as the stock rotation rights are limited and the Company believes that it has the ability to reasonably estimate and establish allowances for expected product returns in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists. Development revenue is recognized when services are performed and was not significant for any periods presented.

Prior to the fourth quarter of fiscal 2008, revenue with respect to sales to certain distributors was deferred until the products were sold by the distributors to third parties. During the fiscal quarter ended October 3, 2008, the Company evaluated three distributors for which revenue has historically been recognized when the purchased products are sold by the distributor to a third party due to the Company s inability in prior years to enforce the contractual terms related to any right of return. The Company s evaluation revealed that it is able to enforce the contractual right of return for the three distributors in an effective manner similar to that experienced with the other distributor customers. As a result, in the fourth quarter of fiscal 2008, the Company commenced the recognition of revenue on these three distributors upon shipment which is consistent with the revenue recognition point of other distributor customers. As a result, in the fiscal quarter ended October 3, 2008, the Company recognized $3.9 million of revenue on sales to these

three distributors related to the change to revenue recognition upon shipment with a corresponding

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charge to cost of goods sold of $1.8 million. At January 2, 2009 and October 3, 2008, there is no significant deferred revenue related to sales to the Company s distributors.

Revenue with respect to sales to customers to whom the Company has significant obligations after delivery is deferred until all significant obligations have been completed. At January 2, 2009 there was no deferred revenue. At October 3, 2008, deferred revenue related to shipments of products for which the Company had on-going performance obligations was $0.2 million. Deferred revenue is included in other current liabilities on the accompanying condensed consolidated balance sheets.

During the first quarter of fiscal 2008, the Company recorded approximately $14.7 million of non-recurring revenue from the buyout of a future royalty stream.

Liquidity The Company has a $50.0 million credit facility with a bank, under which it had borrowed $32.9 million as of January 2, 2009. This credit facility matures on November 27, 2009 and is subject to additional 364-day extensions at the discretion of the bank.

The Company believes that its existing sources of liquidity, together with cash expected to be generated from product sales, will be sufficient to fund its operations, research and development, anticipated capital expenditures and working capital for at least the next twelve months. However, additional operating losses or lower than expected product sales will adversely affect the Company s cash flow and financial condition and could impair its ability to satisfy its indebtedness obligations as such obligations come due.

Recent unfavorable economic conditions have led to a tightening in the credit markets, a low level of liquidity in many financial markets and extreme volatility in the credit and equity markets. If the economy or markets in which we operate continue to be subject to adverse economic conditions, our business, financial condition, cash flow and results of operations will be adversely affected. If the credit markets remain difficult to access or worsen or our performance is unfavorable due to economic conditions or for any other reasons, we may not be able to obtain sufficient capital to repay amounts due under (i) our credit facility expiring November 2009 (ii) our $141.4 million floating rate senior secured notes when they become due in November 2010 or earlier as a result of a mandatory offer to repurchase, and (iii) our $250.0 million convertible subordinated notes when they become due in March 2026 or earlier as a result of the mandatory repurchase requirements. The first mandatory repurchase date for our convertible subordinated notes is March 1, 2011. In the event we are unable to satisfy or refinance our debt obligations as the obligations are required to be paid, we will be required to consider strategic and other alternatives, including, among other things, the negotiation of revised terms of our indebtedness, the exchange of new securities for existing indebtedness obligations and the sale of assets to generate funds. There is no assurance that we would be successful in completing any of these alternatives.

Restricted Cash The Company s short-term debt credit agreement requires that the Company and its consolidated subsidiaries maintain minimum levels of cash on deposit with the bank throughout the term of the agreement. The Company classified $8.5 million and $8.8 million as restricted cash with respect to this credit agreement as of January 2, 2009 and October 3, 2008, respectively. See Note 5 for further information on the Company s short-term debt.

As of January 2, 2009, the Company had one irrevocable stand-by letter of credit outstanding. The irrevocable stand-by letter of credit is collateralized by restricted cash balances of $12.0 million to secure inventory purchases from a vendor. The letter of credit expires on
May 31, 2009. The restricted cash balance securing the letter of credit is classified as current restricted cash on the condensed consolidated balance sheets. In addition, the Company has letters of credit collateralized by restricted cash aggregating $6.7 million to secure various long-term operating leases and the Company s self-insured worker s compensation plan. The restricted cash associated with these letters of credit is classified as other long-term assets on the condensed consolidated balance sheets.

As of October 3, 2008, the Company had one irrevocable stand-by letter of credit outstanding. The irrevocable stand-by letter of credit is collateralized by restricted cash balances of $18.0 million to secure inventory purchases from a vendor. The restricted cash balance securing the letter of credit is classified as current restricted cash on the consolidated balance sheet. In addition, the Company has letters of credit collateralized by restricted cash aggregating $6.8 million to secure various long-term operating leases and the Company's self-insured worker's compensation plan. The restricted cash associated with these letters of credit is classified as other long term assets on the consolidated

balance sheets.

Income Taxes The Company utilizes the asset and liability method of accounting for income taxes as set forth in Statement of Financial Accounting Standard (SFAS) No. 109, Accounting for Income Taxes , or SFAS 109. SFAS No. 109 establishes financial accounting and reporting standards for the effect of income taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax

liabilities and assets for the future tax consequences of events that have been recognized in an entity s financial statements or tax returns. A valuation allowance is recorded to reduce deferred tax assets when it is more likely than not that some of the deferred tax assets will not be realized.

In July 2006 the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income
Taxes an interpretation of FASB Statement No. 109 , or FIN 48. Under FIN 48, which the Company adopted effective September 29, 2007, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits within operations as income tax expense. Judgment is required in assessing the future tax consequences of events that have been recognized in the Company s financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial position, results of operations, or cash flows.

Review of Accounting for Research and Development Costs During the fiscal quarter ended December 28, 2007, the Company reviewed its methodology of capitalizing photo mask costs used in product development. Photo mask designs are subject to significant verification and uncertainty regarding the final performance of the related part. Due to these uncertainties, the Company reevaluated its prior practice of capitalizing such costs and concluded that these costs should have been expensed as research and development costs as incurred. As a result, in the fiscal quarter ended December 28, 2007, the Company recorded a correcting adjustment of $5.3 million, representing the unamortized portion of the capitalized photo mask costs as of September 29, 2007. Based upon an evaluation of all relevant quantitative and qualitative factors, and after considering the provisions of Accounting Principles Board Opinion No. 28 Interim Financial Reporting, (APB 28), paragraph 29, and SEC Staff Accounting Bulletin Nos. 99 Materiality (SAB 99) and 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108), the Company believes that this correcting adjustment was not material to its estimated full-year results for 2008. In addition, the Company does not believe the correcting adjustment is material to the amounts reported in previous periods.

Derivative Financial Instruments The Company s derivative financial instruments as of January 2, 2009 principally consist of (i) the Company s warrant to purchase six million shares of Mindspeed Technologies, Inc. (Mindspeed) common stock and (ii) interest rate swaps. See Note 5 for information regarding the Mindspeed warrant.

Interest Rate Swaps During fiscal 2008, the Company entered into three interest rate swap agreements with Bear Stearns Capital Markets, Inc. (counterparty) for a combined notional amount of $200 million to mitigate interest rate risk on $200 million of its Floating Rate Senior Secured Notes due 2010. In December 2008, the interest rate swap agreements were assigned, without modification, to J.P. Morgan Chase Bank, N.A.. Under the terms of the swaps, the Company will pay a fixed rate of 2.98% and receive a floating rate equal to three-month LIBOR, which will offset the floating rate paid on the Notes. The interest rate swaps meet the criteria for designation as cash flow hedges in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). As a result of the repurchase of $80 million of the Company s Floating Rate Senior Secured Notes in the fourth quarter of fiscal 2008, one of the swap contracts with a notional amount of $100 million was terminated. As a result of the swap contract termination, the Company recognized a $0.3 million gain based on the fair value of the contract on the termination date. The remaining two swap agreements require the Company to post cash collateral with the counterparty in a minimum amount of $2.1 million. The amount of collateral will adjust monthly based on a mark-to-market of the swaps. At January 2, 2009, the Company was required to post $3.5 million of cash collateral with the counterparty, which is included in other non-current assets on the accompanying condensed consolidated balance sheet. Based on the fair value of the swap agreements, the Company recorded a derivative liability of $2.1 million at January 2, 2009, which is included in other liabilities on the accompanying condensed consolidated balance sheet. The gain or loss is recognized immediately in other (income) expense, net, in the statements of

operations when a designated hedging instrument is either terminated early or an improbable or ineffective portion of the hedge is identified.

At October 3, 2008, the Company had outstanding foreign currency forward exchange contracts with a notional amount of 210 million Indian Rupees, or approximately $4.4 million. All foreign currency forward exchange contracts matured at various dates through December 2008 and were not renewed. At January 2, 2009, there were no foreign currency forward exchange contracts outstanding.

The Company may use other derivatives from time to time to manage its exposure to changes in interest rates, equity prices or other risks. The Company does not enter into derivative financial instruments for speculative or trading purposes.

Supplemental Cash Flow Information Cash paid for interest was $2.7 million and $6.5 million for the fiscal quarter ended January 2, 2009 and December 28, 2007, respectively. Cash paid for income taxes for the fiscal quarter ended January 2, 2009 and December 28, 2007 was $0.5 million and $1.6 million, respectively. In the fiscal quarter ended January 2, 2009, non-cash investing activities included a $1.0 million accrual for a purchase payment to Zarlink Semiconductor, Inc. (see Note 5).

Net Loss Per Share Net loss per share is computed in accordance with SFAS No. 128, Earnings Per Share. Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding and potentially dilutive securities outstanding during the period. Potentially dilutive securities include stock options and warrants and shares of stock issuable upon conversion of the Company s convertible subordinated notes. The dilutive effect of stock options and warrants is computed under the treasury stock method, and the dilutive effect of convertible subordinated notes is computed using the if-converted method. Potentially dilutive securities are excluded from the computations of diluted net loss per share if their effect would be antidilutive.

The following potentially dilutive securities have been excluded from the diluted net loss per share calculations because their effect would have been antidilutive (in thousands):

	Fiscal Quarter Ended	
	January 2, 2009	**December 28, 2007**
Stock options and warrants	6,872	9,472
4.00% convertible subordinated notes due March 2026	5,081	5,081
	11,953	14,553

	Fiscal Quarter Ended	
	January 2, 2009	**December 28, 2007**
Weighted average shares for basic net loss per share	49,657	49,236
Employee stock options and restricted stock units		163
Weighted average shares for diluted (loss) income per share	49,657	49,399

Reclassifications The Company has reclassified the change in accrued restructuring expenses from accrued expenses and other current liabilities, and other, net, to accrued restructuring expenses on its condensed consolidated statements of cash flows for the fiscal quarter ended December 28, 2007. The Company has also reclassified expenses related to short-term debt from other, net, to repayments of short-term debt, net of expenses, for the fiscal quarter ended December 28, 2007. These reclassifications on the condensed consolidated statements cash flows did not affect the Company s reported net increase (decrease) in cash and cash equivalents for the period.

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		Fiscal Quarter Ended December 28, 2007
Accrued expenses and other current liabilities, before reclassification	$	(18,970)
Accrued restructuring expenses		(2,795)
Accrued expenses and other current liabilities, after reclassification	$	(21,765)
Other, net, before reclassification	$	2,569
Expenses related to short-term debt		818
Other, net, after reclassification	$	3,387
Repayments of short-term debt, net of expenses, before reclassification	$	(9,027)
Expenses related to short-term debt		(818)
Repayments of short-term debt, net of expenses, after reclassification	$	(9,845)

Business Enterprise Segments The Company operates in one reportable segment, broadband communications. SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for the way that public business enterprises report information about operating segments in condensed consolidated financial statements. Although the Company had two operating segments at January 2, 2009, under the aggregation criteria set forth in SFAS No. 131, it only operates in one reportable segment, broadband communications. The Company s reporting units, which are also the Company s operating units, Imaging and PC Media (IPM) and Broadband Access Products (BBA) were identified based upon the availability of discrete financial information and the chief operating decision maker s regular review of the financial information for these operating segments. The Company evaluated these reporting units for components and noted that there are none below the IPM and BBA reporting units.

Under SFAS No. 131, two or more operating segments may be aggregated into a single operating segment for financial reporting purposes if aggregation is consistent with the objective and basic principles of SFAS No. 131, if the segments have similar economic characteristics, and if the segments are similar in each of the following areas:

- the nature of their products and services;
- the nature of their production processes;
- the type or class of customer for their products and services; and
- the methods used to distribute their products or provide their services.

The Company meets each of the aggregation criteria for the following reasons:

- the sale of semiconductor products is the only material source of revenue for each of the Company s two operating segments;
- the products sold by each of the Company s operating segments use the same standard manufacturing process;
- the products marketed by each of the Company s operating segments are sold to similar customers; and
- all of the Company s products are sold through its internal sales force and common distributors.

Because the Company meets each of the criteria set forth above and each of its operating segments has similar economic characteristics, the Company aggregates its results of operations in one reportable segment.

Goodwill Goodwill is not amortized. Instead, goodwill is tested for impairment on an annual basis and between annual tests whenever events or changes in circumstances indicate that the carrying amount may not be recoverable, in accordance with SFAS No. 142, Goodwill and Other Intangible Assets. Under SFAS No. 142, goodwill is tested at the reporting unit level, which is defined as an operating segment or one level below the operating segment. Goodwill impairment testing is a two-step process.

The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill. For estimating fair values for purposes the goodwill impairment tests, the Company uses a weighted-average of present value techniques, specifically discounted cash flows and the use of multiples of revenues and earnings associated with comparable companies. The discounted cash flow technique considers the estimated internal value based upon the Company s marketing and investment strategies. The use of revenues and earnings multiples of comparable companies considers external performance metrics. The Company applies a weighted-average of the two models, with the internal discounted cash flow model weighted more heavily than the revenue and earnings multiple model. The Company believes the resulting fair value provides a balance of both internal and external measurement components.

If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test must be performed to measure the amount of impairment loss, if any. The second step of the goodwill impairment test, used to measure the amount of impairment loss, compares the implied fair value of reporting unit goodwill with the carrying amount of that goodwill. If the carrying amount of reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss must be recognized in an amount equal to that excess. Goodwill impairment testing requires significant judgment and management estimates, including, but not limited to, the determination of (i) the number of reporting units, (ii) the goodwill and other assets and liabilities to be allocated to the reporting units and (iii) the fair values of the reporting units. The estimates and assumptions described above, along with other factors such as discount rates, will significantly affect the outcome of the impairment tests and the amounts of any resulting impairment losses.

Goodwill is tested at the reporting unit level annually and, if necessary, whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The global decline in consumer confidence and spending has dramatically impacted the Company s financial performance as well as many of our competitors, peers, customers, and suppliers. This impact resulted in the Company s evaluation of the recoverability of Goodwill during the first quarter of fiscal 2009.

The Company s IPM business unit accounted for approximately 57 percent of the Company s total revenues in the first quarter of fiscal 2009 and is associated with $110 million of goodwill as of January 2, 2009. Overall financial performance declines in the first quarter of fiscal 2009 resulted in an interim test for goodwill impairment. Based upon the results of the testing for the quarter ended January 2, 2009, the Company determined that despite recent declines in the IPM business unit, performance levels remain sufficient to support the current IPM related goodwill. The Company's fair value methods used for purposes of the goodwill impairment tests incorporated a weighted-average of present value techniques, specifically discounted cash flows and the use of multiples of revenues and earnings associated with comparable companies.

Recently Adopted Accounting Pronouncements

On October 4, 2008, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 157, Fair Value Measurements (SFAS No. 157), for its financial assets and liabilities. The Company s adoption of SFAS No. 157 did not have a material impact on its financial position, results of operations or liquidity.

SFAS No. 157 provides a framework for measuring fair value and requires expanded disclosures regarding fair value measurements.

SFAS No. 157 defines fair value as the price that would be received for an asset or the exit price that would be paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. SFAS No. 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs, where available. The following summarizes the three levels of inputs required by the standard that the Company uses to measure fair value.

Level 1: Quoted prices in active markets for identical assets or liabilities.

Level 2: Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related assets or liabilities.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

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SFAS No. 157 requires the use of observable market inputs (quoted market prices) when measuring fair value and requires a Level 1 quoted price to be used to measure fair value whenever possible.

In accordance with FASB Staff Position (FSP) No. FAS 157-2, Effective Date of FASB Statement No. 157 (FSP FAS 157-2), the Company elected to defer until October 3, 2009 the adoption of SFAS No. 157 for all nonfinancial assets and liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis. The adoption of SFAS No. 157 for those assets and liabilities within the scope of FSP FAS 157-2 is not expected to have a material impact on the Company s financial position, results of operations or liquidity.

On October 4, 2008, the Company adopted SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (SFAS No. 159), which permits entities to choose to measure many financial instruments and certain other items at fair value. The Company already records marketable securities at fair value in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. The adoption of SFAS No. 159 did not have an impact on the Company s condensed consolidated financial statements as management did not elect the fair value option for any other financial instruments or certain other assets and liabilities.

Recently Issued Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS No. 141R), which replaces SFAS No 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. The Company will adopt SFAS No. 141R no later than the first quarter of fiscal 2010 and it will apply prospectively to business combinations completed on or after that date.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51, (SFAS No. 160) which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent s equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. The Company will adopt
SFAS No. 160 no later than the first quarter of fiscal 2010 and it will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. The Company is currently assessing the potential impact that adoption of SFAS No. 160 would have on its financial position and results of operations.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS No. 161).
SFAS No. 161 requires expanded disclosures regarding the location and amount of derivative instruments in an entity s financial statements, how derivative instruments and related hedged items are accounted for under SFAS No. 133 and how derivative instruments and related hedged items affect an entity s financial position, operating results and cash flows. SFAS No. 161 is effective for periods beginning on or after November 15, 2008. The Company does not believe that the adoption of SFAS No. 161 will have a material impact on its financial statement disclosures.

In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142. This change is intended to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R and other generally accepted accounting principles (GAAP). The requirement for determining useful lives must be applied prospectively to intangible assets acquired after the effective date and the disclosure requirements must be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. FSP 142-3 is effective

for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, which will require the Company to adopt these provisions in the first quarter of fiscal 2010. The Company is currently evaluating the impact of adopting FSP 142-3 on its condensed consolidated financial statements.

In May 2008, the FASB issued FSP APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) (FSP APB 14-1). FSP APB 14-1 requires the issuer to separately account for the liability and equity components of convertible debt instruments in a manner that reflects the issuer s nonconvertible debt borrowing rate. The guidance will result in companies recognizing higher interest expense in the statement of operations due to amortization of the discount that results from separating the liability and equity components. FSP APB 14-1 will be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Based on its initial analysis, the Company expects that the adoption of FSP APB 14-1 will result in an increase in the interest expense recognized on its convertible subordinated notes. See Note 5 to the Condensed Consolidated Financial Statements for further information on long-term debt.

In December 2008, the FASB issued FSP (FSP) FAS 140-4 and FIN 46(R)-8, Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities (FSP 140-4 and FIN 46(R)-8). FSP 140-4 and FIN 46(R)-8 amends FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, to require public entities to provide additional disclosures about transfers of financial assets. It also amends FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, to require public enterprises, including sponsors that have a variable interest in a variable interest entity, to provide additional disclosures about their involvement with variable interest entities. Additionally, this FSP requires certain disclosures to be provided by a public enterprise that is (a) a sponsor of a qualifying special purpose entity (SPE) that holds a variable interest in the qualifying SPE but was not the transferor (nontransferor) of financial assets to the qualifying SPE and (b) a servicer of a qualifying SPE that holds a significant variable interest in the qualifying SPE but was not the transferor (nontransferor) of financial assets to the qualifying SPE. FSP 140-4 and FIN 46(R)-8 is effective for periods beginning on or after December 15, 2008. The Company does not believe that the adoption of FSP 140-4 and FIN 46(R)-8 will have a material impact on its financial statement disclosures.

3. Sale of Assets and Discontinued Operations

On August 11, 2008, the Company announced that it had completed the sale of its Broadband Media Processing (BMP) product lines to NXP B.V. (NXP). Pursuant to the Asset Purchase Agreement (the agreement), NXP acquired certain assets including, among other things, specified patents, inventory and contracts, and assumed certain employee-related liabilities. Pursuant to the agreement, the Company obtained a license to utilize technology that was sold to NXP and NXP obtained a license to utilize certain intellectual property that the Company retained. In addition, NXP agreed to provide employment to approximately 700 of the Company s employees at locations in the United States, Europe, Israel, Asia-Pacific and Japan.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company determined that the BMP business, which constituted an operating segment of the Company, qualifies as a discontinued operation. The results of the BMP business are being reported as discontinued operations in the condensed consolidated statements of operations for all periods presented. In accordance with the provisions of EITF No. 87-24, *Allocation of Interest to Discontinued Operations*, interest expense is allocated to discontinued operations based on the expected proceeds from the sale, net of any expected permitted investments, over the next twelve months. For the fiscal quarter ended December 28, 2007, interest expense allocated to discontinued operations was $2.1 million.

For the fiscal quarters ended January 2, 2009 and December 28, 2007, BMP revenues and pretax loss classified as discontinued operations were $1.0 million and $7.2 million and $51.0 million and $12.7 million, respectively.

4. Fair Value of Certain Financial Assets and Liabilities

In accordance with SFAS No. 157, the following represents the Company s fair value hierarchy for its financial assets and liabilities measured at fair value on a recurring basis as of January 2, 2009:

	Level 1	Level 2	Total
Assets:			
Cash and cash equivalents	$ 110,327	$	$ 110,327
Restricted cash	20,500		20,500
Marketable securities	403		403
Mindspeed warrant		63	63
Total Assets	$ 131,230	$ 63	$ 131,293
Liabilities:			
Interest rate swap financial instruments	$	$ 2,135	$ 2,135
Total Liabilities	$	$ 2,135	$ 2,135

Level 2 assets consist of the Company s warrant to purchase six million shares of Mindspeed common stock at an exercise price of $17.04 per share through June 2013. At January 2, 2009, the warrant was valued using the Black-Scholes-Merton model with expected terms for portions of the warrant varying from one to five years, expected volatility of 64%, a weighted average risk-free interest rate of 1.05% and no dividend yield (see Note 5).

Level 2 liabilities consist of the Company s interest rate swap derivatives. The fair value of interest rate swap derivatives is primarily based on third-party pricing service models. These models use discounted cash flows that utilize the appropriate market-based forward swap curves commensurate with the terms of the underlying instruments.

5. Supplemental Financial Information

Inventories

Inventories consist of the following (in thousands):

	January 2, 2009	October 3, 2008
Work-in-process	$ 13,656	$ 16,082
Finished goods	12,358	20,357
	$ 26,014	$ 36,439

At January 2, 2009 and October 3, 2008, inventories were net of excess and obsolete (E&O) inventory reserves of $14.6 million and $17.6 million, respectively.

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Intangible Assets

Intangible assets consist of the following (in thousands):

	January 2, 2009			October 3, 2008		
	Gross Carrying Amount	Accumulated Amortization	Book Value	Gross Carrying Amount	Accumulated Amortization	Book Value
Developed technology	$ 53,928	$ (50,898)	$ 3,030	$ 67,724	$ (62,285)	$ 5,439
Product licenses	3,510	(1,357)	2,153	11,032	(7,105)	3,927
Other intangible assets	7,240	(2,513)	4,727	8,240	(2,635)	5,605
	$ 64,678	$ (54,768)	$ 9,910	$ 86,996	$ (72,025)	$ 14,971

Intangible assets are amortized over a weighted-average period of approximately five years. Annual amortization expense is expected to be as follows (in thousands):

	Remainder of 2009	2010	2011	2012	2013	Thereafter
Amortization expense	$ 4,035	$ 1,353	$ 1,237	$ 1,237	$ 1,031	$ 1,017

In October 2008, the Company sold intellectual property to a third party (see Note 10).

Goodwill

Goodwill is tested at the reporting unit level annually and, if necessary, whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The global decline in consumer confidence and spending has dramatically impacted the Company s financial performance as well as many of our competitors, peers, customers, and suppliers. This impact resulted in the Company s evaluation of the recoverability of Goodwill during the first quarter of fiscal 2009.

The Company s IPM business unit accounted for approximately 57 percent of the Company s total revenues in the first quarter and is associated with $110 million of goodwill as of January 2, 2009. Overall financial performance declines in the first quarter of fiscal 2009 resulted in an interim test for goodwill impairment. Based upon the results of the testing for the quarter ended January 2, 2009, the Company determined that despite recent declines in the IPM business unit, performance levels remain sufficient to support the current IPM related goodwill balance. The Company s fair value methods used for purposes the goodwill impairment tests incorporates a weighted average of present value techniques, specifically discounted cash flows and the use of multiples of revenues and earnings associated with comparable companies.

The changes in the carrying amounts of goodwill were as follows (in thousands):

Goodwill at October 3, 2008	$ 110,412
Additions	1,000
Other adjustments	(52)
Goodwill at January 2, 2009	$ 111,360

In October 2006, we acquired the assets of Zarlink Semiconductor Inc. s packet switching business for $5.0 million. Under the terms of the Zarlink acquisition, we were required to pay additional amounts based upon the achievement of certain revenue targets. In the fiscal quarter ended January 2, 2009 we recorded an additional and final purchase payment of $1.0 million paid in January 2009.

Mindspeed Warrant

The Company has a warrant to purchase six million shares of Mindspeed common stock at an exercise price of $17.04 per share through June 2013. At January 2, 2009 and October 3, 2008, the market value of Mindspeed common stock

was $0.92 and $2.08 per share, respectively. The Company accounts for the Mindspeed warrant as a derivative instrument, and changes in the fair value of the warrant are included in other (expense) income, net each period. At January 2, 2009 and October 3, 2008, the aggregate fair value of the Mindspeed warrant included on the accompanying condensed consolidated balance sheets was $0.1 million and $0.5 million, respectively. At January 2, 2009, the warrant was valued using the Black-Scholes-Merton model with expected terms for portions of the warrant varying from one to five years, expected volatility of 64%, a weighted average risk-free interest rate of 1.05% and

no dividend yield. The aggregate fair value of the warrant is reflected as a long-term asset on the accompanying condensed consolidated balance sheets because the Company does not intend to liquidate any portion of the warrant in the next twelve months.

The valuation of this derivative instrument is subjective, and option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Changes in these assumptions can materially affect the fair value estimate. The Company could, at any point in time, ultimately realize amounts significantly different than the carrying value.

Short-Term Debt

On November 29, 2005, the Company established an accounts receivable financing facility whereby it sells, from time to time, certain accounts receivable to Conexant USA, LLC (Conexant USA), a special purpose entity which is a consolidated subsidiary of the Company. Under the terms of the Company s agreements with Conexant USA, the Company retains the responsibility to service and collect accounts receivable sold to Conexant USA and receives a weekly fee from Conexant USA for handling administrative matters which is equal to 1.0%, on a per annum basis, of the uncollected value of the accounts receivable.

Concurrent with the Company s agreements with Conexant USA, Conexant USA entered into a credit facility which is secured by the assets of Conexant USA. Conexant USA is required to maintain certain minimum amounts on deposit (restricted cash) with the bank during the term of the credit agreement. Borrowings under the credit facility, which cannot exceed the lesser of $50.0 million and 85% of the uncollected value of purchased accounts receivable that are eligible for coverage under an insurance policy for the receivables, bear interest equal to 7-day LIBOR (reset weekly) plus 1.25% and was approximately 1.65% at January 2, 2009. In addition, Conexant USA pays a fee of 0.2% per annum for the unused portion of the line of credit. The credit agreement matures in November 2009 and remains subject to additional 364-day renewal periods at the discretion of the bank. In connection with the renewal in November 2008, the interest rate applied to borrowings under the credit facility increased from 7-day LIBOR plus 0.6% to 7-day LIBOR plus 1.25%.

The credit facility requires the Company and its consolidated subsidiaries to maintain minimum levels of shareholders equity and cash and cash equivalents. Further, any failure by the Company or Conexant USA to pay their respective debts as they become due would allow the bank to terminate the credit agreement and cause all borrowings under the credit facility to immediately become due and payable. At January 2, 2009, Conexant USA had borrowed $32.9 million under this credit facility and the Company was in compliance with all credit facility requirements.

Long-Term Debt

Long-term debt consists of the following (in thousands):

	January 2, 2009	October 3, 2008
Floating rate senior secured notes due November 2010	$ 141,400	$ 141,400
4.00% convertible subordinated notes due March 2026 with a conversion price of $49.20	250,000	250,000
Total	391,400	391,400
Less: current portion of long-term debt		(17,707)
Long-term debt	$ 391,400	$ 373,693

Floating rate senior secured notes due November 2010 In November 2006, the Company issued $275.0 million aggregate principal amount of floating rate senior secured notes due November 2010. Proceeds from this issuance, net of fees paid or payable, were approximately $264.8 million. The senior secured notes bear interest at three-month LIBOR (reset quarterly) plus 3.75%, and interest is payable in arrears quarterly on each February 15, May 15, August 15 and November 15, beginning on February 15, 2007. The senior secured notes are redeemable in whole or in part, at the option of the Company, at any time on or after November 15, 2008 at varying redemption prices that

generally include premiums, which are defined in the indenture for the notes, plus accrued and unpaid interest. The

Company is required to offer to repurchase, for cash, notes at a price of 100% of the principal amount, plus any accrued and unpaid interest, with the net proceeds of certain asset dispositions if such proceeds are not used within 360 days to invest in assets (other than current assets) related to the Company s business. In addition, upon a change of control, the Company is required to make an offer to redeem all of the senior secured notes at a redemption price equal to 101% of the aggregate principal amount thereof plus accrued and unpaid interest. The floating rate senior secured notes rank equally in right of payment with all of the Company s existing and future senior debt and senior to all of its existing and future subordinated debt. The notes are guaranteed by certain of the Company s U.S. subsidiaries (the Subsidiary Guarantors). The guarantees rank equally in right of payment with all of the Subsidiary Guarantors existing and future senior debt and senior to all of the Subsidiary Guarantors existing and future subordinated debt. The notes and guarantees (and certain hedging obligations that may be entered into with respect thereto) are secured by first-priority liens, subject to permitted liens, on substantially all of the Company s and the Subsidiary Guarantors assets (other than accounts receivable and proceeds therefrom and subject to certain exceptions), including, but not limited to, the intellectual property, real property, plant and equipment now owned or hereafter acquired by the Company and the Subsidiary Guarantors. See Note 15 for financial information regarding the Subsidiary Guarantors.
The indenture governing the senior secured notes contains a number of covenants that restrict, subject to certain exceptions, the Company s ability and the ability of its restricted subsidiaries to: incur or guarantee additional indebtedness or issue certain redeemable or preferred stock; repurchase capital stock; pay dividends on or make other distributions in respect of its capital stock or make other restricted payments; make certain investments; create liens; redeem junior debt; sell certain assets; consolidate, merge, sell or otherwise dispose of all or substantially all of its assets; enter into certain types of transactions with affiliates; and enter into sale-leaseback transactions.
The sale of the Company s investment in Jazz Semiconductor, Inc. (Jazz) in February 2007 and the sale of two other equity investments in January 2007 qualified as asset dispositions requiring the Company to make offers to repurchase a portion of the notes no later than 361 days following the February 2007 asset dispositions. Based on the proceeds received from these asset dispositions and the Company s cash investments in assets (other than current assets) related to the Company s business made within 360 days following the asset dispositions, the Company was required to make an offer to repurchase not more than $53.6 million of the senior secured notes, at 100% of the principal amount plus any accrued and unpaid interest in February 2008. As a result of 100% acceptance of the offer by the Company s bondholders, $53.6 million of the senior secured notes were repurchased during the second quarter of fiscal 2008. The Company recorded a pretax loss on debt repurchase of $1.4 million during the second quarter of fiscal 2008 which included the write-off of deferred debt issuance costs.
Following the sale of the BMP business unit in August 2008 (see Note 3), the Company made an offer to repurchase $80.0 million of the senior secured notes at 100% of the principal amount plus any accrued and unpaid interest in September 2008. As a result of the 100% acceptance of the offer by the Company s bondholders, $80.0 million of the senior secured notes were repurchased during the fourth quarter of fiscal 2008. The Company recorded a pretax loss on debt repurchase of $1.6 million during the fourth quarter of fiscal 2008 which included the write-off of deferred debt issuance costs. The pretax loss on debt repurchase of $1.6 million has been included in net loss from discontinued operations. During the fiscal quarter ended January 2, 2009, we did not have additional sufficient asset dispositions to trigger another required repurchase offer.
4.00% convertible subordinated notes due March 2026 In March 2006, the Company issued $200.0 million principal amount of 4.00% convertible subordinated notes due March 2026 and, in May 2006, the initial purchaser of the notes exercised its option to purchase an additional $50.0 million principal amount of the 4.00% convertible subordinated notes due March 2026. Total proceeds to the Company from these issuances, net of issuance costs, were $243.6 million. The notes are general unsecured obligations of the Company. Interest on the notes is payable in arrears semiannually on each March 1 and September 1, beginning on September 1, 2006. The notes are convertible, at the option of the holder upon satisfaction of certain conditions, into shares of the Company s common stock at a conversion price of $49.20 per share, subject to adjustment for certain events. Upon conversion, the Company has the right to deliver, in lieu of common stock, cash or a combination of cash and common stock. Beginning on March 1, 2011, the notes may be redeemed at the Company s option at a price equal to 100% of the principal amount, plus any accrued and unpaid interest. Holders may require the Company to repurchase, for cash, all or part

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of their notes on March 1, 2011, March 1, 2016 and March 1, 2021 at a price of 100% of the principal amount, plus any accrued and unpaid interest.

6. Commitments and Contingencies

Legal Matters

Certain claims have been asserted against the Company, including claims alleging the use of the intellectual property rights of others in certain of the Company s products. The resolution of these matters may entail the negotiation of a license agreement, a settlement, or the adjudication of such claims through arbitration or litigation. The outcome of litigation cannot be predicted with certainty and some lawsuits, claims or proceedings may be disposed of unfavorably for the Company. Many intellectual property disputes have a risk of injunctive relief and there can be no assurance that a license will be granted. Injunctive relief could have a material adverse effect on the financial condition or results of operations of the Company. Based on its evaluation of matters which are pending or asserted and taking into account the Company s reserves for such matters, management believes the disposition of such matters will not have a material adverse effect on the Company s financial condition, results of operations, or cash flows.

IPO Litigation In November 2001, Collegeware Asset Management, LP, on behalf of itself and a putative class of persons who purchased the common stock of GlobeSpan, Inc. (GlobeSpan, Inc. later became GlobespanVirata, Inc., and is now the Company s Conexant, Inc. subsidiary) between June 23, 1999 and December 6, 2000, filed a complaint in the U.S. District Court for the Southern District of New York alleging violations of federal securities laws by the underwriters of GlobeSpan, Inc. s initial and secondary public offerings as well as by certain GlobeSpan, Inc. officers and directors. The complaint alleges that the defendants violated federal securities laws by issuing and selling GlobeSpan, Inc. s common stock in the initial and secondary offerings without disclosing to investors that the underwriters had (1) solicited and received undisclosed and excessive commissions or other compensation and (2) entered into agreements requiring certain of their customers to purchase the stock in the aftermarket at escalating prices. The complaint seeks unspecified damages. The complaint was consolidated with class actions against approximately 300 other companies making similar allegations regarding the public offerings of those companies from 1998 through 2000. A tentative settlement of the claims against issuers and their officers and directors, including the GlobeSpan, Inc. officers and directors, was reached in 2004, but the settlement was never finally approved, and was abandoned after the United States Court of Appeals for the Second Circuit ruled, in an appeal by the underwriter defendants, that certification of similarly-defined classes was improper. The tentative settlement was abandoned in 2007, in light of a decision of the U.S. Court of Appeals for the Second Circuit vacating orders certifying similarly-defined classes in cases against the underwriters. The Company does not believe the ultimate outcome of this litigation will have a material adverse impact on its financial condition, results of operations, or cash flows.

Class Action Suit In February 2005, the Company and certain of its current and former officers and the Company s Employee Benefits Plan Committee were named as defendants in Graden v. Conexant, et al., a lawsuit filed on behalf of all persons who were participants in the Company s 401(k) Plan (Plan) during a specified class period. This suit was filed in the U.S. District Court of New Jersey and alleges that the defendants breached their fiduciary duties under the Employee Retirement Income Security Act, as amended, to the Plan and the participants in the Plan. The plaintiff filed an amended complaint on August 11, 2005. The amended complaint alleged that plaintiff lost money in the Plan due to (i) poor Company merger-related performance, (ii) misleading disclosures by the Company regarding the merger, (iii) breaches of fiduciary duty regarding management of Plan assets, (iv) being encouraged to invest in Conexant Stock Fund, (v) being unable to diversify out of said fund and (vi) having the Company make its matching contributions in said fund. On October 12, 2005, the defendants filed a motion to dismiss this case. The plaintiff responded to the motion to dismiss on December 30, 2005, and the defendants reply was filed on February 17, 2006. On March 31, 2006, the judge dismissed this case and ordered it closed. Plaintiff filed a notice of appeal on April 17, 2006. The appellate argument was held on April 19, 2007. On July 31, 2007, the Third Circuit Court of Appeals vacated the District Court s order dismissing Graden s complaint and remanded the case for further proceedings. On August 27, 2008, the motion to dismiss was granted in part and denied in part. The judge left in claims against all of the individual defendants as well as against the Company. In January 2009, the Company and plaintiff agreed in principle to settle all outstanding claims in the litigation for $3.25 million. The Company recorded a Special Charge of $3.7 million as of January 2, 2009, to cover this settlement and any

associated costs. The settlement remains subject to the negotiation of a definitive settlement agreement, confirmatory discovery, and approval by the District Court.

Based on its evaluation of legal matters which are pending or asserted, management believes the disposition of such matters will not have a material adverse effect on the Company s financial condition, results of operations, or cash flows.

Guarantees and Indemnifications

The Company has made guarantees and indemnities, under which it may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with the Company s spin-off from Rockwell International Corporation, the Company assumed responsibility for all contingent liabilities and then-current and future litigation (including environmental and intellectual property proceedings) against Rockwell or its subsidiaries in respect of the operations of the semiconductor systems business of Rockwell. In connection with the Company s contribution of certain of its manufacturing operations to Jazz Semiconductors, Inc., the Company agreed to indemnify Jazz for certain environmental matters and other customary divestiture-related matters. In connection with the sales of its products, the Company provides intellectual property indemnities to its customers. In connection with certain facility leases, the Company has indemnified its lessors for certain claims arising from the facility or the lease. The Company indemnifies its directors and officers to the maximum extent permitted under the laws of the State of Delaware.

The durations of the Company s guarantees and indemnities vary, and in many cases are indefinite. The guarantees and indemnities to customers in connection with product sales generally are subject to limits based upon the amount of the related product sales. The majority of other guarantees and indemnities do not provide for any limitation of the maximum potential future payments the Company could be obligated to make. The Company has not recorded any liability for these guarantees and indemnities in the accompanying condensed consolidated balance sheets as they are not estimated to be material. Product warranty costs are not significant.

7. Stock Option Plans

The Company has stock option plans and long-term incentive plans under which employees and directors may be granted options to purchase shares of the Company s common stock. As of January 2, 2009, approximately 7.7 million shares of the Company s common stock are available for grant under the stock option and long-term incentive plans. Stock options are granted with exercise prices of not less than the fair market value at grant date, generally vest over four years and expire eight or ten years after the grant date. The Company settles stock option exercises with newly issued shares of common stock. The Company has also assumed stock option plans in connection with business combinations.

The Company accounts for its stock option plans in accordance with SFAS No. 123(R), Share-Based Payment. Under SFAS No. 123(R), the Company is required to measure compensation cost for all stock-based awards at fair value on the date of grant and recognize compensation expense in its condensed consolidated statements of operations over the service period that the awards are expected to vest. The Company measures the fair value of service-based awards and performance-based awards on the date of grant. Performance-based awards are evaluated for vesting probability each reporting period. Awards with market conditions are valued on the date of grant using the Monte Carlo Simulation Method giving consideration to the range of various vesting probabilities.

The following weighted average assumptions were used in the estimated grant date fair value calculations for share-based payments. There were no stock purchase plan grants in the quarters ended January 2, 2009 or December 28, 2007.

	Fiscal Quarter Ended	
	January 2, 2009	**December 28, 2007**
Stock option plans:		
Expected dividend yield	$	$
Expected stock price volatility	75%	66%

Risk free interest rate	2.5%	4.0%
Average expected life (in years)	5.25	4.88

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The expected stock price volatility rates are based on the historical volatility of the Company s common stock. The risk free interest rates are based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option or award. The average expected life represents the weighted average period of time that options or awards granted are expected to be outstanding, as calculated using the simplified method described in the SEC s Staff Accounting Bulletin No. 110.
A summary of stock option activity is as follows (shares in thousands):

	Shares	Weighted Average Exercise Price
Outstanding, October 3, 2008	7,357	$ 23.54
Granted	20	1.97
Exercised		
Forfeited	(978)	22.74
Outstanding, January 2, 2009	6,399	23.60
Shares vested and expected to vest, January 2, 2009	6,239	23.80
Exercisable, January 2, 2009	5,447	24.95

At January 2, 2009, of the 6.4 million stock options outstanding, approximately 5.1 million options were held by current employees and directors of the Company, and approximately 1.3 million options were held by employees of former businesses of the Company (i.e., Mindspeed and Skyworks Solutions, Inc.) who remain employed by one of these businesses. At January 2, 2009, stock options outstanding had an immaterial aggregate intrinsic value and a weighted-average remaining contractual term of 3.2 years. At January 2, 2009, exercisable stock options had an immaterial aggregate intrinsic value and a weighted-average remaining contractual term of 2.7 years. The total intrinsic value of options exercised and total cash received from employees as a result of stock option exercises during the fiscal quarter ended January 2, 2009 and December 28, 2007 was immaterial.

Directors Stock Plan

The Company has a Directors Stock Plan (DSP) that provides for each non-employee director to receive specified levels of stock option grants upon election to the Board of Directors and periodically thereafter. Under the DSP, each non-employee director may elect to receive all or a portion of the cash retainer to which the director is entitled through the issuance of common stock. During the fiscal quarter ended January 2, 2009, no grants were awarded under the DSP. At January 2, 2009, approximately 0.1 million shares of the Company s common stock are available for grant under the DSP.

Employee Stock Purchase Plan

The Company has an employee stock purchase plan (ESPP) that allows eligible employees to purchase shares of the Company s common stock at six-month intervals during an offering period at 85% of the lower of the fair market value on the first day of the offering period or the purchase date. Under the ESPP, employees may authorize the Company to withhold up to 15% of their compensation for each pay period to purchase shares under the plan, subject to certain limitations, and employees are limited to the purchase of 200 shares per offering period. Offering periods generally commence on the first trading day of February and August of each year and are generally six months in duration, but may be terminated earlier under certain circumstances. No shares were issued under the ESPP during the fiscal quarter ended January 2, 2009. At January 2, 2009, approximately 2.0 million shares of the Company s common stock are reserved for future issuance under the ESPP, of which 1.3 million shares will become available in 0.3 million share

annual increases, subject to the Board of Directors selecting a lower amount. Effective January 31, 2009, the Company has suspended the ESPP plan for domestic (U.S.) employees.
During the fiscal quarter ended January 2, 2009 and December 28, 2007, the Company recognized compensation expense of $1.4 million and $2.9 million, respectively, for stock options, and $0.1 million and $0.2 million for stock purchase plans in its condensed consolidated statements of operations. The Company classified stock-based

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compensation expense of $0.6 million to discontinued operations for the fiscal quarter ended December 28, 2007. At January 2, 2009, the total unrecognized fair value compensation cost related to non-vested stock options and employee stock purchase plan awards was $7.9 million, which is expected to be recognized over a remaining weighted average period of approximately 1.4 years.

2001 Performance Share Plan and 2004 New Hire Equity Incentive Plan

The Company s long-term incentive plans also provide for the issuance of share-based awards to officers and other employees and certain non-employees of the Company. These awards are subject to forfeiture if employment terminates during the prescribed vesting period (generally within four years of the date of award) or, in certain cases, if prescribed performance criteria are not met. The Company has the 2001 Performance Share Plan (Performance Plan), under which it originally reserved 0.4 million shares for issuance as well as the 2004 New Hire Equity Incentive Plan (New Hire Plan), under which it originally reserved 1.2 million shares for issuance.

Performance Plan

The performance-based awards may be settled, at the Company s election at the time of payment, in cash, shares of common stock or any combination of cash and common stock. A summary of share-based award activity under the Performance Plan is as follows (shares in thousands):

	Shares	Weighted Average Grant Date Fair Value
Outstanding, October 3, 2008	400	$ 6.49
Granted		
Vested	(100)	5.30
Forfeited		
Outstanding, January 2, 2009	300	$ 6.88

During the fiscal quarter ended January 2, 2009, the Company recognized expense of $0.6 million related to the Performance Plan. During the fiscal quarter ended December 28, 2007, the Company recorded a reversal of previously recognized stock based compensation expense of $1.1 million related to the non-achievement of certain performance criteria and stock based compensation expense of $0.1 million related to award grants that were still outstanding. At January 2, 2009, the total unrecognized fair value compensation cost related to non-vested Performance Plan share awards was $0.7 million, which is expected to be recognized in fiscal 2009. As of January 2, 2009, no performance criteria apply to any unvested shares. At January 2, 2009, approximately 0.2 million shares of the Company s common stock are available for issuance under the Performance Plan.

2004 New Hire Plan

The New Hire Plan contains service-based awards as well as awards which vest based on the achievement of certain stock price appreciation conditions. A summary of share-based award activity under the New Hire Plan is as follows (shares in thousands):

	Shares	Weighted Average Grant Date Fair Value
Outstanding, October 3, 2008	74	$ 10.59
Granted		
Vested		
Forfeited	(25)	13.70

Outstanding, January 2, 2009	49	$	9.01

Shares of the market condition awards may vest based upon two years of service and certain stock price appreciation conditions. The Company measures share awards with market conditions at fair value on the grant-date using valuation techniques in accordance with SFAS No. 123(R), which gives consideration to the range of various vesting probabilities.

During the fiscal quarter ended January 2, 2009 and December 28, 2007, the Company recognized $0.1 million and $0.5 million in stock based compensation expense related to the New Hire Plan, respectively. In addition, due to the termination of the Company s former CFO during the fiscal quarter ended January 2, 2009, the vesting period of 24 service-based awards was accelerated and 25 market condition awards were forfeited due to non-achievement of performance criteria resulting in the recognition of $0.3 million of stock based compensation and the reversal of $0.1 million of stock based compensation, respectively. The 24 service based awards will fully vest in February 2009. At January 2, 2009, the total unrecognized fair value compensation cost related to non-vested New Hire Plan was $0.1 million, which is expected to be recognized in fiscal 2009.

8. Comprehensive Loss

Comprehensive loss consists of the following (in thousands):

	Fiscal Quarter Ended	
	January 2, 2009	December 28, 2007
Net loss	$ (17,689)	$ (9,218)
Other comprehensive (loss) income:		
Foreign currency translation adjustments	(1,095)	299
Unrealized losses on marketable securities	(14)	
Unrealized losses on foreign currency forward hedge contracts	(153)	(377)
Unrealized losses on interest rate swap contracts	(2,184)	
Other-than-temporary impairment of marketable securities	1,986	
Gains on settlement of foreign currency forward hedge contracts	659	
Minimum pension liability adjustments		(1,110)
Other comprehensive loss	(801)	(1,189)
Comprehensive loss	$ (18,490)	$ (10,407)

Accumulated other comprehensive loss consists of the following (in thousands):

	January 2, 2009	October 3, 2008
Foreign currency translation adjustments	$ (787)	$ 308
Unrealized gains (losses) on marketable securities	38	(1,934)
Unrealized losses on derivative instruments	(2,135)	(457)
Accumulated other comprehensive loss	$ (2,884)	$ (2,083)

9. Income Taxes

The Company recorded a tax provision of $0.9 million for the quarter ended January 2, 2009 and the quarter ended December 28, 2007, primarily reflecting income taxes imposed on our foreign subsidiaries. All of our U.S. Federal income taxes and the majority of our state income taxes are offset by fully reserved deferred tax assets.

10. Gain on Sale of Intellectual Property

In October 2008, the Company sold a portfolio of patents including patents related to its prior wireless networking technology to a third party for cash of $14.5 million, net of costs, and recognized a gain of $12.9 million on the transaction. In accordance with the terms of the agreement with the third party, the Company retains a cross-license to

this portfolio of patents.

11. Special Charges

For the fiscal quarter ended January 2, 2009, special charges primarily consist of $6.6 million of restructuring charges related to revised sublease assumptions associated with vacated facilities and a $3.7 million charge for a legal settlement (See Note 6). For the fiscal quarter ended December 28, 2007, special charges consisted of $5.2

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million of restructuring charges offset by the reversal of a $0.9 million reserve for the settlement of a proposed tax assessment related to an acquired foreign subsidiary.

Restructuring Charges

The Company has implemented a number of cost reduction initiatives since fiscal 2005 to improve its operating cost structure. The cost reduction initiatives included workforce reductions and the closure or consolidation of certain facilities, among other actions.

As of January 2, 2009, the Company has remaining restructuring accruals of $40.0 million, of which $0.1 million relates to workforce reductions and $39.9 million relates to facility and other costs. Of the $40.0 million of restructuring accruals at January 2, 2009, $7.9 million is included in other current liabilities and $32.1 million is included in other non-current liabilities in the accompanying condensed consolidated balance sheets. The Company expects to pay the amounts accrued for the workforce reductions through fiscal 2009 and expects to pay the obligations for the non-cancelable lease and other commitments over their respective terms, which expire at various dates through fiscal 2021. The facility charges were determined in accordance with the provisions of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities . The Company s accrued liabilities include the net present value of the future lease obligations of $67.8 million, net of contracted sublease income of $10.3 million, and projected sublease income of $17.6 million, and will accrete the remaining amounts into expense over the remaining terms of the non-cancellable leases. Cash payments to complete the restructuring actions will be funded from available cash reserves and funds from product sales, and are not expected to significantly impact the Company s liquidity.

Fiscal 2008 Restructuring Actions During fiscal 2008, the Company announced its decision to discontinue investments in standalone wireless networking solutions and other product areas. In relation to these announcements in fiscal 2008, the Company recorded $6.3 million of total charges for the cost of severance benefits for the affected employees. Additionally, the Company recorded charges of $1.8 million relating to the consolidation of certain facilities under non-cancelable leases that were vacated. Restructuring charges in the fiscal quarter ended January 2, 2009 related to the fiscal 2008 restructuring actions included $0.6 million of additional severance charges.

Activity and liability balances recorded as part of the Fiscal 2008 Restructuring Actions through January 2, 2009 were as follows (in thousands):

	Workforce Reductions	Facility and Other	Total
Charged to costs and expenses	$ 6,254	$ 1,762	$ 8,016
Cash payments	(6,161)	(731)	(6,892)
Restructuring balance, October 3, 2008	93	1,031	1,124
Charged to costs and expenses	600	196	796
Reclassification to other current liabilities and other liabilities		(175)	(175)
Cash payments	(561)	(118)	(679)
Restructuring balance, January 2, 2009	$ 132	$ 934	$ 1,066

Fiscal 2007 Restructuring Actions During fiscal 2007, the Company announced several facility closures and workforce reductions. In total, the Company has notified approximately 670 employees of their involuntary termination and recorded $9.5 million of total charges for the cost of severance benefits for the affected employees. Additionally, the Company recorded charges of $2.0 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated. The non-cash facility accruals resulted from the reclassification of deferred gains on the previous sale-leaseback of two facilities totaling $8.0 million in fiscal 2008 and $4.9 million in fiscal 2007. As a result of the Company s sale of its BMP business unit in fiscal 2008, $2.9 million and $2.2 million, incurred in fiscal 2008 and 2007, respectively, related to fiscal 2007 restructuring actions were reclassified to discontinued operations in the condensed consolidated statements of operations. Restructuring charges in the fiscal quarter ended

January 2, 2009 related to the fiscal 2007 restructuring actions included $9.1 million due to a decrease in estimated future rental income from sub-tenants resulting from declines in sublease activity. Of the $9.1 million charge, $7.0 million related to facilities associated with the sale of the BMP business and have been included in discontinued operations for the quarter ended January 2, 2009.

Activity and liability balances recorded as part of the Fiscal 2007 Restructuring Actions through January 2, 2009 were as follows (in thousands):

	Workforce Reductions	Facility and Other	Total
Charged to costs and expenses	$ 9,477	$ 2,040	$ 11,517
Non-cash items		4,868	4,868
Cash payments	(5,841)	(268)	(6,109)
Restructuring balance, September 28, 2007	3,636	6,640	10,276
Charged to costs and expenses	11	6,312	6,323
Non-cash items		8,039	8,039
Cash payments	(3,631)	(4,309)	(7,940)
Restructuring balance, October 3, 2008	16	16,682	16,698
Charged to costs and expenses	(1)	9,125	9,124
Cash payments	(15)	(1,206)	(1,221)
Restructuring balance, January 2, 2009	$	$ 24,601	$ 24,601

Fiscal 2006 and 2005 Restructuring Actions During fiscal years 2006 and 2005, the Company announced operating site closures and workforce reductions. In total, the Company notified approximately 385 employees of their involuntary termination. During fiscal 2006 and 2005, the Company recorded total charges of $24.1 million based on the estimates of the cost of severance benefits for the affected employees and the estimated relocation benefits for those employees who were offered and accepted relocation assistance. Additionally, the Company recorded charges of $21.3 million relating to the consolidation of certain facilities under non-cancelable leases that were vacated. Restructuring charges in the fiscal quarter ended January 2, 2009 related to the fiscal 2006 and 2005 restructuring actions included $3.7 million due to a decrease in estimated future rental income from sub-tenants resulting from declines in sub lease activity.

Activity and liability balances recorded as part of the Fiscal 2006 and 2005 Restructuring Actions through January 2, 2009 were as follows (in thousands):

	Workforce Reductions	Facility and Other	Total
Restructuring balance, October 1, 2005	$ 3,609	$ 25,220	$ 28,829
Charged to costs and expenses	1,852	1,407	3,259
Reclassification from accrued compensation and benefits and other	1,844	55	1,899
Cash payments	(5,893)	(8,031)	(13,924)
Restructuring balance, September 29, 2006	1,412	18,651	20,063
Reclassification to other current liabilities and other liabilities		(2,687)	(2,687)
Charged to costs and expenses	55	559	614
Cash payments	(1,336)	(4,007)	(5,343)
Restructuring balance, September 28, 2007	131	12,516	12,647
Reclassification from other current liabilities and other liabilities		3,359	3,359
Charged to costs and expenses	(130)	285	155
Cash payments	(1)	(5,123)	(5,124)

Restructuring balance, October 3, 2008		11,037	11,037
Charged to costs and expenses		3,738	3,738
Cash payments		(431)	(431)
Restructuring balance, January 2, 2009	$	$ 14,344	$ 14,344

Litigation

In the quarter ended January 2, 2009, the Company recorded $3.7 million in litigation charges related to the settlement of its class action suit discussed in Note 6 regarding legal matters.

12. Other expense, net

Other expense, net consists of the following (in thousands):

	Fiscal Quarter Ended	
	January 2, 2009	December 28, 2007
Investment and interest income	$ (857)	$ (2,771)
Other-than-temporary impairment of marketable securities	2,635	
Decrease in the fair value of derivative instruments	482	8,364
Other	35	(248)
Other expense, net	$ 2,295	$ 5,345

Other expense, net during the fiscal quarter ended January 2, 2009 was primarily comprised of an other-than-temporary impairment of marketable securities of $2.6 million and a $0.5 million decrease in the fair value of the Company s warrant to purchase six million shares of Mindspeed common stock, offset by $0.9 million of investment and interest income on invested cash balances.

Other expense, net during the fiscal quarter ended December 28, 2007 was primarily comprised of an $8.3 million decrease in the fair value of the Company s warrant to purchase six million shares of Mindspeed common stock mainly due to a decrease in Mindspeed s stock price during the period, offset by $2.8 million of investment and interest income on invested cash balances.

13. Related Party Transactions

Mindspeed Technologies, Inc.

As of January 2, 2009, the Company holds a warrant to purchase six million shares of Mindspeed common stock at an exercise price of $17.04 per share exercisable through June 2013. In addition, two members of the Company s Board of Directors also serve on the Board of Mindspeed. No significant amounts were due to or receivable from Mindspeed at January 2, 2009.

Lease Agreement The Company subleases an office building to Mindspeed. Under the sublease agreement, Mindspeed pays amounts for rental expense and operating expenses, which include utilities, common area maintenance, and security services. During each of the three-month periods ended January 2, 2009, and December 28, 2007, the Company recorded income related to the Mindspeed sublease agreement of $0.4 million. Additionally, Mindspeed made payments directly to the Company s landlord totaling $0.8 million during each of the three-month periods ended January 2, 2009 and December 28, 2007.

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14. Geographic Information

Net revenues by geographic area, based upon country of destination, were as follows (in thousands):

	Fiscal Quarter Ended	
	January 2, 2009	December 28, 2007
United States	$ 4,830	$ 6,363
Other Americas	1,645	3,372
Total Americas	6,475	9,735
China	54,495	87,488
Taiwan	6,931	8,306
Japan	3,834	7,078
Malaysia	3,465	3,832
Thailand	2,973	4,148
Singapore	2,625	13,891
South Korea	1,347	3,973
Other Asia-Pacific	792	189
Total Asia-Pacific	76,462	128,905
Europe, Middle East and Africa	3,561	7,293
	$ 86,498	$ 145,933

The Company believes a portion of the products sold to original equipment manufacturers (OEMs) and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe. One distributor accounted for 13% and 14% of net revenues for the fiscal quarter ended January 2, 2009 and December 28, 2007, respectively. Sales to the Company s twenty largest customers represented approximately 69% and 74% of net revenues for the fiscal quarter ended January 2, 2009 and December 28, 2007, respectively.

Long-lived assets consist of property, plant and equipment and certain other long-term assets. Long-lived assets by geographic area were as follows (in thousands):

	January 2, 2009	October 3, 2008
United States	$ 50,735	$ 52,515
India	3,747	4,499
Other Asia-Pacific	5,683	6,766
Europe, Middle East and Africa	30	34
	$ 60,195	$ 63,814

15. Supplemental Guarantor Financial Information

In November 2006, the Company issued $275.0 million of floating rate senior secured notes due November 2010. The floating rate senior secured notes rank equally in right of payment with all of the Company s (the Parent s) existing and future senior debt and senior to all of its existing and future subordinated debt. The notes are also jointly, severally and unconditionally guaranteed, on a senior basis, by three of the Parent s wholly owned U.S. subsidiaries: Conexant,

Inc., Brooktree Broadband Holding, Inc., and Ficon Technology, Inc. (collectively, the Subsidiary Guarantors). The guarantees rank equally in right of payment with all of the Subsidiary Guarantors existing and future senior debt and senior to all of the Subsidiary Guarantors existing and future subordinated debt.

The notes and guarantees (and certain hedging obligations that may be entered into with respect thereto) are secured by first-priority liens, subject to permitted liens, on substantially all of the Parent s and the Subsidiary Guarantors assets (other than accounts receivable and proceeds therefrom and subject to certain exceptions), including, but not limited to, the intellectual property, owned real property, plant and equipment now owned or hereafter acquired by the Parent and the Subsidiary Guarantors.

In lieu of providing separate financial statements for the Subsidiary Guarantors, the Company has included the accompanying condensed consolidating financial statements. These condensed consolidating financial statements are presented on the equity method of accounting. Under this method, the Parent s and Subsidiary Guarantors

investments in their subsidiaries are recorded at cost and adjusted for their share of the subsidiaries cumulative results of operations, capital contributions and distributions and other equity changes. The financial information of the three Subsidiary Guarantors has been combined in the condensed consolidating financial statements.

The following guarantor financial information has been adjusted to reflect the Company s discontinued operations. See Note 3 for further information regarding the sale of the Company s BMP product line during fiscal 2008.

In addition, subsequent to the issuance of the Company s condensed consolidated interim financial statements for the fiscal quarter ended December 28, 2007, the Company has corrected its guarantor financial information to: (1) properly apply the equity method of accounting to its condensed consolidating statements of operations for the fiscal quarter ended December 28, 2007; and (2) properly present the results of its intercompany transactions within its condensed consolidating statements of cash flows (as financing activities rather than operating activities) for the fiscal quarter ended December 28, 2007 in accordance with SEC Regulation S-X, Rule 3-10(f).

The following tables present the Company s condensed consolidating balance sheets as of January 2, 2009 and October 3, 2008 (in thousands):

			January 2, 2009		
	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Current assets:					
Cash and cash equivalents	$ 77,877	$	$ 32,450	$	$ 110,327
Restricted cash	12,000		8,500		20,500
Receivables, net		169,158	43,948	(172,592)	40,514
Inventories	26,014				26,014
Other current assets	35,032	3	5,850		40,885
Total current assets	150,923	169,161	90,748	(172,592)	238,240
Property and equipment, net	12,512		8,820		21,332
Goodwill	18,911	89,352	3,097		111,360
Intangible assets, net	7,341	2,150	419		9,910
Other assets	36,517		2,493		39,010
Investments in subsidiaries	286,981	19,728		(306,709)	
Total assets	$ 513,185	$ 280,391	$ 105,577	$ (479,301)	$ 419,852
Current liabilities:					
Current portion of long-term debt	$	$	$	$	$
Short-term debt			32,868		32,868
Accounts payable	157,460		37,915	(172,592)	22,783
Accrued compensation and benefits	8,629		3,323		11,952
Other current liabilities	38,326	933	2,570		41,829
Total current liabilities	204,415	933	76,676	(172,592)	109,432
Long-term debt	391,400				391,400
Other liabilities	70,335		1,650		71,985
Total liabilities	666,150	933	78,326	(172,592)	572,817

Shareholders (deficit) equity	(152,965)	279,458	27,251	(306,709)	(152,965)
Total liabilities and equity (deficit)	$ 513,185	$ 280,391	$ 105,577	$ (479,301)	$ 419,852

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	October 3, 2008				
	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Current assets:					
Cash and cash equivalents	$ 69,738	$	$ 36,145	$	$ 105,883
Restricted cash	18,000		8,800		26,800
Receivables		169,158	57,584	(177,745)	48,997
Inventories	36,439				36,439
Other current assets	33,543	3	4,991		38,537
Total current assets	157,720	169,161	107,520	(177,745)	256,656
Property and equipment, net	14,366		10,546		24,912
Goodwill	17,911	89,404	3,097		110,412
Intangible assets, net	8,527	5,992	452		14,971
Other assets	36,955		2,497		39,452
Investments in subsidiaries	291,511	19,188		(310,699)	
Total assets	$ 526,990	$ 283,745	$ 124,112	$ (488,444)	$ 446,403
Current liabilities:					
Current portion of long-term debt	$ 17,707	$	$	$	$ 17,707
Short-term debt			40,117		40,117
Accounts payable	164,057		48,582	(177,745)	34,894
Accrued compensation and benefits	12,078		2,911		14,989
Other current liabilities	40,479	932	2,974		44,385
Total current liabilities	234,321	932	94,584	(177,745)	152,092
Long-term debt	373,693				373,693
Other liabilities	55,710		1,642		57,352
Total liabilities	663,724	932	96,226	(177,745)	583,137
Shareholders (deficit) equity	(136,734)	282,813	27,886	(310,699)	(136,734)
Total liabilities and equity (deficit)	$ 526,990	$ 283,745	$ 124,112	$ (488,444)	$ 446,403

The following tables present the Company s condensed consolidating statements of operations for the fiscal quarter ended January 2, 2009 and December 28, 2007 (in thousands):

	Fiscal Quarter Ended January 2, 2009				
	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Net revenues	$ 82,710	$ 5,894	$ 3,788	$ (5,894)	$ 86,498
Cost of goods sold	36,760		3,588		40,348
Gross margin	45,950	5,894	200	(5,894)	46,150

	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Operating expenses:					
Research and development	26,313				26,313
Selling, general and administrative	18,303		1,180		19,483
Amortization of intangible assets	1,185	2,152	34		3,371
Gain on sale of intellectual property	(12,858)				(12,858)
Special charges	10,157		52		10,209
Total operating expenses	43,100	2,152	1,266		46,518
Operating income (loss)	2,850	3,742	(1,066)	(5,894)	(368)
(Loss) equity in income of subsidiaries	(1,896)	539		1,357	
Interest expense	5,474		580		6,054
Other expense (income), net	4,368		(2,073)		2,295
Income (loss) before income taxes and gain (loss) on equity method investments	(8,888)	4,281	427	(4,537)	(8,717)
Provision for income taxes	667		245		912
(Loss) income before loss on equity method investments	(9,555)	4,281	182	(4,537)	(9,629)
Loss on equity method investments	(846)				(846)
Net (loss) income from continuing operations	(10,401)	4,281	182	(4,537)	(10,475)
Net (loss) gain from discontinued operations	(7,288)		74		(7,214)
Net (loss) income	$ (17,689)	$ 4,281	$ 256	$ (4,537)	$ (17,689)

	Fiscal Quarter Ended December 28, 2007				
	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Net revenues	$ 119,969	$ 11,196	$ 25,964	$ (11,196)	$ 145,933
Cost of goods sold	40,223		23,589		63,812
Gross margin	79,746	11,196	2,375	(11,196)	82,121

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	Fiscal Quarter Ended December 28, 2007				
	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Operating expenses:					
Research and development	37,648		175		37,823
Selling, general and administrative	16,516		3,498		20,014
Amortization of intangible assets	466	244	3,861		4,571
Special charges	3,977		372		4,349
Total operating expenses	58,607	244	7,906		66,757
Operating income (loss)	21,139	10,952	(5,531)	(11,196)	15,364
Equity in (loss) income of subsidiaries	(2,115)	1,641		474	
Interest expense	7,659		1,790		9,449
Other expense (income), net	11,183		(5,838)		5,345
Income (loss) before income taxes and gain (loss) on equity method investments	182	12,593	(1,483)	(10,722)	570
Provision for income taxes	474		388		862
Income (loss) before gain (loss) on equity method investments	(292)	12,593	(1,871)	(10,722)	(292)
Gain on equity method investments	3,773				3,773
Net income from continuing operations	3,481	12,593	(1,871)	(10,722)	3,481
Net loss from discontinued operations	(12,699)				(12,699)
Net (loss) income	$ (9,218)	$ 12,593	$ (1,871)	$ (10,722)	$ (9,218)

The following tables present the Company s condensed consolidating statements of cash flows for the fiscal quarter ended January 2, 2009 and December 28, 2007 (in thousands):

	Fiscal Quarter Ended January 2, 2009				
	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$ (19,686)	$ 1,017	$ 5,389	$ 7,817	$ (5,463)
Cash flows from investing activities:					
	(111)		(70)		(181)

Purchases of property plant and equipment					
Payments for acquisitions	(1,953)				(1,953)
Purchases of accounts receivable			(67,360)	67,360	
Proceeds from collection of purchased accounts receivable			75,177	(75,177)	
Release of restricted cash	6,000		300		6,300
Proceeds from sale of intellectual property, net	14,548				14,548
Net cash provided by (used in) investing activities	18,484		8,047	(7,817)	18,714
Cash flows from financing activities:					
Repayment of short-term debt, net of expenses			(7,900)		(7,900)
Intercompany, net	10,248	(1,017)	(9,231)		
Interest rate swap security deposit	(907)				(907)
Net cash provided by (used in) financing activities	9,341	(1,017)	(17,131)		(8,807)
Net increase (decrease) in cash and cash equivalents	8,139		(3,695)		4,444
Cash and cash equivalents at beginning of period	69,738		36,145		105,883
Cash and cash equivalents at end of period	$ 77,877	$	$ 32,450	$	$ 110,327

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	Fiscal Quarter Ended December 28, 2007				
	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$ 10,712	$ (458)	$ (7,340)	$ 5,832	$ 8,746
Cash flows from investing activities:					
Purchases of property plant and equipment	(566)		(1,048)		(1,614)
Purchases of accounts receivable			(145,848)	145,848	
Proceeds from collection of purchased accounts receivable			151,680	(151,680)	
Purchases of equity securities and other assets	(755)				(755)
Net cash (used in) provided by investing activities	(1,321)		4,784	(5,832)	(2,369)
Cash flows from financing activities:					
Repayment of short-term debt, net of expenses			(9,845)		(9,845)
Intercompany, net	(5,136)	458	4,678		
Proceeds from issuance of common stock	4				4
Net cash provided by (used in) financing activities	(5,132)	458	(5,167)		(9,841)
Net increase (decrease) in cash and cash equivalents	4,259		(7,723)		(3,464)
Cash and cash equivalents at beginning of period	199,263		36,342		235,605
Cash and cash equivalents at end of period	$ 203,522	$	$ 28,619	$	$ 232,141

16. Subsequent Events

Subsequent to January 2, 2009, the Company completed actions that resulted in the elimination of approximately 140 positions worldwide. In the second fiscal quarter of 2009, the Company recorded a charge for $2.2 million related to the headcount reduction. The Company has also suspended the company match for the domestic 401(k) plan.

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

The following discussion and analysis should be read in conjunction with our unaudited condensed consolidated financial statements and the notes thereto included in Part I Item 1 of this Quarterly Report, as well as other cautionary statements and risks described elsewhere in this Quarterly Report, and our audited consolidated financial statements and notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the fiscal year ended October 3, 2008.

Overview

We design, develop and sell semiconductor system solutions, comprised of semiconductor devices, software and reference designs for use in broadband communications applications that enable high-speed transmission, processing and distribution of audio, video, voice and data to and throughout homes and business enterprises worldwide. Our access solutions connect people through personal communications access products, such as personal computers (PCs), to audio, video, voice and data services over wireless and wire line broadband connections as well as over dial-up Internet connections. Our central office solutions are used by service providers to deliver high-speed audio, video, voice and data services over copper telephone lines and optical fiber networks to homes and businesses around the globe. In addition, media processing products enable the capture, display, storage, playback and transfer of audio and video content in applications throughout home and small office environments. These solutions enable broadband connections and network content to be shared throughout a home or small office-home office environment using a variety of communications devices.

We market and sell our semiconductor products and system solutions directly to leading original equipment manufacturers (OEMs) of communication electronics products, and indirectly through electronic components distributors. We also sell our products to third-party electronic manufacturing service providers, who manufacture

products incorporating our semiconductor products for OEMs. Sales to distributors and other resellers accounted for approximately 25% of our net revenues in the fiscal quarter ended January 2, 2009, compared to 25% of our net revenues in the fiscal quarter ended December 28, 2007. One distributor accounted for 13% and 14% of net revenues for the fiscal quarter ended January 2, 2009 and December 28, 2007, respectively. Our top 20 customers accounted for approximately 69% and 74% of net revenues for the fiscal quarter ended January 2, 2009 and December 28, 2007, respectively. Revenues derived from customers located in the Americas, the Asia-Pacific region and Europe (including the Middle East and Africa) were 7%, 88% and 4%, respectively, of our net revenues for the fiscal quarter ended January 2, 2009 and were 7%, 88% and 5%, respectively, of our net revenues for the fiscal quarter ended December 28, 2007. We believe a portion of the products we sell to OEMs and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe.

Critical Accounting Policies

The condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, which require us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the condensed consolidated financial statements, revenues and expenses during the periods reported and related disclosures. Actual results could differ from those estimates. Information with respect to our critical accounting policies that we believe have the most significant effect on our reported results and require subjective or complex judgments of management is contained on pages 38-43 of the Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended October 3, 2008. Management believes that at January 2, 2009, there has been no material change to this information.

Business Enterprise Segments

We operate in one reportable segment, broadband communications. Statement of Financial Accounting Standards (SFAS) No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for the way that public business enterprises report information about operating segments in annual condensed consolidated financial statements. Although we had two operating segments at January 2, 2009, under the aggregation criteria set forth in SFAS No. 131, we only operate in one reportable segment, broadband communications. The Company s reporting units, which are also the Company s operating units, Imaging and PC Media (IPM) and Broadband Access Products (BBA) were identified based upon the availability of discrete financial information and the chief operating decision maker s regular review of the financial information for these operating segments. The Company evaluated these reporting units for components and noted that there are none below the IPM and BBA reporting units.

Under SFAS No. 131, two or more operating segments may be aggregated into a single operating segment for financial reporting purposes if aggregation is consistent with the objective and basic principles of SFAS No. 131, if the segments have similar economic characteristics, and if the segments are similar in each of the following areas:

the nature of their products and services;

the nature of their production processes;

the type or class of customer for their products and services; and

the methods used to distribute their products or provide their services.

We meet each of the aggregation criteria for the following reasons:

the sale of semiconductor products is the only material source of revenue for each of our two operating segments;

the products sold by each of our operating segments use the same standard manufacturing process;

the products marketed by each of our operating segments are sold to similar customers; and

all of our products are sold through our internal sales force and common distributors.

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Because we meet each of the criteria set forth above and each of our operating segments has similar economic characteristics, we aggregate our results of operations in one reportable segment.

In early fiscal 2008, we decided to discontinue our investments in stand-alone wireless networking products and technologies. As a result, we have moved gateway-oriented embedded wireless networking products and technologies, which enable and support our DSL gateway solutions, into our BBA product line beginning in fiscal 2008. In August 2008, we completed the sale of our Broadband Media Processing (BMP) product lines to NXP. As a result, the revenues generated by sales of BMP products have been reported as discontinued operations for all periods presented.

Net revenues from continuing operations by product line are as follows (in thousands):

	Fiscal Quarter Ended	
	January 2, 2009	December 28, 2007
Imaging and PC Media	$ 49,662	$ 75,445
Broadband Access Products	36,836	70,488
	$ 86,498	$ 145,933

Results of Operations

Net Revenues

We recognize revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the sales price and terms are fixed and determinable, and (iv) the collection of the receivable is reasonably assured. These terms are typically met upon shipment of product to the customer. The majority of our distributors have limited stock rotation rights, which allow them to rotate up to 10% of product in their inventory two times per year. We recognize revenue to these distributors upon shipment of product to the distributor, as the stock rotation rights are limited and we believe that we have the ability to reasonably estimate and establish allowances for expected product returns in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists. Development revenue is recognized when services are performed and was not significant for any periods presented.

Prior to the fourth quarter of fiscal 2008, revenue with respect to sales to certain distributors was deferred until the products were sold by the distributors to third parties. During the fourth fiscal quarter ended October 3, 2008, we evaluated three distributors for which revenue has historically been recognized when the purchased products are sold by the distributor to a third party due to our inability in prior years to enforce the contractual terms related to any right of return. Our evaluation revealed that we are able to enforce the contractual right of return for the three distributors in an effective manner similar to that experienced with the other distributor customers. As a result, in the fourth quarter of fiscal 2008, we commenced the recognition of revenue on these three distributors upon shipment, which is consistent with the revenue recognition point of other distributor customers. At January 2, 2009 and October 3,2008, there is no significant deferred revenue related to sales to our distributors.

Revenue with respect to sales to customers to whom we have significant obligations after delivery is deferred until all significant obligations have been completed. At January 2, 2009, there was no deferred revenue. At October 3, 2008, deferred revenue related to shipments of products for which the Company had on-going performance obligations was $0.2 million.

Our net revenues decreased 41% to $86.5 million in the fiscal quarter ended January 2, 2009 from $145.9 million in the fiscal quarter ended December 28, 2007. The fiscal quarter ended December 28, 2007 included approximately $14.7 million of non-recurring revenue from the buyout of a future royalty stream. The decline in net revenues, excluding the impact of the non-recurring revenue, was driven by a 34% decrease in net revenues generated by our Imaging and PC Media (IPM) business, which comprises 57% of our total net revenues. The decrease in our IPM business was attributable to a 37% decrease in unit volume shipments which was offset slightly by a 4% increase in average selling price (ASPs). In addition, net revenues generated by our Broadband Access (BBA) business decreased 48%. BBA revenue, which comprises 43% of our total net revenues, decreased a result of a 46% decline in unit

volume shipments coupled with a 21% decrease in ASPs.

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The global economic recession severely dampened semiconductor industry sales in the first quarter of fiscal 2009, historically a strong quarter for the industry. Weakening demand for the major drivers of semiconductor sales which includes automotive products, personal computers, cell phones, and corporate information technology products, resulted in a sharp drop in semiconductor industry sales. More than 50% of semiconductor demand and the fortunes of the semiconductor industry are increasingly linked to macroeconomic conditions such as gross domestic product, consumer confidence, and disposable income. Demand for all of our products has experienced significant decline in line with the industry decline. We expect revenues to further decline in the fiscal quarter ended April 3, 2009 as compared to the fiscal quarter ended January 2, 2009 as a result of the effects of the overall economic environment. Facing these challenges, the Company has been working to reduce operating costs and actively managing working capital, while continuing to focus on delivering innovative products to gain market share when a market recovery commences.

Gross Margin

Gross margin represents net revenues less cost of goods sold. As a fabless semiconductor company, we use third parties for wafer production and assembly and test services. Our cost of goods sold consists predominantly of purchased finished wafers, assembly and test services, royalties, other intellectual property costs, labor and overhead associated with product procurement and non-cash stock-based compensation charges for procurement personnel.

Our gross margin percentage for the fiscal quarter ended January 2, 2009 was 53.4% compared with 56.3% for the fiscal quarter ended December 28, 2007. Excluding the $14.7 million royalty buy-out in the fiscal quarter ended December 28, 2007, our gross margin percentage would have been 51.4% compared to 53.4% for the fiscal quarter ended January 2, 2009. The two point gross margin percentage increase in the fiscal quarter ended January 2, 2009 is primarily attributable to a shift in product mix.

We assess the recoverability of our inventories on a quarterly basis through a review of inventory levels in relation to foreseeable demand, generally over the following twelve months. Foreseeable demand is based upon available information, including sales backlog and forecasts, product marketing plans and product life cycle information. When the inventory on hand exceeds the foreseeable demand, we write down the value of those inventories which, at the time of our review, we expect to be unable to sell. The amount of the inventory write-down is the excess of historical cost over estimated realizable value. Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory. Demand for our products may fluctuate significantly over time, and actual demand and market conditions may be more or less favorable than those projected by management. In the event that actual demand is lower than originally projected, additional inventory write-downs may be required. Similarly, in the event that actual demand exceeds original projections, gross margins may be favorably impacted in future periods. During the fiscal quarter ended January 2, 2009 and December 28, 2007, we recorded $0.3 million and $2.7 million, respectively, of net charges for excess and obsolete (E&O) inventory. Activity in our E&O inventory reserves for the applicable periods in fiscal 2008 and 2007 was as follows (in thousands):

	Fiscal Quarter Ended	
(in thousands)	**January 2, 2009**	**December 28, 2007**
E&O reserves at beginning of period	$ 17,579	$ 17,139
Additions	1,096	3,535
Release upon sales of product	(809)	(870)
Scrap	(3,006)	(1,353)
Standards adjustments and other	(256)	94
E&O reserves at end of period	$ 14,604	$ 18,545

We review our E&O inventory balances at the product line level on a quarterly basis and regularly evaluate the disposition of all E&O inventory products. It is possible that some of these reserved products will be sold, which will

benefit our gross margin in the period sold. During the fiscal quarter ended January 2, 2009 and December 28, 2007, we sold $0.8 million and $0.9 million, respectively, of reserved products.

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Our products are used by communications electronics OEMs that have designed our products into communications equipment. For many of our products, we gain these design wins through a lengthy sales cycle, which often includes providing technical support to the OEM customer. Moreover, once a customer has designed a particular supplier s components into a product, substituting another supplier s components often requires substantial design changes, which involve significant cost, time, effort and risk. In the event of the loss of business from existing OEM customers, we may be unable to secure new customers for our existing products without first achieving new design wins. When the quantities of inventory on hand exceed foreseeable demand from existing OEM customers into whose products our products have been designed, we generally will be unable to sell our excess inventories to others, and the estimated realizable value of such inventories to us is generally zero.

On a quarterly basis, we also assess the net realizable value of our inventories. When the estimated ASP, less costs to sell our inventory, falls below our inventory cost, we adjust our inventory to its current estimated market value. During the fiscal quarter ended January 2, 2009 and December 28, 2007, credits to adjust certain products to their estimated market values were immaterial. Increases to the lower of cost or market (LCM) inventory reserves may be required based upon actual ASPs and changes to our current estimates, which would impact our gross margin percentage in future periods.

Research and Development

Our research and development (R&D) expenses consist principally of direct personnel costs to develop new semiconductor products, allocated indirect costs of the R&D function, photo mask and other costs for pre-production evaluation and testing of new devices, and design and test tool costs. Our R&D expenses also include the costs for design automation advanced package development and non-cash stock-based compensation charges for R&D personnel.

R&D expense decreased $11.5 million, or 30%, in the fiscal quarter ended January 2, 2009 compared to the fiscal quarter ended December 28, 2007. The decrease is due to a 35% reduction in R&D headcount from December 2007 to December 2008, restructuring activities and cost cutting measures, lower non-cash stock compensation of $1.1 million and a correcting adjustment of $5.3 million in the fiscal quarter ended December 28, 2007, representing the unamortized portion of the capitalized photo mask costs as of September 29, 2007. Based upon an evaluation of all relevant quantitative and qualitative factors, and after considering the provisions of APB 28, paragraph 29, and SAB Nos. 99 and 108, we believe that this correcting adjustment is not material to our full year results for fiscal 2008. In addition, we do not believe the correcting adjustment is material to the amounts reported in previous periods.

Selling, General and Administrative

Our selling, general and administrative (SG&A) expenses include personnel costs, sales representative commissions, advertising and other marketing costs. Our SG&A expenses also include costs of corporate functions including legal, accounting, treasury, human resources, customer service, sales, marketing, field application engineering, allocated indirect costs of the SG&A function, and non-cash stock-based compensation charges for SG&A personnel.

SG&A expense decreased $0.5 million, or 3%, in the fiscal quarter ended January 2, 2009 compared to the fiscal quarter ended December 28, 2007. The decrease is primarily due to the 22% decline in SG&A headcount from December 2007 to December 2008, as well as restructuring measures and other cost cutting efforts, partially offset by an increase in non-cash stock compensation expense of $0.9 million.

Amortization of Intangible Assets

Amortization of intangible assets consists of amortization expense for intangible assets acquired in various business combinations. Our intangible assets are being amortized over a weighted-average period of approximately two years. Amortization expense decreased $1.2 million, or 26%, in the fiscal quarter ended January 2, 2009 compared to the fiscal quarter ended December 28, 2007. The decrease in amortization expense is primarily attributable to the

intangible assets we sold to a third party in October 2008 and other intangible assets that became fully amortized in fiscal 2008.

Gain on Sale of Intellectual Property

In October 2008, the Company sold a portfolio of patents including patents related to its prior wireless networking technology to a third party for cash of $14.5 million, net of costs, and recognized a gain of $12.9 million on the transaction. In accordance with the terms of the agreement with the third party, the Company retains a cross-license to this portfolio of patents.

Special Charges

Special charges in the fiscal quarter ended January 2, 2009 included $6.6 million of restructuring charges related to our fiscal 2008, 2007, 2006 and 2005 restructuring actions primarily due to a decrease in estimated future rental income from sub-tenants based on tenant defaults in the fiscal quarter and a review of subleasing assumptions and a charge of $3.7 million related to a legal settlement.

Special charges in the fiscal quarter ended December 28, 2007 were comprised of $3.4 million of restructuring charges that were attributable to employee severance and termination benefit costs related to our fiscal 2008, 2007 and 2006 restructuring actions and $1.8 million of facilities related charges resulting from the accretion of rent expense related to our prior restructuring actions. These special charges were offset by the reversal of a $0.9 million reserve related to the settlement of a proposed tax assessment for an acquired foreign subsidiary.

Interest Expense

Interest expense decreased $3.4 million, or 36%, in the fiscal quarter ended January 2, 2009 compared to the fiscal quarter ended December 28, 2007. The decrease is primarily attributable to the repurchase of $53.6 million and $80.0 million of our senior secured notes in March and September 2008, respectively, debt refinancing activities implemented in fiscal 2007, and declines in interest rates on our variable rate debt.

Other expense (income), net

	Fiscal Quarter Ended	
(in thousands)	**January 2, 2009**	**December 28, 2007**
Investment and interest income	$ (857)	$ (2,771)
Other-than-temporary impairment of marketable securities	2,635	
Decrease in the fair value of derivative instruments	482	8,364
Other	35	(248)
Other expense (income), net	$ 2,295	$ 5,345

Other expense, net during the fiscal quarter ended January 2, 2009 was primarily comprised of an other-than-temporary impairment of marketable securities of $2.6 million and a $0.5 million decrease in the fair value of the Company s warrant to purchase six million shares of Mindspeed common stock, offset by $0.9 million of investment and interest income on invested cash balances.

Other expense, net during the fiscal quarter ended December 28, 2007 was primarily comprised of an $8.3 million decrease in the fair value of the Company s warrant to purchase six million shares of Mindspeed common stock mainly due to a decrease in Mindspeed s stock price during the period, offset by $2.8 million of investment and interest income on invested cash balances.

Provision for Income Taxes

We recorded a tax provision of $0.9 million for the quarter ended January 2, 2009 and the quarter ended December 28, 2007, primarily reflecting income taxes imposed on our foreign subsidiaries. All of our U.S. Federal income taxes and the majority of our state income taxes are offset by fully reserved deferred tax assets

Liquidity and Capital Resources

Our principal sources of liquidity are our cash and cash equivalents, sales of non-core assets and operating cash flow. We believe that our existing sources of liquidity, together with cash expected to be generated from product sales, will be sufficient to fund our operations, research and development, anticipated capital expenditures and working capital for at least the next twelve months. However, additional operating losses or lower than expected product sales will adversely affect our cash flow and financial condition and could impair our ability to satisfy our indebtedness obligations as such obligations come due.

Recent unfavorable economic conditions have led to a tightening in the credit markets, a low level of liquidity in many financial markets and extreme volatility in the credit and equity markets. If the economy or markets in which we operate continue to be subject to adverse economic conditions, our business, financial condition, cash flow and results of operations will be adversely affected. If the credit markets remain difficult to access or worsen or our performance is unfavorable due to economic conditions or for any other reasons, we may not be able to obtain sufficient capital to repay amounts due under (i) our credit facility expiring November 2009 (ii) our $141.4 million floating rate senior secured notes when they become due in November 2010 or earlier as a result of a mandatory offer to repurchase, and (iii) our $250.0 million convertible subordinated notes when they become due in March 2026 or earlier as a result of the mandatory repurchase requirements. The first mandatory repurchase date for our convertible subordinated notes is March 1, 2011. In the event we are unable to satisfy or refinance our debt obligations as the obligations are required to be paid, we will be required to consider strategic and other alternatives, including, among other things, the negotiation of revised terms of our indebtedness, the exchange of new securities for existing indebtedness obligations and the sale of assets to generate funds. There is no assurance that we would be successful in completing any of these alternatives.

Our cash and cash equivalents increased $4.4 million between October 3, 2008 and January 2, 2009. The increase was primarily due to $14.5 million in net cash proceeds from the sale of intellectual property related to our prior wireless networking technology, $6.3 million released from a standby letter of credit, offset by $5.5 million of cash used in operations and $7.9 million of net repayments on the credit facility.

At January 2, 2009, we had a total of $250.0 million aggregate principal amount of convertible subordinated notes outstanding. These notes are due in March 2026, but the holders may require us to repurchase, for cash, all or part of their notes on March 1, 2011, March 1, 2016 and March 1, 2021 at a price of 100% of the principal amount, plus any accrued and unpaid interest.

At January 2, 2009, we also had a total of $141.4 million aggregate principal amount of floating rate senior secured notes outstanding. These notes are due in November 2010, but we are required to offer to repurchase, for cash, the notes at a price of 100% of the principal amount, plus any accrued and unpaid interest, with the net proceeds of certain asset dispositions if such proceeds are not used within 360 days to invest in assets (other than current assets) related to our business. The sale of the our investment in Jazz Semiconductor, Inc. (Jazz) in February 2007 and the sale of two other equity investments in January 2007 qualified as asset dispositions requiring us to make offers to repurchase a portion of the notes no later than 361 days following the February 2007 asset dispositions. Based on the proceeds received from these asset dispositions and our cash investments in assets (other than current assets) related to our business made within 360 days following the asset dispositions, we were required to make an offer to repurchase not more than $53.6 million of the senior secured notes, at 100% of the principal amount plus any accrued and unpaid interest in February 2008. As a result of 100% acceptance of the offer by our bondholders, $53.6 million of the senior secured notes were repurchased during the second quarter of fiscal 2008. We recorded a pretax loss on debt repurchase of $1.4 million during the second quarter of fiscal 2008, which included the write-off of deferred debt issuance costs.

The sale of the Company s investment in Jazz Semiconductor, Inc. (Jazz) in February 2007 and the sale of two other equity investments in January 2007 qualified as asset dispositions requiring the Company to make offers to repurchase a portion of the notes no later than 361 days following the February 2007 asset dispositions. Based on the proceeds received from these asset dispositions and the Company s cash investments in assets (other than current assets) related to the Company s business made within 360 days following the asset dispositions, the Company was required to make an offer to repurchase not more than $53.6 million of the senior secured notes, at 100% of the

principal amount plus any accrued and unpaid interest in February 2008. As a result of 100% acceptance of the offer by the Company s bondholders, $53.6 million of the senior secured notes were repurchased during the second quarter of fiscal 2008. The Company recorded a pretax loss on debt repurchase of $1.4 million during the second quarter of fiscal 2008 which included the write-off of deferred debt issuance costs.

Following the sale of the BMP business unit, we made an offer to repurchase $80.0 million of the senior secured notes at 100% of the principal amount plus any accrued and unpaid interest in September 2008. As a result of the 100% acceptance of the offer by our bondholders, $80.0 million of the senior secured notes were repurchased during the fourth quarter of fiscal 2008. We recorded a pretax loss on debt repurchase of $1.6 million during the fourth quarter of fiscal 2008, which included the write-off of deferred debt issuance costs. The pretax loss on debt repurchase of $1.6 million has been included in net loss from discontinued operations. During the fiscal quarter ended January 2, 2009, we did not have additional sufficient asset dispositions to trigger another required repurchase offer.

We also have a $50.0 million credit facility with a bank, under which we had borrowed $ 32.9 million as of January 2, 2009. The term of this credit facility has been extended through November 27, 2009, and the facility remains subject to additional 364-day extensions at the discretion of the bank.

Cash flows are as follows (in thousands):

	Fiscal Quarter Ended	
(in thousands)	**January 2, 2009**	**December 28, 2007**
Net cash (used in) provided by operating activities	$ (5,463)	$ 8,746
Net cash (used in) provided by investing activities	18,714	(2,369)
Net cash used in financing activities	(8,807)	(9,841)
Net increase (decrease) in cash and cash equivalents	$ 4,444	$ (3,464)

Cash used in operating activities was $5.5 million for the fiscal quarter ended January 2, 2009 compared to cash provided by operations of $8.7 million for the fiscal quarter ended December 28, 2007. During the fiscal quarter ended January 2, 2009, we used $12.9 million of cash from operations and generated $7.4 million in working capital improvements (accounts receivable, inventories and accounts payable). The cash generated from working capital was primarily driven by a $8.5 million decrease in accounts receivable and an $10.4 million decrease in inventory levels due to the overall lower business volumes and the general economic downturn.

Cash provided by investing activities was $18.7 million for the fiscal quarter ended January 2, 2009 compared to cash used in investing activities of $2.4 million for the fiscal quarter ended December 28, 2007. In the first quarter of fiscal 2009, we sold intellectual property for net proceeds of $14.5 million related to our prior wireless networking technology and $6.3 million of restricted cash was released associated with a standby letter of credit.

Cash used in financing activities was $8.8 million for the fiscal quarter ended January 2, 2009 compared to $9.8 million for the fiscal quarter ended December 28, 2007, and in both periods were primarily attributable to scheduled debt payments.

Contractual Commitments

There have been no material changes to our contractual commitments from those previously disclosed in our Annual Report on Form 10-K for our fiscal year ended October 3, 2008. For a summary of the contractual commitments at October 3, 2008, see Part II, Item 7, page 36 in our 2008 Annual Report on Form 10-K.

Off-Balance Sheet Arrangements

We have made guarantees and indemnities, under which we may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with our spin-off from Rockwell International Corporation (Rockwell), we assumed responsibility for all contingent liabilities and then-current and future litigation

(including environmental and intellectual property proceedings) against Rockwell or its subsidiaries in respect of the operations of the semiconductor systems business of Rockwell. In connection with our contribution of certain of our manufacturing operations to Jazz, we agreed to indemnify Jazz for certain environmental matters and other customary divestiture-related matters. In connection with the sales of our products, we provide intellectual property indemnities to our customers. In connection with certain facility leases, we have indemnified our lessors for certain claims arising from the facility or the lease. We indemnify our directors and officers to the maximum extent permitted under the laws of the State of Delaware.

The durations of our guarantees and indemnities vary, and in many cases are indefinite. The guarantees and indemnities to customers in connection with product sales generally are subject to limits based upon the amount of the related product sales. The majority of other guarantees and indemnities do not provide for any limitation of the maximum potential future payments we could be obligated to make. We have not recorded any liability for these guarantees and indemnities in our condensed consolidated balance sheets. Product warranty costs are not significant.

Special Purpose Entities

We have one special purpose entity, Conexant USA, LLC, which was formed in September 2005 in anticipation of establishing the credit facility. This special purpose entity is a wholly-owned, consolidated subsidiary of ours. Conexant USA, LLC is not permitted, nor may its assets be used, to guarantee or satisfy any of our obligations or those of our subsidiaries.

On November 29, 2005, we established an accounts receivable financing facility whereby we will sell, from time to time, certain insured accounts receivable to Conexant USA, LLC, and Conexant USA, LLC entered into a revolving credit agreement with a bank that is secured by the assets of the special purpose entity. The revolving credit facility currently matures on November 27, 2009 and is subject to annual renewal. Our borrowing limit on the revolving credit agreement is $50.0 million, of which $32.9 million is outstanding at January 2, 2009.

Recently Adopted Accounting Pronouncements

On October 4, 2008, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 157, Fair Value Measurements (SFAS No. 157), for its financial assets and liabilities. The Company s adoption of SFAS No. 157 did not have a material impact on its financial position, results of operations or liquidity.

SFAS No. 157 provides a framework for measuring fair value and requires expanded disclosures regarding fair value measurements. SFAS No. 157 defines fair value as the price that would be received for an asset or the exit price that would be paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. SFAS No. 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs, where available. The following summarizes the three levels of inputs required by the standard that the Company uses to measure fair value.

Level 1: Quoted prices in active markets for identical assets or liabilities.

Level 2: Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related assets or liabilities.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

SFAS No. 157 requires the use of observable market inputs (quoted market prices) when measuring fair value and requires a Level 1 quoted price to be used to measure fair value whenever possible.

In accordance with FASB Staff Position (FSP) No. FAS 157-2, Effective Date of FASB Statement No. 157 (FSP FAS 157-2), the Company elected to defer until October 3, 2009 the adoption of SFAS No. 157 for all nonfinancial assets and liabilities that are not recognized or disclosed at fair value in the financial statements on a

recurring basis. The adoption of SFAS No. 157 for those assets and liabilities within the scope of FSP FAS 157-2 is not expected to have a material impact on the Company s financial position, results of operations or liquidity.

On October 4, 2008, the Company adopted SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (SFAS No. 159), which permits entities to choose to measure many financial instruments and certain other items at fair value. The Company already records marketable securities at fair value in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. The adoption of SFAS No. 159 did not have an impact on the Company s condensed consolidated financial statements as management did not elect the fair value option for any other financial instruments or certain other assets and liabilities.

Recently Issued Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS No. 141R), which replaces SFAS No 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. The Company will adopt SFAS No. 141R no later than the first quarter of fiscal 2010 and it will apply prospectively to business combinations completed on or after that date.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51, (SFAS No. 160) which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent s equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. The Company will adopt SFAS No. 160 no later than the first quarter of fiscal 2010 and it will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. The Company is currently assessing the potential impact that adoption of SFAS No. 160 would have on its financial position and results of operations.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS No. 161). SFAS No. 161 requires expanded disclosures regarding the location and amount of derivative instruments in an entity s financial statements, how derivative instruments and related hedged items are accounted for under SFAS No. 133 and how derivative instruments and related hedged items affect an entity s financial position, operating results and cash flows. SFAS No. 161 is effective for periods beginning on or after November 15, 2008. The Company does not believe that the adoption of SFAS No. 161 will have a material impact on its financial statement disclosures.

In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142. This change is intended to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R and other generally accepted accounting principles (GAAP). The requirement for determining useful lives must be applied prospectively to intangible assets acquired after the effective date and the disclosure requirements must be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, which will require the Company to adopt these provisions in the first quarter of fiscal 2010. The Company is currently evaluating the impact of adopting FSP 142-3 on its condensed consolidated financial statements.

In May 2008, the FASB issued FSP APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) (FSP APB 14-1). FSP APB 14-1 requires the issuer

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to separately account for the liability and equity components of convertible debt instruments in a manner that reflects the issuer s nonconvertible debt borrowing rate. The guidance will result in companies recognizing higher interest expense in the statement of operations due to amortization of the discount that results from separating the liability and equity components. FSP APB 14-1 will be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Based on its initial analysis, the Company expects that the adoption of FSP APB 14-1 will result in an increase in the interest expense recognized on its convertible subordinated notes. See Note 5 to the Condensed Consolidated Financial Statements for further information on long-term debt.

In December 2008, the FASB issued FSP (FSP) FAS 140-4 and FIN 46(R)-8, Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities (FSP 140-4 and FIN 46(R)-8). FSP 140-4 and FIN 46(R)-8 amends FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, to require public entities to provide additional disclosures about transfers of financial assets. It also amends FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, to require public enterprises, including sponsors that have a variable interest in a variable interest entity, to provide additional disclosures about their involvement with variable interest entities. Additionally, this FSP requires certain disclosures to be provided by a public enterprise that is (a) a sponsor of a qualifying special purpose entity (SPE) that holds a variable interest in the qualifying SPE but was not the transferor (nontransferor) of financial assets to the qualifying SPE and (b) a servicer of a qualifying SPE that holds a significant variable interest in the qualifying SPE but was not the transferor (nontransferor) of financial assets to the qualifying SPE. FSP 140-4 and FIN 46(R)-8 is effective for periods beginning on or after December 15, 2008. The Company does not believe that the adoption of FSP 140-4 and FIN 46(R)-8 will have a material impact on its financial statement disclosures.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our financial instruments include cash and cash equivalents, the Mindspeed warrant, short-term debt and long-term debt. Our main investment objectives are the preservation of investment capital and the maximization of after tax returns on our investment portfolio. Consequently, we invest with only high credit quality issuers, and we limit the amount of our credit exposure to any one issuer.

Our cash and cash equivalents are not subject to significant interest rate risk due to the short maturities of these instruments. As of January 2, 2009, the carrying value of our cash and cash equivalents approximates fair value.

We hold a warrant to purchase six million shares of Mindspeed common stock at an exercise price of $17.04 per share through June 2013. For financial accounting purposes, this is a derivative instrument and the fair value of the warrant is subject to significant risk related to changes in the market price of Mindspeed s common stock. As of January 2, 2009, a 10% decrease in the market price of Mindspeed s common stock would result in an immaterial decrease in the fair value of this warrant. At January 2, 2009, the market price of Mindspeed s common stock was $0.92 per share. During the fiscal quarter ended January 2, 2009, the market price of Mindspeed s common stock ranged from a low of $0.56 per share to a high of $2.17 per share.

Our short-term debt consists of borrowings under a 364-day credit facility. Interest related to our short-term debt is at 7-day LIBOR plus 1.25%, which is reset weekly and was approximately 1.65% at January 2, 2009. In connection with our extension of the term of this credit facility through November 27, 2009, the interest rate applied to our borrowings under the facility increased from 7-day LIBOR plus 0.6% to 7-day LIBOR plus 1.25%. We do not believe our short-term debt is subject to significant market risk.

Our long-term debt consists of convertible subordinated notes with interest at fixed rates and floating rate senior secured notes. Interest related to our floating rate senior secured notes is at three-month LIBOR plus 3.75%, which is reset quarterly and was approximately 5.90% at January 2, 2009. At January 2, 2009, we are party to two interest rate swap agreements for a combined notional amount of $100 million to eliminate interest rate risk on $100 million of our floating rate senior secured notes due 2010. Under the terms of the swaps, we will pay a fixed rate of 2.98% and receive a floating rate equal to three-month LIBOR, which will offset the floating rate paid on the notes. The

fair value of our convertible subordinated notes is subject to significant fluctuation due to their convertibility into shares of our common stock.

The following table shows the fair values of our financial instruments as of January 2, 2009 (in thousands):

	Carrying Value	Fair Value
	(In thousands)	
Cash and cash equivalents	$110,327	$110,327
Restricted cash	27,261	27,261
Marketable available-for-sale securities	403	403
Other equity securities	7,976	7,976
Mindspeed warrant	63	63
Short-term debt	32,868	32,868
Interest rate swap financial instruments	2,135	2,135
Long-term debt: senior secured notes	141,400	134,330
Long-term debt: convertible subordinated notes	250,000	112,500

Exchange Rate Risk

We consider our direct exposure to foreign exchange rate fluctuations to be minimal. Currently, sales to customers and arrangements with third-party manufacturers provide for pricing and payment in United States dollars, and, therefore, are not subject to exchange rate fluctuations. Increases in the value of the United States dollar relative to other currencies could make our products more expensive, which could negatively impact our ability to compete. Conversely, decreases in the value of the United States dollar relative to other currencies could result in our suppliers raising their prices to continue doing business with us. Fluctuations in currency exchange rates could affect our business in the future.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and our principal financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting during the quarter ended January 2, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

IPO Litigation In November 2001, Collegeware Asset Management, LP, on behalf of itself and a putative class of persons who purchased the common stock of GlobeSpan, Inc. (GlobeSpan, Inc. later became GlobespanVirata, Inc., and is now the Company s Conexant, Inc. subsidiary) between June 23, 1999 and December 6, 2000, filed a complaint in the U.S. District Court for the Southern District of New York alleging violations of federal securities laws by the underwriters of GlobeSpan, Inc. s initial and secondary public offerings as well as by certain GlobeSpan, Inc. officers and directors. The complaint alleges that the defendants violated federal securities laws by issuing and selling GlobeSpan, Inc. s common stock in the initial and secondary offerings without disclosing to investors that the underwriters had (1) solicited and received undisclosed and excessive commissions or other compensation and (2) entered into agreements requiring certain of their customers to purchase the stock in the aftermarket at escalating prices. The complaint seeks unspecified damages. The complaint was consolidated with class actions against approximately 300 other companies making similar allegations regarding the public offerings of those companies from 1998 through 2000. A tentative settlement of the claims against issuers and their officers and directors, including the GlobeSpan, Inc. officers and directors, was reached in 2004, but the settlement was never finally approved, and was abandoned after the United States Court of Appeals for the Second Circuit ruled, in

an appeal by the underwriter defendants, that certification of similarly-defined classes was improper. The tentative settlement was abandoned in 2007, in light of a decision of the U.S. Court of Appeals for the Second Circuit vacating orders certifying similarly-defined classes in cases against the underwriters. The Company does not believe the ultimate outcome of this litigation will have a material adverse impact on its financial condition, results of operations, or cash flows.

Class Action Suit In February 2005, the Company and certain of its current and former officers and the Company s Employee Benefits Plan Committee were named as defendants in Graden v. Conexant, et al., a lawsuit filed on behalf of all persons who were participants in the Company s 401(k) Plan (Plan) during a specified class period. This suit was filed in the U.S. District Court of New Jersey and alleges that the defendants breached their fiduciary duties under the Employee Retirement Income Security Act, as amended, to the Plan and the participants in the Plan. The plaintiff filed an amended complaint on August 11, 2005. The amended complaint alleged that plaintiff lost money in the Plan due to (i) poor Company merger-related performance, (ii) misleading disclosures by the Company regarding the merger, (iii) breaches of fiduciary duty regarding management of Plan assets, (iv) being encouraged to invest in Conexant Stock Fund, (v) being unable to diversify out of said fund and (vi) having the Company make its matching contributions in said fund. On October 12, 2005, the defendants filed a motion to dismiss this case. The plaintiff responded to the motion to dismiss on December 30, 2005, and the defendants reply was filed on February 17, 2006. On March 31, 2006, the judge dismissed this case and ordered it closed. Plaintiff filed a notice of appeal on April 17, 2006. The appellate argument was held on April 19, 2007. On July 31, 2007, the Third Circuit Court of Appeals vacated the District Court s order dismissing Graden s complaint and remanded the case for further proceedings. On August 27, 2008, the motion to dismiss was granted in part and denied in part. The judge left in claims against all of the individual defendants as well as against the Company. In January 2009, the Company and plaintiff agreed in principle to settle all outstanding claims in the litigation for $3.25 million. The Company recorded a Special Charge of $3.7 million as of January 2, 2009, to cover this settlement and any associated costs. The settlement remains subject to the negotiation of a definitive settlement agreement, confirmatory discovery, and approval by the District Court.

ITEM 1A. RISK FACTORS

Our business, financial condition and results of operations can be impacted by a number of risk factors, any one of which could cause our actual results to vary materially from recent results or from our anticipated future results. Any of these risks could materially and adversely affect our business, financial condition and results of operations, which in turn could materially and adversely affect the price of our common stock or other securities.

We have updated the risk factors discussed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended October 3, 2008, as set forth below. We do not believe any of the updates constitute material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended October 3, 2008.

References in this section to our fiscal year refer to the fiscal year ending on the Friday nearest September 30 of each year. References in this section to our fiscal quarter refer to the fiscal quarter ending on the Friday nearest December 31 of each year.

We face a risk that capital needed for our business and to repay our debt obligations will not be available when we need it.

At January 2, 2009, we had $141.4 million aggregate principal amount of floating rate senior secured notes outstanding due November 2010 and $250.0 million aggregate principal amount of convertible subordinated notes outstanding. The convertible notes are due in March 2026, but the holders may require us to repurchase, for cash, all or part of their notes on March 1, 2011, March 1, 2016 and March 1, 2021 at a price of 100% of the principal amount, plus any accrued and unpaid interest.

We also have a $50.0 million credit facility with a bank, under which we had borrowed $32.9 million as of January 2, 2009. The term of this credit facility has been extended through November 27, 2009, and the facility remains subject to additional 364-day extensions at the discretion of the bank.

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Recent unfavorable economic conditions have led to a tightening in the credit markets, a low level of liquidity in many financial markets and extreme volatility in the credit and equity markets. In addition, if the economy or markets in which we operate continue to be subject to adverse economic conditions, our business, financial condition, cash flow and results of operations will be adversely affected. Ifng-right:2px;padding-top:2px;padding-bottom:2px;">

%

Chicago Marriott Downtown

2
%
(6)
18
%
(7)
5
%

Courtyard Denver Downtown

1.5
%
(8)
10
%

4
%

Courtyard Manhattan/Fifth Avenue

6
%

25
%

4
%

Courtyard Manhattan/Midtown East

1.75
%
(9)
15
%

4

%

Frenchman's Reef & Morning Star Beach Resort (10)

3
%

15
%

5.5
%

The Gwen Chicago

2
%
(11)
15
%

4
%

Havana Cabana Key West

3
%

10
%

4
%

Hilton Boston Downtown

2
%

10
%

4
%

Hilton Burlington

1.5
%
(12)

10
%

—

Hilton Garden Inn New York City/Times Square Central

3
%

20
%

4
%

Hotel Emblem

2.75
%

15
%

4
%

Hotel Palomar Phoenix

3.5
%

20
%

4
%

JW Marriott Denver at Cherry Creek

2.5
%

10
%

4
%

The Landing Resort & Spa

1.5
%

15
%

4
%

Lexington Hotel New York

3
%

20
%

5
%

Renaissance Charleston

3.5
%

20
%

5
%

Renaissance Worthington

3
%

25
%

5
%

Salt Lake City Marriott Downtown

2
%
(13)
20
%

5
%

L'Auberge de Sedona

0.5
%
(14)
10
%

4
%

Orchards Inn Sedona

0.5
%
(14)
10
%

4
%

Sheraton Suites Key West

3
%

10
%

4
%

Shorebreak Hotel

2.5
%

15
%

4
%

The Lodge at Sonoma, a Renaissance Resort & Spa

3
%

20
%

5
%

Vail Marriott Mountain Resort & Spa

3
%

20
%

4
%

Westin Fort Lauderdale Beach Resort

2
%

15
%

4
%

Westin San Diego

1.5
%
(12)
10
%

4
%

Westin Washington D.C. City Center

2
%

15
%

4
%

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(1) As a percentage of gross revenues.
(2) Based on a percentage of hotel operating profits above a specified return on our invested capital or specified operating profit thresholds.
(3) The base management fee decreases to 2% of gross revenues between February 2018 and January 2021.
(4) The owner's priority expires in 2028, after which the manager will receive 50% of the hotel's operating profits.
(5) The contribution is reduced to 1% until operating profits exceed an owner's priority of $4.4 million.
(6) The base management fee decreased from 3.0% to 2.0% for October 2017 through September 2021 and will then revert back to 3% for the remainder of the term.

(7) Calculated as 18% of net operating income. There is no owner's priority; however, the Company's contribution to the hotel's multi-year property renovation is treated as a deduction in calculating net operating income.
(8) The base management fee is a sum of 1.5% of gross revenues and 1.5% of gross operating profit.
(9) Beginning in January 2018, the base management fee increased to 1.75% of gross revenues through the remainder of the term.
(10) We terminated the management agreement with Marriott, effective February 20, 2018. The hotel is currently closed as a result of the physical damage incurred from Hurricanes Irma and Maria.
(11) The base management fee increases to 2.25% for 2018 through the remainder of the term.
(12) Total management fees are capped at 2.5% of gross revenues.
(13) The base management fee decreased from 3% to 1.5% beginning May 2016 and increased to 2.0% in May 2018 and will increase to 3.0% in May 2021 through the remainder of the term.
(14) Prior to December 2017, the base management fee was 2.45% of gross revenues under the previous hotel manager. The base management fee increases to 1.0% for 2019 and 1.5% for 2020 through the remainder of the term.

Additional information regarding fees incurred under hotel management agreements can be found in Note 12 to our accompanying consolidated financial statements.

Franchise Agreements

The following table sets forth the terms of the hotel franchise agreements for our 13 franchised hotels:

	Expiration Date of Agreement	Franchise Fee
Vail Marriott Mountain Resort & Spa	12/2021	6% of gross room sales plus 3% of gross food and beverage sales
JW Marriott Denver at Cherry Creek	10/2026	6% of gross room sales and 3% of gross food and beverage sales
Lexington Hotel New York	3/2032	5% of gross room sales
Courtyard Denver Downtown	10/2027	4.5% of gross room sales (1)
Hilton Boston Downtown	7/2022	5% of gross room sales and 3% of gross food and beverage sales; program fee of 4% of gross room sales
Westin Washington D.C. City Center	12/2030	7% of gross room sales and 3% of gross food and beverage sales
Westin San Diego	12/2030	7% of gross room sales and 3% of gross food and beverage sales
Hilton Burlington	7/2032	4% of gross room sales and 3% of gross food and beverage sales; program fee of 4% of gross room sales (2)
Hilton Garden Inn New York/Times Square Central	6/2033	5% of gross room sales; program fee of 4.3% of gross room sales
Westin Fort Lauderdale Beach Resort	12/2034	6% of gross room sales and 2% of gross food and beverage sales
The Gwen Chicago	9/2035	4.5% of gross room sales
Sheraton Suites Key West	2/2026	5% of gross room sales
Courtyard Manhattan/Midtown East	8/2042	6% of gross room sales

(1) Prior to October 2017, the franchise fee was 5.5% of gross room sales. The franchise fee reverts back to 5.5% of gross room sales beginning October 2019.

(2) Prior to August 2018, the franchise fee was 3% of gross room sales. The franchise fee increased to 4% of gross room sales beginning August 2018 and will increase to 5% of gross room sales beginning August 2019 through the remainder of the term.

Additional information regarding fees incurred under franchise agreements can be found in Note 12 to our accompanying consolidated financial statements.

Mortgage Debt

Eight of our hotels are encumbered by mortgage debt. Additional information regarding such hotels can be found in Note 8 to our accompanying consolidated financial statements.

Ground Leases

Ten of our hotels are subject to ground lease agreements. Additional information regarding our hotels that are subject to ground leases can be found in Note 13 to our accompanying consolidated financial statements.

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Item 3. Legal Proceedings

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.

Item 4. Mine Safety Disclosures

Not applicable.

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Part II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our common stock trades on the NYSE under the symbol “DRH”. The closing price of our common stock on the NYSE on December 31, 2018 was $9.08 per share.

Stock Performance Graph

The following graph compares the five-year cumulative total stockholder return on our common stock against the cumulative total returns of the Standard & Poor's 500 Index (the “S&P 500 Total Return”) and the Dow Jones U.S. Hotels & Lodging REITs Index (the “Dow Jones U.S. Hotels Total Return”). We believe the Dow Jones U.S. Hotels & Lodging REITs Index's total return provides a relevant industry sector comparison to our common stock's total stockholder return given the index is based on REITs that primarily invest in lodging real estate.

The graph assumes an initial investment on December 31, 2013 of $100 in our common stock in each of the indices and also assumes the reinvestment of dividends. The total return values do not include dividends declared, but not paid, during the period.

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	Year Ended December 31,					
	2013	2014	2015	2016	2017	2018
DiamondRock Hospitality Company Total Return	$100.00	$132.84	$89.92	$113.13	$115.82	$96.24
S&P 500 Total Return	$100.00	$113.69	$115.26	$129.05	$157.22	$150.33
Dow Jones U.S. Hotels Total Return	$100.00	$129.43	$94.00	$116.80	$124.66	$109.10

This performance graph shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or incorporated by reference into any filing by us under the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing.

Dividend Information

In order to maintain our qualification as a REIT, we 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.

We generally pay quarterly cash dividends to common stockholders at the discretion of our board of directors.

Stockholder Information

As of February 22, 2019, there were 16 record holders of our common stock and we believe we have more than one thousand beneficial holders. As of February 22, 2019, there were 14 holders of OP units (in addition to the Company).

In order to comply with certain requirements related to our qualification as a REIT, our charter, subject to certain exceptions, limits the number of common shares that may be owned by any single person or affiliated group to 9.8% of the outstanding common shares.

Equity Compensation Plan Information

The following table provides information as of December 31, 2018 regarding shares of common stock that may be issued under the Company's equity compensation plans.

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
	(a)	(b)	(c)
Equity compensation plans approved by security holders	1,546,472 [1]	— [2]	5,236,147
	—	—	—

Equity compensation plans not approved by security holders			
Total	1,546,472	—	5,236,147

(1) Includes 764,549 shares of common stock issuable pursuant to our deferred compensation plan and 781,923 shares of common stock issuable upon the achievement of certain performance conditions.
(2) Performance stock units and deferred stock units do not have any exercise price.

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Fourth Quarter 2018 Repurchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Dollar Amount that May Yet be Purchased Under the Plans or Programs (in thousands) (1)
October 1 - October 31, 2018	65,638 (2)	$ 11.54	—	$ 150,000
November 1 - November 30, 2018	—	$ —	—	$ 250,000
December 1 - December 31, 2018	3,384,359	$ 9.49	3,384,359	$ 217,886

(1) Represents amounts available under the Company's 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. Our share repurchase program will be effective until November 6, 2020.

(2) Reflects shares surrendered to the Company by employees for payment of tax withholding obligations in connection with the issuance of common stock under our deferred compensation plan.

Item 6. Selected Financial Data

The selected historical financial information as of and for the years ended December 31, 2018, 2017, 2016, 2015 and 2014 has been derived from our audited historical financial statements. The selected historical financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," the consolidated financial statements as of December 31, 2018 and 2017 and for the years ended December 31, 2018, 2017 and 2016, and the related notes contained elsewhere in this Annual Report on Form 10-K.

	Year Ended December 31,				
	2018	2017	2016	2015	2014
	(in thousands)				
Revenues:					
Rooms	$631,048	$635,932	$650,624	$673,578	$628,870
Food and beverage	184,097	183,049	194,756	208,173	195,077
Other	48,559	51,024	51,178	49,239	48,915
Total revenues	863,704	870,005	896,558	930,990	872,862
Operating expenses:					
Rooms	158,078	158,534	159,151	163,549	162,870
Food and beverage	118,709	120,460	125,916	137,297	135,402
Management fees	22,159	21,969	30,143	30,633	30,027
Other hotel expenses	322,713	302,272	302,805	317,623	295,826
Impairment losses	—	3,209	—	10,461	—
Hotel acquisition costs	—	2,028	—	949	2,177
Corporate expenses [(1)]	28,563	26,711	23,629	24,061	22,267
Depreciation and amortization	104,524	99,090	97,444	101,143	99,650
Business interruption insurance income	(19,379)	(4,051)	—	—	—
Gain on property insurance settlement	(1,724)	—	—	—	(1,825)
Gain on litigation settlement, net	—	—	—	—	(10,999)
Total operating expenses	733,643	730,222	739,088	785,716	735,395
Interest and other income, net	(1,806)	(1,820)	(762)	(688)	(3,027)
Interest expense	40,970	38,481	41,735	52,684	58,278
Gain on repayments of notes receivable	—	—	—	(3,927)	(13,550)
Loss (gain) on sales of hotel properties, net	—	764	(10,698)	—	(50,969)
Gain on hotel property acquisition	—	—	—	—	(23,894)
Loss on early extinguishment of debt	—	274	—	—	1,616
Income before income taxes	90,897	102,084	127,195	97,205	169,013
Income tax expense	(3,101)	(10,207)	(12,399)	(11,575)	(5,636)
Net income	87,796	91,877	114,796	85,630	163,377
Less: Net income attributable to noncontrolling interests	(12)	—	—	—	—
Net income attributable to common stockholders	$87,784	$91,877	$114,796	$85,630	$163,377

(1) Corporate expenses for the year ended December 31, 2018 include approximately $0.8 million of costs related to the departure of our former Chief Financial Officer. Corporate expenses for the year ended December 31, 2016 include the reversal of approximately $0.6 million of previously recognized compensation expense resulting from the forfeiture of equity awards related to the resignation of our former Executive Vice President and Chief Operating Officer. Corporate expenses for the year ended December 31, 2014 include reimbursement of $1.8 million of previously incurred legal fees and other costs from the proceeds of a litigation settlement relating to

Westin Boston Waterfront.

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	Year Ended December 31,				
	2018	2017	2016	2015	2014
	(in thousands, except for per share data)				
Earnings per share:					
Net income per share attributable to common stockholders, basic	$0.43	$0.46	$0.57	$0.43	$0.83
Net income per share attributable to common stockholders, diluted	$0.43	$0.46	$0.57	$0.43	$0.83
Other data:					
Dividends declared per common share	$0.50	$0.50	$0.50	$0.50	$0.41

	As of December 31,				
	2018	2017	2016	2015	2014
	(in thousands)				
Balance sheet data:					
Property and equipment, net	$2,944,617	$2,692,286	$2,646,676	$2,882,176	$2,764,393
Cash and cash equivalents	43,863	183,569	243,095	213,584	144,365
Total assets	3,197,580	3,100,858	3,050,908	3,312,510	3,151,687
Total debt	977,966	937,792	920,539	1,169,749	1,031,666
Total liabilities	1,306,987	1,267,213	1,214,121	1,487,905	1,322,700
Stockholders' equity	1,882,897	1,833,645	1,836,787	1,824,605	1,828,987

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the consolidated financial statements and related notes thereto included elsewhere in this report. This discussion contains forward-looking statements about our business. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in "Special Note About Forward-Looking Statements" and "Risk Factors" contained in this Annual Report on Form 10-K and in our other reports that we file from time to time with the SEC.

Overview

DiamondRock Hospitality Company is a lodging-focused real estate company operating as a REIT for federal income tax purposes that owns a portfolio of premium hotels and resorts. As of December 31, 2018, we owned a portfolio of 31 premium hotels and resorts that contain 10,091 guest rooms located in 21 different markets in North America and the U.S. Virgin Islands. Our hotel in the U.S. Virgin Islands, Frenchman's Reef, is currently closed due to damage incurred by 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.

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), 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 basis. ADR and RevPAR include only room revenue. Room revenue comprised approximately

73% of our total revenues for the year ended December 31, 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, new hotel construction and the pricing strategies of competitors. In addition, our ADR, occupancy percentage and RevPAR performance is dependent on the continued success of our hotels' global brands.

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

Overview of 2018

Key highlights for 2018 include the following:

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. In December 2018, we acquired the 142-room Cavallo Point in Sausalito, California, for a total contractual purchase price of $152 million.

Financing Activity. On October 18, 2018, we entered into a new five-year $50 million unsecured term loan. On December 5, 2018, we drew down the full balance of the term loan in connection with the closing of the Cavallo Point acquisition.

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 Hurricanes Irma and Maria in 2017 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 ensure the best outcome for our stockholders. During the year ended December 31, 2018, we recognized $16.1 million of business interruption insurance 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 year ended December 31, 2018, we recognized $2.1 million of business interruption income and a $1.7 million gain on the property damage insurance settlement.

The Lodge at Sonoma Renaissance Resort & Spa. In July 2018, we settled our insurance claim for smoke damage and business interruption for $1.3 million, net of deductibles. During the year ended December 31, 2018, we recognized $1.2 million of business interruption income related to The Lodge at Sonoma.

Outlook for 2019

Although economic indicators such as GDP growth, corporate earnings, consumer confidence and employment reflect a stable U.S. economy, we expect RevPAR growth to decelerate in 2019. Furthermore we anticipate the U.S. lodging industry will be challenged by rising labor costs.
Our portfolio is weighted towards top-25 urban markets, which have experienced hotel supply increases in excess of the national average in recent years. However, we expect our resort hotels to continue to outperform the broader U.S. market, with recent repositionings driving value within the portfolio. Following $115 million of hotel renovations and capital improvements in 2018, we expect lower renovation disruption in 2019. Additionally, we continue to work closely with our hotel managers to control operating costs.
Despite anticipated deceleration, we enter 2019 with several favorable factors, including: (1) ownership of a high-quality portfolio concentrated in urban and resort locations; (2) increased internal growth from the continuation

of our asset management initiatives; (3) a low leveraged capital structure relative to our peers; and (4) an unrestricted cash balance of $44 million and no outstanding borrowings on our $300 million senior unsecured credit facility as of December 31, 2018.

Results of Operations

The following table sets forth certain operating information for the year ended December 31, 2018 for each of the hotels we owned during 2018.

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Property (1)	Location	Number of Rooms	Occupancy (%)		ADR($)	RevPAR($)	% Change from 2017 RevPAR (2)	
Chicago Marriott	Chicago, Illinois	1,200	73.8	%	$230.37	$ 169.96	6.4	%
Westin Boston Waterfront Hotel	Boston, Massachusetts	793	74.3	%	251.58	186.93	(4.4	)%
Lexington Hotel New York	New York, New York	725	90.5	%	251.84	227.86	0.0	%
Salt Lake City Marriott Downtown	Salt Lake City, Utah	510	70.2	%	171.74	120.61	(5.0	)%
Renaissance Worthington	Fort Worth, Texas	504	74.9	%	186.66	139.78	3.2	%
Westin San Diego	San Diego, California	436	81.8	%	193.56	158.35	(2.9	)%
Westin Fort Lauderdale Beach Resort	Fort Lauderdale, Florida	432	81.3	%	196.67	159.99	(1.4	)%
Westin Washington, D.C. City Center	Washington, D.C.	410	87.0	%	206.19	179.33	(6.2	)%
Hilton Boston Downtown	Boston, Massachusetts	403	88.2	%	296.75	261.71	5.5	%
Vail Marriott Mountain Resort & Spa	Vail, Colorado	344	57.5	%	293.49	168.77	(14.0	)%
Marriott Atlanta Alpharetta	Atlanta, Georgia	318	69.5	%	170.35	118.37	(6.0	)%
Courtyard Manhattan/Midtown East	New York, New York	321	94.5	%	261.95	247.46	4.6	%
The Gwen Chicago	Chicago, Illinois	311	82.6	%	255.00	210.53	23.5	%
Hilton Garden Inn New York City/Times Square Central	New York, New York	282	98.0	%	260.20	254.88	6.8	%
Bethesda Marriott Suites	Bethesda, Maryland	272	67.7	%	177.23	119.90	(5.7	)%
Hilton Burlington	Burlington, Vermont	258	81.4	%	187.81	152.89	6.3	%
Hotel Palomar Phoenix (3)	Phoenix, Arizona	242	77.8	%	181.69	141.30	2.8	%
JW Marriott Denver at Cherry Creek	Denver, Colorado	196	81.5	%	247.17	201.39	(4.9	)%
Courtyard Manhattan/Fifth Avenue	New York, New York	189	91.4	%	273.47	249.93	6.0	%
Sheraton Suites Key West	Key West, Florida	184	84.9	%	250.68	212.87	(2.8	)%
The Lodge at Sonoma, a Renaissance Resort & Spa	Sonoma, California	182	71.6	%	304.70	218.02	7.6	%
Courtyard Denver Downtown	Denver, Colorado	177	82.9	%	192.38	159.40	(3.5	)%
Renaissance Charleston	Charleston, South Carolina	166	84.1	%	254.60	213.99	7.1	%
Shorebreak Hotel	Huntington Beach, California	157	76.6	%	256.29	196.30	8.8	%
Cavallo Point, The Lodge at the Golden Gate (4)	Sausalito, California	142	57.6	%	450.98	259.85	0.3	%
Havana Cabana Key West (5)	Key West, Florida	106	73.5	%	185.25	136.07	(15.9	)%
Hotel Emblem (6)	San Francisco, California	94	81.6	%	204.17	166.70	(6.6	)%
L'Auberge de Sedona	Sedona, Arizona	88	76.0	%	602.63	457.86	10.0	%
The Landing Resort & Spa (3)	South Lake Tahoe, California	77	61.6	%	319.11	196.47	1.1	%
Orchards Inn Sedona	Sedona, Arizona	70	75.5	%	256.70	193.87	6.0	%
Total/Weighted Average		9,589	79.1	%	$234.04	$ 185.13	0.0	%

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(1)

Frenchman's Reef was closed on September 6, 2017 due to Hurricane Irma and remains closed. Accordingly, there is no operating information for the year ended December 31, 2018.

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

(3) The operating statistics reflect our ownership period from March 1, 2018 to December 31, 2018.

(4) The operating statistics reflect our ownership period from December 10, 2018 to December 31, 2018.

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

(6) The hotel closed on September 4, 2018 for a comprehensive renovation. Accordingly, the operating information presented only includes operations through the closure date.

Comparison of the Year Ended December 31, 2018 to the Year Ended December 31, 2017

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

	Year Ended December 31,		
	2018	2017	% Change
Rooms	$631.0	$635.9	(0.8)%
Food and beverage	184.1	183.1	0.5
Other	48.6	51.0	(4.7)
Total revenues	$863.7	$870.0	(0.7)%

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Our total revenues decreased $6.3 million from $870.0 million for the year ended December 31, 2017 to $863.7 million for the year ended December 31, 2018. The decrease includes amounts that are not comparable year-over-year as follows:

- $50.1 million decrease from Frenchman's Reef, which was closed on September 6, 2017 due to Hurricane Irma and remained closed through the end of 2018.
- $0.6 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.
- $2.2 million decrease from Hotel Emblem, which closed beginning September 4, 2018 for renovations.
- $8.4 million increase from The Landing Resort & Spa, which was acquired on March 1, 2018.
- $18.4 million increase from the Hotel Palomar Phoenix, which was acquired on March 1, 2018.
- $2.4 million increase from Cavallo Point, which was acquired on December 12, 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.

Excluding these non-comparable amounts our total revenues increased $13.2 million, or 1.6%.

The following are key hotel operating statistics for the years ended December 31, 2018 and 2017. The 2017 amounts reflect the period in 2017 comparable to our ownership period in 2018 for the The Landing Resort & Spa, Hotel Palomar Phoenix, Cavallo Point, 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 Emblem beginning September 4, 2017, due to the renovation closure on September 4, 2018.

	Year Ended December 31,		
	2018	2017	% Change
Occupancy %	79.1 %	80.1 %	(1.0) percentage points
ADR	$234.40	$228.71	2.5 %
RevPAR	$185.51	$183.18	1.3 %

Excluding non-comparable amounts, our rooms revenues increased $8.2 million, or 1.4%.

Food and beverage revenues increased $1.0 million from the year ended December 31, 2017, which includes amounts that are not comparable year-over-year 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 2018.
- $0.2 million decrease from Hotel Emblem, which closed beginning September 4, 2018 for renovations.
- $0.2 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.
- $2.8 million increase from The Landing Resort & Spa, which was acquired on March 1, 2018.
- $7.2 million increase from the Hotel Palomar Phoenix, which was acquired on March 1, 2018.
- $0.8 million increase from Cavallo Point, which was acquired on December 12, 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 $3.0 million, or 1.8%, 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 $2.0 million, or 4.6%, 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 (in millions):

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	Year Ended December 31,		
	2018	2017	% Change
Rooms departmental expenses	$158.1	$158.5	(0.3)%
Food and beverage departmental expenses	118.7	120.5	(1.5)
Other departmental expenses	10.4	11.5	(9.6)
General and administrative	75.4	74.7	0.9
Utilities	20.7	23.4	(11.5)
Repairs and maintenance	32.4	34.5	(6.1)
Sales and marketing	61.1	59.1	3.4
Franchise fees	26.1	24.0	8.8
Base management fees	16.4	15.7	4.5
Incentive management fees	5.8	6.3	(7.9)
Property taxes	55.5	51.9	6.9
Other fixed charges	18.5	12.9	43.4
Severance costs	10.9	—	100.0
Ground rent—Contractual	4.7	4.1	14.6
Ground rent—Non-cash	7.0	6.1	14.8
Total hotel operating expenses	$621.7	$603.2	3.1 %

Our hotel operating expenses increased $18.5 million from $603.2 million for the year ended December 31, 2017 to $621.7 million for the year ended December 31, 2018. The increase in hotel operating expenses includes amounts that are not comparable year-over-year as follows:

- $37.3 million decrease from Frenchman's Reef, which was closed on September 6, 2017 due to Hurricane Irma and remained closed through the end of 2018.
- $0.7 million decrease from Hotel Emblem, which closed beginning September 4, 2018 for renovations.
- $1.2 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.
- $6.9 million increase from The Landing Resort & Spa, which was acquired on March 1, 2018.
- $13.7 million increase from the Hotel Palomar Phoenix, which was acquired on March 1, 2018.
- $1.6 million increase from Cavallo Point, which was acquired on December 12, 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.

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 year ended December 31, 2018. This amortization reduced base management fees and is included within the non-comparable decrease of hotel operating expenses. For the year ended December 31, 2017, we recognized $2.6 million of accelerated amortization of key money in connection with the termination of the hotel manager of Frenchman's Reef from the date of our notice of termination in 2017, which is included within the non-comparable decrease of hotel operating expenses. Additionally, 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 year ended December 31, 2017. This amortization reduced base management fees during the year ended December 31, 2017. In total, this accelerated amortization reduced base management fees by $4.5 million during the year ended December 31, 2017.

For the year ended December 31, 2018, we incurred $10.9 million of severance costs related to payments made to unionized employees under a voluntary buyout program 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 $16.7 million, or 2.9%, from the year ended December 31, 2017.

Depreciation and amortization. Our depreciation and amortization expense increased $5.4 million from the year ended December 31, 2017. The increase is primarily due to depreciation from our 2018 hotel acquisitions and on capital expenditures from our recent hotel renovations.

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Impairment losses. During the year ended December 31, 2017, we recorded impairment losses of $3.2 million. The loss is comprised of $1.8 million from the write-off of construction in progress that was determined not to be recoverable, $0.9 million from the write-off of property and equipment disposed at our hotels impacted by the hurricanes during September 2017 that is not expected to be recovered by insurance proceeds, and $0.5 million on a rent receivable asset related to a tenant lease at the Lexington Hotel New York. We did not recognize any impairment losses during the year ended December 31, 2018.

Hotel acquisition costs. All three of our 2018 hotel acquisitions are accounted for as acquisitions of assets. Accordingly, 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 on January 1, 2018. We incurred $2.0 million of hotel acquisition costs during the year ended December 31, 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 and restricted stock. Corporate expenses also include corporate operating costs, professional fees and directors' fees. Our corporate expenses increased $1.9 million, from $26.7 million for the year ended December 31, 2017 to $28.6 million for the year ended December 31, 2018. The increase is primarily 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 year ended December 31, 2018, we recognized $19.4 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 consolidated statement of operations. For the year ended December 31, 2017, we recognized $4.1 million of business interruption insurance income, which is in addition to $7.3 million of expense reimbursements from insurance recorded within other hotel expenses on our accompanying 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 $41.0 million and $38.5 million for the years ended December 31, 2018 and December 31, 2017, respectively, and is comprised of the following (in millions):

	Year Ended December 31,	
	2018	2017
Mortgage debt interest	$27.1	$29.3
Term loan interest	10.6	6.2
Credit facility interest and unused fees	1.2	1.0
Amortization of deferred financing costs	2.1	2.0
	$41.0	$38.5

The increase in interest expense is primarily related to the $200 million unsecured term loan entered into in April 2017, the $50 million unsecured term loan entered into in October 2018, which we drew down in full in December 2018, and higher interest rates on our term loans compared with 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.

Loss on early extinguishment of debt. We prepaid the $170.4 million mortgage loan previously secured by the Lexington Hotel New York on April 26, 2017 and recognized a loss on early extinguishment of debt of approximately $0.3 million.

Income taxes. We recorded income tax expense of $3.1 million in 2018 and $10.2 million in 2017. The 2018 income tax expense includes $2.6 million of income tax expense incurred on the $7.9 million pre-tax income of our domestic TRSs, foreign income tax expense of less than $0.1 million incurred on the $14.0 million pre-tax income of the TRS that owns Frenchman's Reef, and $0.5 million of corporate state income tax. The 2017 income tax expense includes $8.7 million of income tax expense incurred on the $26.9 million pre-tax income of our domestic TRSs and foreign income tax expense of $1.5 million incurred on the $11.4 million pre-tax income of the TRS that owns Frenchman's Reef. The 2017 income tax provision included a benefit of $4.2 million due to a remeasurement of our net deferred tax liabilities as of December 31, 2017 as a result of the TCJA, which

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lowered the corporate tax rates from a maximum of 35% to a flat rate of 21% effective for tax years beginning after December 31, 2017.

Comparison of the Year Ended December 31, 2017 to the Year Ended December 31, 2016

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

	Year Ended December 31,		
	2017	2016	% Change
Rooms	$635.9	$650.6	(2.3)%
Food and beverage	183.1	194.8	(6.0)
Other	51.0	51.2	(0.4)
Total revenues	$870.0	$896.6	(3.0)%

Our total revenues decreased $26.6 million from $896.6 million for the year ended December 31, 2016 to $870.0 million for the year ended December 31, 2017. Our total revenues include amounts that are not comparable year-over-year due to acquisitions and dispositions as follows:

•$14.1 million decrease from the Orlando Airport Marriott, which was sold on June 8, 2016.
•$24.8 million decrease from the Minneapolis Hilton, which was sold on June 30, 2016.
•$6.4 million decrease from the Hilton Garden Inn Chelsea/New York City, which was sold on July 7, 2016.
•$21.8 million increase from the L'Auberge de Sedona, which was acquired on February 28, 2017.
•$7.5 million increase from the Orchards Inn Sedona, which was acquired on February 28, 2017.

Additionally, the year-over year change in total revenues includes a decrease of $18.6 million that is not comparable due to the closure of Frenchman's Reef and the Havana Cabana Key West. Both hotels closed on September 6, 2017 due to Hurricane Irma and remain closed through the end of 2017.

Excluding these non-comparable amounts our total revenues increased $8.0 million, or 1.0%.

The following are key hotel operating statistics for the years ended December 31, 2017 and 2016. The 2016 amounts reflect the period in 2016 comparable to our ownership period in 2017 for the L'Auberge de Sedona and Orchards Inn Sedona and exclude the hotels sold in 2016. The 2016 amounts also exclude the results from Frenchman's Reef and the Havana Cabana Key West for the period in 2016 comparable to the hotels' closure beginning September 6, 2017 through the end of 2017.

	Year Ended December 31,		
	2017	2016	% Change
Occupancy %	80.6 %	79.8 %	0.8 percentage points
ADR	$230.61	$227.46	1.4 %
RevPAR	$185.93	$181.58	2.4 %

Excluding non-comparable amounts, our rooms revenues increased $10.4 million, or 1.7%.

Food and beverage revenues decreased $11.7 million from the year ended December 31, 2016, which includes amounts that are not comparable year-over-year due to acquisitions and dispositions as follows:

•$4.7 million decrease from the Orlando Airport Marriott, which was sold on June 8, 2016.
•$9.1 million decrease from the Minneapolis Hilton, which was sold on June 30, 2016.
•$0.1 million decrease from the Hilton Garden Inn Chelsea/New York City, which was sold on July 7, 2016.
•$7.0 million increase from the L'Auberge de Sedona, which was acquired on February 28, 2017.
•$3.3 million increase from the Orchards Inn Sedona, which was acquired on February 28, 2017.

Additionally, the year-over year change in food and beverage revenues includes a decrease of $5.0 million that are not comparable due to the closure of Frenchman's Reef and the Havana Cabana Key West. Both hotels closed on September 6, 2017 due to Hurricane Irma and remained closed through the end of 2017.

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Excluding these non-comparable amounts, food and beverage revenues decreased $3.1 million, or 1.8%. The decrease in food and beverage revenues is primarily a result of a decrease in banquets.

Excluding non-comparable amounts, other revenues, which primarily represent spa, parking, resort fees and attrition and cancellation fees, increased by $0.7 million.

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

	Year Ended December 31,		
	2017	2016	% Change
Rooms departmental expenses	$158.5	$159.2	(0.4)%
Food and beverage departmental expenses	120.5	125.9	(4.3)
Other departmental expenses	11.5	11.4	0.9
General and administrative	74.7	76.5	(2.4)
Utilities	23.4	25.9	(9.7)
Repairs and maintenance	34.5	35.6	(3.1)
Sales and marketing	59.1	62.0	(4.7)
Franchise fees	24.0	21.8	10.1
Base management fees	15.7	22.3	(29.6)
Incentive management fees	6.3	7.8	(19.2)
Property taxes	51.9	46.4	11.9
Other fixed charges	12.9	10.6	21.7
Ground rent—Contractual	4.1	6.9	(40.6)
Ground rent—Non-cash	6.1	5.7	7.0
Total hotel operating expenses	$603.2	$618.0	(2.4)%

Our hotel operating expenses decreased $14.8 million from $618.0 million for the year ended December 31, 2016 to $603.2 million for the year ended December 31, 2017. The decrease in hotel operating expenses includes amounts that are not comparable year-over-year due to acquisitions and dispositions as follows:

•$9.1 million decrease from the Orlando Airport Marriott, which was sold on June 8, 2016.
•$19.4 million decrease from the Minneapolis Hilton, which was sold on June 30, 2016.
•$4.8 million decrease from the Hilton Garden Inn Chelsea/New York City, which was sold on July 7, 2016.
•$15.8 million increase from the L'Auberge de Sedona, which was acquired on February 28, 2017.
•$4.9 million increase from the Orchards Inn Sedona, which was acquired on February 28, 2017.

Additionally, the year-over year change in hotel operating expenses include a decrease of $12.0 million of net hotel operating expenses that are not comparable due to the closure of Frenchman's Reef and the Havana Cabana Key West. Both hotels closed on September 6, 2017 due to Hurricane Irma and remained closed through the end of 2017.

Excluding the non-comparable amounts, hotel operating expenses increased $11.1 million, or 2.9%, from the year ended December 31, 2016.

In connection with the change in hotel manager of the Courtyard Manhattan/Midtown East, we recognized $1.9 million of accelerated amortization of key money during the year ended December 31, 2017. In connection with the termination of the hotel manager of Frenchman's Reef, we accelerated the amortization of key money from the date of

our notice of termination in 2017 through the effective termination date of February 20, 2018. We recognized an additional $2.6 million of amortization of key money during the year ended December 31, 2017 in connection with this acceleration. In total, this accelerated amortization reduced base management fees by $4.5 million during the year ended December 31, 2017.

Other fixed charges increased $2.3 million, or 21.7%, from the year ended December 31, 2016, primarily due to hurricane-related costs that are not recoverable through insurance.

Depreciation and amortization. Our depreciation and amortization expense increased $1.6 million from the year ended December 31, 2016. The increase is primarily due to depreciation from our 2017 hotel acquisitions and on capital expenditures from our recent hotel renovations, partially offset by our 2016 hotel dispositions.

Impairment losses. During the year ended December 31, 2017, we recorded impairment losses of $3.2 million. The loss is comprised of $1.8 million from the write-off of construction in progress that was determined not to be recoverable, $0.9 million from the write-off of property and equipment disposed at our hotels impacted by the hurricanes during September 2017 that is not expected to be recovered by insurance proceeds, and $0.5 million on a rent receivable asset related to a tenant lease at the Lexington Hotel New York. We did not recognize any impairment losses during the year ended December 31, 2016.

Hotel acquisition costs. We recorded $2.0 million of hotel acquisition costs during the year ended December 31, 2017, which is comprised of $2.2 million of costs incurred from the acquisitions of L'Auberge de Sedona and Orchards Inn Sedona, offset by a refund of $0.2 million of transfer taxes related to the acquisition of the Hotel Emblem. We had no hotel acquisitions during the year ended December 31, 2016.

Corporate expenses. Corporate expenses principally consist of employee-related costs, including base payroll, bonus and restricted stock. Corporate expenses also include corporate operating costs, professional fees and directors' fees. Our corporate expenses increased $3.1 million, from $23.6 million for the year ended December 31, 2016 to $26.7 million for the year ended December 31, 2017. The increase is primarily due to higher employee-related costs in 2017 and the reversal of $0.7 million in 2016 of previously recognized compensation expense resulting from the forfeiture of equity awards related to the resignation of our former Executive Vice President and Chief Operating Officer.

Business interruption insurance income. In September 2017, Hurricanes Irma and Maria caused significant damage to Frenchman's Reef and the Havana Cabana Key West. These natural disasters resulted in lost revenue and additional expenses covered under our insurance policy. For the year ended December 31, 2017, we recognized $4.1 million of business interruption insurance income, which is in addition to $7.3 million of expense reimbursements from insurance recorded within other hotel expenses on our accompanying consolidated statement of operations.

Interest expense. Our interest expense was $38.5 million and $41.7 million for the years ended December 31, 2017 and December 31, 2016, respectively, and is comprised of the following (in millions):

	Year Ended December 31,	
	2017	2016
Mortgage debt interest	$29.3	$36.8
Term loan interest	6.2	1.3
Credit facility interest and unused fees	1.0	1.3
Amortization of deferred financing costs	2.0	2.3
	$38.5	$41.7

The decrease in mortgage debt interest expense is primarily related to the repayment of the mortgage loans secured by the the Courtyard Manhattan Fifth Avenue and the Lexington Hotel. The decrease is also attributed to the sale of the Hilton Minneapolis on June 30, 2016. The decrease in interest expense is partially offset by the increase in interest expense on our two unsecured term loans, entered into in May 2016 and April 2017.

Loss on early extinguishment of debt. We prepaid the $170.4 million mortgage loan previously secured by the Lexington Hotel New York on April 26, 2017 and recognized a loss on early extinguishment of debt of approximately $0.3 million.

Income taxes. We recorded income tax expense of $10.2 million in 2017 and $12.4 million in 2016. The 2017 income tax expense includes $8.7 million of income tax expense incurred on the $26.9 million pre-tax income of our domestic TRSs and foreign income tax expense of $1.5 million incurred on the $11.4 million pre-tax income of the TRS that owns Frenchman's Reef. The 2016 income tax expense includes $12.4 million of income tax expense incurred on the $29.4 million pre-tax income of our TRS. There was no foreign income tax expense incurred on the TRS that owns Frenchman's Reef. The 2017 income tax provision included a benefit of $4.2 million due to a remeasurement of our net deferred tax liabilities as of December 31, 2017 as a result of the TCJA, which lowered the corporate tax rates from a maximum of 35% to a flat rate of 21% effective for tax years beginning after December 31, 2017.

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.

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 OP 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 OP 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.

ATM Program

We have equity distribution agreements, dated August 8, 2018, with a number of sales agents (the “Current ATM Program") 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”). 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 year ended December 31, 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.
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 prudent to reduce the inherent risk of highly cyclical lodging fundamentals through a low leverage 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 generally structure our hotel acquisitions to be straightforward and to fit within our capital structure; however, we will consider a more complex transaction, such as the issuance of OP units in connection with the acquisition of Cavallo Point, 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 December 31, 2018, we had $978.0 million of debt outstanding with a weighted average interest rate of 4.01% and a weighted average maturity date of approximately 5.5 years. We maintain one of the lowest levered balance sheets among our lodging REIT peers. We maintain balance sheet flexibility with limited near-term debt maturities, capacity under our senior unsecured credit facility and 23 of our 31 hotels unencumbered by mortgage debt. We remain committed to our core strategy of prudent leverage.

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

Share Repurchase Program

Our board of directors has approved a 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 consolidated financial statements.

During the year ended December 31, 2018, we repurchased 3,384,359 shares of our common stock at an average price of $9.49 per share for a total purchase price of $32.2 million. Subsequent to December 31, 2018, we repurchased 3,143,922 shares of our common stock at an average price of $9.52 per share for a total purchase price of $30.0 million. We retired all repurchased shares on their respective settlement dates. As of February 26, 2019, we have $188.0 million of authorized capacity remaining under our share repurchase program.

Short-Term Borrowings

Other than borrowings under our senior unsecured credit facility, 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. Information about our senior unsecured credit facility is found in Note 8 to the accompanying consolidated financial statements. As of December 31, 2018, we had no outstanding borrowings on our senior unsecured credit facility.

Senior Unsecured Term Loans

We are party to a $100 million unsecured term loan expiring in May 2021, a $200 million unsecured term loan expiring in April 2022, and a $50 million unsecured term loan expiring in October 2023. Information about our senior unsecured term loans is found in Note 8 to the accompanying consolidated financial statements.

Sources and Uses of Cash

Our principal sources of cash are net cash flow from hotel operations, sales of common stock, borrowings under mortgage debt, term loans, our senior unsecured credit facility, proceeds from hotel dispositions, and proceeds from insurance claims. Our principal uses of cash are acquisitions of hotel properties, debt service and maturities, share repurchases, capital expenditures, operating costs, corporate expenses, natural disaster remediation and repair costs and dividends. As of December 31, 2018, we had $43.9 million of unrestricted corporate cash and $47.7 million of restricted cash, and no outstanding borrowings on our senior unsecured credit facility.

Our net cash provided by operations was $219.3 million for the year ended December 31, 2018. Our cash from operations generally consists of the net cash flow from hotel operations offset by cash paid for corporate expenses and other working capital changes.

Our net cash used in investing activities was $344.3 million for the year ended December 31, 2018, which consisted of $259.9 million paid for the acquisitions of The Landing Resort & Spa, Hotel Palomar Phoenix and Cavallo Point, and capital expenditures at our hotels of $115.2 million, offset by $30.7 million of proceeds from our property insurance policy related to our hotels impacted by Hurricanes Irma and Maria.

Our net cash used in financing activities was $7.2 million for the year ended December 31, 2018, which consisted of $102.7 million of dividend payments, $33.1 million paid to repurchase shares under our share repurchase program and upon the vesting of restricted stock for the payment of tax withholding obligations, $0.4 million of financing costs related to our unsecured term loan, and $13.6 million of scheduled mortgage debt principal payments, partially offset by $50.0 million of proceeds from our new unsecured term loan, and $92.7 million in net proceeds from our Prior ATM Program.

We currently anticipate our significant sources of cash for the year ending December 31, 2019 will be the net cash flow from hotel operations, insurance claims, and potential property dispositions. We expect our estimated uses of cash for the year ending

December 31, 2019 will be regularly scheduled debt service payments, capital expenditures, dividends, corporate expenses, potential hotel acquisitions, and share repurchases.

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 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.

The following table sets forth the dividends on our common shares for the years ended December 31, 2018 and 2017, and through the date of this report:

Payment Date	Record Date	Dividend per Share
April 12, 2017	March 31, 2017	$0.125
July 12, 2017	June 30, 2017	$0.125
October 12, 2017	September 29, 2017	$0.125
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
January 14, 2019	January 4, 2019	$0.125

Capital Expenditures

The management and franchise agreements for each of our hotels provide for the establishment of separate property improvement reserves 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 reserves under the applicable management or franchise agreement. As of December 31, 2018, we have set aside $43.1 million for capital projects in property improvement funds, which are included in restricted cash.

We spent approximately $115.2 million on capital improvements during the year ended December 31, 2018, which included the following significant projects:

- Chicago Marriott Downtown: We substantially completed the hotel's $110 million multi-year renovation, which included the remaining 258 of 1,200 guest rooms and the hotel's 60,000 square feet of meeting space.
- Havana Cabana Key West: We completed a comprehensive renovation of the hotel as part of the remediation of the substantial wind and water-related damage caused by Hurricane Irma. The hotel reopened as the Havana Cabana Key West in April 2018.
- Bethesda Marriott Suites: We completed a renovation of the guest rooms at the hotel during the first quarter.
- Westin Boston Waterfront Hotel: We completed a refresh of the hotel's guest rooms during the first quarter.
- Vail Marriott Mountain Resort & Spa: We completed a renovation of the hotel's guest rooms and meeting space during the third quarter.

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- Westin Fort Lauderdale Beach Resort: We completed a renovation of the hotel's guest rooms in the third quarter.
- Hotel Emblem: We substantially completed a comprehensive renovation and re-positioning of the former Hotel Rex as the Hotel Emblem San Francisco, part of Viceroy's Urban Retreats Collection, in the fourth quarter. The hotel closed for approximately four months during renovation and reopened in January 2019.

We expect to spend approximately $125 million on capital improvements at our hotels in 2019, which includes carryover from certain projects that commenced in 2018. Significant projects in 2019 include the following:

- JW Marriott Denver: We commenced a renovation of the hotel's guest rooms and meeting space in January 2019 and will renovate the public space later in 2019. The renovation is expected to secure the hotel's position as the top luxury hotel in the high-end Cherry Creek submarket of Denver.
- Sheraton Suites Key West: We expect to complete a comprehensive renovation of the hotel, which will include upgrades to the resort’s entrance, lobby, restaurant, outdoor lounge, pool area and guestrooms. In order to minimize disruption, the renovation is expected to occur from August to November, the hotel’s slowest period of the year.
- The Lodge at Sonoma: We expect to enhance the cottage rooms and landscaping to better align the hotel with the luxury competition in the market, reposition the restaurant with a new concept from world-renowned chef, Michael Mina, and enhance the spa to a luxury level. We are also evaluating a brand change for the hotel.
- Vail Marriott: We expect to complete the second phase of the hotel renovation, which includes the upgrade renovation of the spa and fitness center. The scope of this project is consistent with our multi-phased strategy to renovate the hotel to a luxury standard.
- Worthington Renaissance: We expect to renovate the the lobby and reposition the food and beverage outlets during the third quarter of 2019.

Contractual Obligations

The following table outlines the timing of payment requirements related to our debt and other commitments of our operating partnership as of December 31, 2018.

	Payments Due by Period				
	Total	Less Than 1 Year	1 to 3 Years	3 to 5 Years	After 5 Years
	(In thousands)				
Long-Term Debt Obligations Including Interest (1)	$1,166,956	$55,051	$255,827	$454,536	$401,542
Operating Lease Obligations - Ground Leases and Office Space	663,219	5,232	10,998	10,219	636,770
Purchase Commitments (2)					
Purchase Orders and Letters of Commitment	56,078	56,078	—	—	—
Total	$1,886,253	$116,361	$266,825	$464,755	$1,038,312

(1) The interest expense for our variable rate loans is calculated based on the rate as of December 31, 2018.
(2) As of December 31, 2018, purchase orders and letters of commitment totaling approximately $56.1 million had been issued for renovations at our properties. We have committed to these projects and anticipate making similar arrangements in the future with our existing properties or any future properties that we may acquire.

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, 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 measures 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 real estate related 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 related 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:

- 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.

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- 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: The Financial Accounting Standards Board promulgates new accounting standards that require or permit 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 derivative 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):

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	Year Ended December 31,		
	2018	2017	2016
	(in thousands)		
Net income	$87,796	$91,877	$114,796
Interest expense	40,970	38,481	41,735
Income tax expense	3,101	10,207	12,399
Real estate related depreciation and amortization	104,524	99,090	97,444
EBITDA	236,391	239,655	266,374
Impairment losses	—	3,209	—
Loss (gain) on sale of hotel properties (1)	—	764	(10,698)
EBITDAre	236,391	243,628	255,676
Non-cash ground rent	7,305	6,290	5,671
Non-cash amortization of favorable and unfavorable contracts, net	(1,969)	(1,912)	(1,912)
Hurricane-related costs (2)	3,855	3,280	—
Loss on early extinguishment of debt	—	274	—
Hotel acquisition costs	—	2,028	—
Hotel manager transition and pre-opening items (3)	(1,491)	(3,637)	—
Severance costs (4)	11,691	—	(563)
Gain on property insurance settlement	(1,724)	—	—
Adjusted EBITDA	$254,058	$249,951	$258,872

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(1) During the year ended December 31, 2017, we recognized an incremental pre-tax loss of $0.8 million due to a post-closing adjustment for hotel expenses incurred under our ownership period related to 2016 dispositions.

(2) Represents stabilization, cleanup, and other costs (such as hotel labor) incurred at our hotels impacted by Hurricanes Irma or Maria that are not expected to be recovered by insurance.

(3) For the year ended December 31, 2018 consists of (a) manager transition costs of $0.1 million related to the Hotel Emblem, L'Auberge de Sedona and Orchards Inn Sedona and (b) pre-opening costs of $0.6 million related to the reopening of the Havana Cabana Key West and Hotel Emblem, offset by $2.2 million of accelerated amortization of key money in connection with the termination of the Frenchman's Reef management agreement. For the year ended December 31, 2017, includes items related to the hotel manager changes as follows: Courtyard Manhattan Midtown East: (a) employee severance costs of approximately $0.3 million, (b) transition costs of approximately $0.1 million offset by (c) $1.9 million of accelerated amortization of key money received from Marriott; transition costs of approximately $0.4 million related to the Hotel Emblem, L'Auberge de Sedona and Orchards Inn Sedona; offset by $2.6 million of accelerated amortization of key money received from Marriott for Frenchman's Reef.

(4) For the year ended December 31, 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 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 consolidated statement of operations. During the year ended December 31, 2016, we reversed $0.6 million of previously recognized compensation expense for forfeited equity awards related to the resignation of our former Executive Vice President and Chief Operating Officer. Amounts recognized in 2016 are classified as corporate expenses on the consolidated statements of operations.

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

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	Year Ended December 31,		
	2018	2017	2016
	(in thousands)		
Net income	$87,796	$91,877	$114,796
Real estate related depreciation and amortization	104,524	99,090	97,444
Impairment losses	—	3,209	—
Loss (gain) on sale of hotel properties, net of income tax (1)	—	458	(9,118)
FFO	192,320	194,634	203,122
Non-cash ground rent	7,305	6,290	5,671
Non-cash amortization of favorable and unfavorable contracts, net	(1,969)	(1,912)	(1,912)
Hurricane-related costs (2)	3,855	3,280	—
Loss on early extinguishment of debt	—	274	—
Hotel acquisition costs	—	2,028	—
Hotel manager transition and pre-opening items (3)	(1,491)	(3,637)	—
Severance costs (4)	11,691	—	(563)
Gain on property insurance settlement	(1,724)	—	—
Fair value adjustments to debt instruments	—	—	19
Adjusted FFO	$209,987	$200,957	$206,337

(1) During the year ended December 31, 2017, we recognized an incremental loss, net of tax, of $0.5 million due to a post-closing adjustment for hotel expenses incurred under our ownership period related to 2016 dispositions.

(2) Represents stabilization, cleanup, and other costs (such as hotel labor) incurred at our hotels impacted by Hurricanes Irma or Maria that are not expected to be recovered by insurance.

(3) For the year ended December 31, 2018 consists of (a) manager transition costs of $0.1 million related to the Hotel Emblem, L'Auberge de Sedona and Orchards Inn Sedona and (b) pre-opening costs of $0.6 million related to the reopening of the Havana Cabana Key West and Hotel Emblem, offset by $2.2 million of accelerated amortization of key money in connection with the termination of the Frenchman's Reef management agreement. For the year ended December 31, 2017, includes items related to the hotel manager changes as follows: Courtyard Manhattan Midtown East: (a) employee severance costs of approximately $0.3 million, (b) transition costs of approximately $0.1 million offset by (c) $1.9 million of accelerated amortization of key money received from Marriott; transition costs of approximately $0.4 million related to the Hotel Emblem, L'Auberge de Sedona and Orchards Inn Sedona; offset by $2.6 million of accelerated amortization of key money received from Marriott for Frenchman's Reef.

(4) For the year ended December 31, 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 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 consolidated statement of operations. During the year ended December 31, 2016, we reversed $0.6 million of previously recognized compensation expense for forfeited equity awards related to the resignation of our former Executive Vice President and Chief Operating Officer. Amounts recognized in 2016 are classified as corporate expenses on the consolidated statements of operations.

Critical Accounting Policies

Our consolidated financial statements include the accounts of DiamondRock Hospitality Company and all consolidated subsidiaries. The preparation of financial statements in conformity with U.S. GAAP 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 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 materially from these estimates. We evaluate our estimates and judgments, including those related to the impairment of long-lived assets, on an ongoing basis. We base our estimates on experience and on various assumptions that are believed to be reasonable under the circumstances. All of our significant accounting policies are disclosed in the notes to our consolidated financial statements. The following represent certain critical accounting policies that require us to exercise our business judgment or make significant estimates:

Investment in Hotels. Acquired hotels, land improvements, building and furniture, fixtures and equipment and identifiable intangible assets that are generally accounted for as asset acquisitions are recorded at total cost and allocated based on relative fair value. 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 useful life of 15 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.

Seasonality

The periods during which our hotels experience higher revenues vary from property to property, depending principally upon location and the customer base served. Accordingly, we expect some seasonality in our business. Volatility in our financial performance from the seasonality of the lodging industry could adversely affect our financial condition and results of operations.

New Accounting Pronouncements Not Yet Implemented

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

Item 7A. 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 December 31, 2018 was $983.8 million of which $350 million was variable rate. If market rates of interest on our variable rate debt fluctuate by 100 basis points, interest expense would increase or decrease, depending on rate movement, future earnings and cash flows, by approximately $3.5 million annually.

Item 8. Financial Statements and Supplementary Data

See Index to the Financial Statements on page F-1.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

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Item 9A. Controls and Procedures

Evaluation of Disclosure 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 (i) is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (ii) is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding disclosure.

Changes in Internal Control over Financial Reporting

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.

Management Report on Internal Control over Financial Reporting

The report of our management regarding internal control over financial reporting is set forth on page F-2 of this Annual Report on Form 10-K under the caption "Management Report on Internal Control over Financial Reporting" and incorporated herein by reference.

Attestation Report of Independent Registered Public Accounting Firm

The report of our independent registered public accounting firm regarding our internal control over financial reporting is set forth on page F-3 of this Annual Report on Form 10-K under the caption "Report of Independent Registered Public Accounting Firm" and incorporated herein by reference.

Item 9B. Other Information

None.

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PART III

The information required by Items 10-14 is incorporated by reference to our proxy statement for the 2019 annual meeting of stockholders (to be filed with the SEC not later than 120 days after the end of the fiscal year covered by this report) ("2019 proxy statement").

Item 10. Directors, Executive Officers and Corporate Governance

Information required by this item is incorporated by reference to our 2019 proxy statement.

Item 11. Executive Compensation

The information required by this item is incorporated by reference to our 2019 proxy statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this item is incorporated by reference to our 2019 proxy statement. Information regarding our equity plans set forth in Item 5 of this Annual Report on Form 10-K is incorporated by reference into this Item 12.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information required by this item is incorporated by reference to our 2019 proxy statement.

Item 14. Principal Accounting Fees and Services

The information required by this item is incorporated by reference to our 2019 proxy statement.

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PART IV

Item 15. Exhibits and Financial Statement Schedules

1. Financial Statements

Included herein at pages F-1 through F-33.

2. Financial Statement Schedules

The following financial statement schedule is included herein on pages F-34 and F-35:

Schedule III - Real Estate and Accumulated Depreciation

All other schedules for which provision is made in Regulation S-X are either not required to be included herein under the related instructions or are inapplicable or the related information is included in the footnotes to the applicable financial statement and, therefore, have been omitted.

3. Exhibits

The following exhibits are included in this Annual Report on Form 10-K for the fiscal year ended December 31, 2018 (and are numbered in accordance with Item 601 of Regulation S-K):

Exhibit Number	Description of Exhibit
3.1.1	Articles of Amendment and Restatement of the Articles of Incorporation of DiamondRock Hospitality Company (incorporated by reference to the Registrant's Registration Statement on Form S-11 filed with the Securities and Exchange Commission on March 1, 2005 (File no. 333-123065))
3.1.2	Amendment to the Articles of Amendment and Restatement of the Articles of Incorporation of DiamondRock Hospitality Company (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on January 10, 2007)
3.1.3	Amendment to the Articles of Amendment and Restatement of the Articles of Incorporation of DiamondRock Hospitality Company (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on July 9, 2012)
3.1.4	Articles Supplementary Prohibiting DiamondRock Hospitality Company From Electing to be Subject to Section 3-803 of the Maryland General Corporation Law Absent Stockholder Approval (incorporated by reference to the Registrant’s Current Report on Form 8-K filed with the Securities and Exchange Commission on February 26, 2014)
3.1.5	Amendment to the Articles of Amendment and Restatement of the Articles of Incorporation of DiamondRock Hospitality Company (incorporated by reference to the Registrant’s Current Report on Form 8-K filed with the Securities and Exchange Commission on May 5, 2016)
3.2.1	Fourth Amended and Restated Bylaws of DiamondRock Hospitality Company (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 5, 2016)
3.2.2	

	First Amendment to the Fourth Amended and Restated Bylaws of DiamondRock Hospitality Company (incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on November 7, 2017)
4.1	Form of Certificate for Common Stock for DiamondRock Hospitality Company (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 5, 2010)
10.1	Amended and Restated Agreement of Limited Partnership of DiamondRock Hospitality Limited Partnership, dated as of August 28, 2018 (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on August 31, 2018)
10.2*	Amended and Restated 2004 Stock Option and Incentive Plan, as amended and restated on April 28, 2010 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 5, 2010)
10.3*	Amendment to DiamondRock Hospitality Company Amended and Restated 2004 Stock Option and Incentive Plan, approved by the Board of Directors on July 20, 2011 (incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on October 19, 2011)

10.4*	DiamondRock Hospitality Company Deferred Compensation Plan (incorporated by reference to the Registrant's Registration Statement on Form S-8 filed with the Securities and Exchange Commission on August 8, 2014)
10.5*	First Amendment to DiamondRock Hospitality Company Deferred Compensation Plan, approved by the Compensation Committee of the Board of Directors on December 15, 2014 (incorporated by reference to the Registrant's Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 27, 2015)
10.6*	Form of Restricted Stock Award Agreement (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 5, 2010)
10.7*	Form of Market Stock Unit Agreement (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on March 9, 2010)
10.8*	Relative TSR Performance Stock Unit Agreement (incorporated by reference to the Registrant's Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 25, 2014)
10.9*	Form of Deferred Stock Unit Award Agreement (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 5, 2010)
10.10*	Form of Director Election Form (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 5, 2010)
10.11*	Form of Incentive Stock Option Agreement (incorporated by reference to the Registrant's Registration Statement on Form S-11 filed with the Securities and Exchange Commission (File no. 333-123065))
10.12*	Form of Non-Qualified Stock Option Agreement (incorporated by reference to the Registrant's Registration Statement on Form S-11 filed with the Securities and Exchange Commission (File no. 333-123065))
10.13	Fourth Amended and Restated Credit Agreement, dated as of May 3, 2016, by and among DiamondRock Hospitality Company, DiamondRock Hospitality Limited Partnership, Wells Fargo Bank, National Association, as Administrative Agent, each of Bank of America, N.A. and Citibank, N.A., as Syndication Agent, U.S. Bank National Association, as Documentation Agent, and each of Wells Fargo Securities, LLC, Merrill Lynch, Pierce Fenner and Smith Incorporated and Citigroup Global Markets, as Joint Lead Arrangers and Joint Lead Bookrunners (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 6, 2016)
10.14	First Amendment to Fourth Amended and Restated Credit Agreement, dated as of April 26, 2017, by and among DiamondRock Hospitality Company, DiamondRock Hospitality Limited Partnership, Wells Fargo Bank National Association, as Administrative Agent, and the lenders party thereto (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 5, 2017)
10.15	Term Loan Agreement, dated as of May 3, 2016, by and among DiamondRock Hospitality Company, DiamondRock Hospitality Limited Partnership, KeyBank National Association, as Administrative Agent, each of Keybanc Capital Markets, PNC Capital Markets LLC and Regions Capital Markets as Joint Lead Arrangers, each of PNC Bank, National Association and Regions Bank as Co-Syndication Agents, and the lenders party thereto (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 6, 2016)
10.16	First Amendment to Term Loan Agreement, dated as of April 26, 2017, by and among DiamondRock Hospitality Company, DiamondRock Hospitality Limited Partnership, KeyBank National Association, as Administrative Agent, and the lenders party thereto (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 5, 2017)
10.17	

	Term Loan Agreement, dated as of April 26, 2017, by and among DiamondRock Hospitality Company, DiamondRock Hospitality Limited Partnership, Regions Bank, as Administrative Agent, each of Regions Capital Markets, KeyBanc Capital Markets, PNC Capital Markets LLC and U.S. Bank National Association as Joint Lead Arrangers, each of KeyBank National Association, PNC Bank, National Association and U.S. Bank National Association, as Co-Syndication Agents, and the lenders party thereto (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 1, 2017)
10.18*	Form of Severance Agreement (and schedule of material differences thereto) (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on April 30, 2012)
10.19*	Form of Stock Appreciation Right (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on March 6, 2008)
10.20*	Form of Dividend Equivalent Right (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on March 6, 2008)
10.21*	Form of Amendment No. 1 to Dividend Equivalent Rights Agreement under the DiamondRock Hospitality Company 2004 Stock Option and Incentive Plan (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 30, 2008)
10.22*	Form of Indemnification Agreement (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 16, 2009)

10.23*	Severance Agreement between DiamondRock Hospitality Company and William J. Tennis, dated as of December 16, 2009 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on April 30, 2012)
10.24*	Letter Agreement, dated as of December 9, 2009, by and between DiamondRock Hospitality Company and William J. Tennis (incorporated by reference to the Registrant's Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 26, 2010)
10.25*	Severance Agreement between DiamondRock Hospitality Company and Troy G. Furbay, dated as of April 9, 2014 (incorporated by reference to the Registrant’s Quarterly Report on From 10-Q filed with the Securities and Exchange Commission on May 12, 2014)
10.26*	Letter Agreement between DiamondRock Hospitality Company and Thomas Healy, dated as of December 21, 2016 (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on January 4, 2017)
10.27*	Severance Agreement between DiamondRock Hospitality Company and Thomas Healy, dated as of January 17, 2017 (incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 5, 2017)
10.28*	DiamondRock Hospitality Company 2016 Equity Incentive Plan, effective as of May 3, 2016 (incorporated by reference to Appendix B to the Registrant's Proxy Statement on Schedule 14A filed with the Securities and Exchange Commission on March 24, 2016)
10.29*	First Amendment to the DiamondRock Hospitality Company 2016 Equity Incentive Plan (incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 26, 2018)
10.30*	Form of Restricted Stock Award Agreement under the 2016 Equity Incentive Plan (incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 5, 2016)
10.31*	Form of Performance Stock Unit Agreement under the 2016 Equity Incentive Plan (incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 5, 2016)
10.32*	Form of Deferred Stock Unit Award Agreement under the 2016 Equity Incentive Plan (incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 5, 2016)
10.33*	Severance Agreement between DiamondRock Hospitality Company and Jay L. Johnson, dated as of March 19, 2018 (incorporated by reference to the Registrant’s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 4, 2018)
10.34*	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)
21.1†	List of DiamondRock Hospitality Company Subsidiaries
23.1†	Consent of KPMG LLP
31.1†	Certification of Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2†	

	Certification of Chief Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1**	Certification of Chief Executive Officer and Chief Financial Officer Required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended.

Attached as Exhibit 101 to this report are the following materials from DiamondRock Hospitality Company's Annual Report on Form 10-K for the year ended December 31, 2018 formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Equity, (iv) the Consolidated Statements of Cash Flows, and (v) the related notes to these consolidated financial statements.

* Exhibit is a management contract or compensatory plan or arrangement.
† Filed herewith
** Furnished herewith

Item 16. Form 10-K Summary

Not applicable.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, in the City of Bethesda, State of Maryland, on February 26, 2019.

DIAMONDROCK HOSPITALITY COMPANY

By: /s/ WILLIAM J. TENNIS
Name: William J. Tennis
Title: Executive Vice President, General Counsel and Corporate Secretary

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ MARK W. BRUGGER Mark W. Brugger	Chief Executive Officer and Director (Principal Executive Officer)	February 26, 2019
/s/ JAY L. JOHNSON Jay L. Johnson	Executive Vice President and Chief Financial Officer (Principal Financial Officer)	February 26, 2019
/s/ BRIONY R. QUINN Briony R. Quinn	Senior Vice President and Treasurer (Principal Accounting Officer)	February 26, 2019
/s/ WILLIAM W. McCARTEN William W. McCarten	Chairman	February 26, 2019
/s/ DANIEL J. ALTOBELLO Daniel J. Altobello	Director	February 26, 2019
/s/ TIMOTHY CHI Timothy Chi	Director	February 26, 2019
/s/ MAUREEN L. McAVEY Maureen L. McAvey	Director	February 26, 2019
/s/ GILBERT T. RAY Gilbert T. Ray	Director	February 26, 2019
/s/ WILLIAM J. SHAW William J. Shaw	Director	February 26, 2019
/s/ BRUCE D. WARDINSKI Bruce D. Wardinski	Director	February 26, 2019
/s/ KATHLEEN WAYTON	Director	February 26, 2019

Kathleen Wayton

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Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Internal control over financial reporting refers to the process designed by, or under the supervision of, our Chief Executive Officer and Chief Financial Officer, and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Management has used the framework set forth in the report entitled Internal Control - Integrated Framework (2013) published by the Committee of Sponsoring Organizations of the Treadway Commission to evaluate the effectiveness of the Company's internal control over financial reporting. Management has concluded that the Company's internal control over financial reporting was effective as of December 31, 2018. KPMG LLP, an independent registered public accounting firm, audited the effectiveness of the Company's internal control over financial reporting as of December 31, 2018, as stated in their report, which appears below.

/s/ Mark W. Brugger
Chief Executive Officer
(Principal Executive Officer)

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

/s/ Briony R. Quinn

Senior Vice President and Treasurer
(Principal Accounting Officer)

February 26, 2019

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Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors
DiamondRock Hospitality Company:

Opinion on Internal Control Over Financial Reporting
We have audited DiamondRock Hospitality Company and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of the Company as of December 31, 2018 and 2017, the related consolidated statements of operations, equity, and cash flows for each of the years in the three-year period ended December 31, 2018, the related notes and financial statement schedule III (collectively, the consolidated financial statements), and our report dated February 26, 2019 expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion
The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB. We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.
Definition and Limitations of Internal Control Over Financial Reporting
A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ KPMG LLP
McLean, Virginia
February 26, 2019

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Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors
DiamondRock Hospitality Company:

Opinion on the Consolidated Financial Statements
We have audited the accompanying consolidated balance sheets of DiamondRock Hospitality Company and subsidiaries (the Company) as of December 31, 2018 and 2017, the related consolidated statements of operations, equity, and cash flows for each of the years in the three year period ended December 31, 2018, the related notes, and financial statement schedule III (collectively, the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2018, in conformity with U.S. generally accepted accounting principles.
We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 26, 2019 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.
Basis for Opinion
These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ KPMG LLP

We have served as the Company's auditor since 2004.
McLean, Virginia
February 26, 2019

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DIAMONDROCK HOSPITALITY COMPANY

CONSOLIDATED BALANCE SHEETS
As of December 31, 2018 and 2017
(in thousands, except share and per share amounts)

	2018	2017
ASSETS		
Property and equipment, net	$2,944,617	$2,692,286
Restricted cash	47,735	40,204
Due from hotel managers	86,914	86,621
Favorable lease assets, net	63,945	26,690
Prepaid and other assets	10,506	71,488
Cash and cash equivalents	43,863	183,569
Total assets	$3,197,580	$3,100,858
LIABILITIES AND EQUITY		
Liabilities:		
Mortgage and other debt, net of unamortized debt issuance costs	$629,747	$639,639
Term loans, net of unamortized debt issuance costs	348,219	298,153
Total debt	977,966	937,792
Deferred income related to key money, net	11,739	14,307
Unfavorable contract liabilities, net	73,151	70,734
Deferred ground rent	93,719	86,614
Due to hotel managers	72,678	74,213
Dividends and distributions declared and unpaid	26,339	25,708
Accounts payable and accrued expenses	51,395	57,845
Total liabilities	1,306,987	1,267,213
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; 204,536,485 and 200,306,733 shares issued and outstanding at December 31, 2018 and 2017, respectively	2,045	2,003
Additional paid-in capital	2,126,472	2,061,451
Accumulated deficit	(245,620)	(229,809)
Total stockholders' equity	1,882,897	1,833,645
Noncontrolling interests	7,696	—
Total equity	1,890,593	1,833,645
Total liabilities, noncontrolling interests and stockholders’ equity	$3,197,580	$3,100,858

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

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DIAMONDROCK HOSPITALITY COMPANY

CONSOLIDATED STATEMENTS OF OPERATIONS
Years Ended December 31, 2018, 2017, and 2016
(in thousands, except share and per share amounts)

	2018	2017	2016
Revenues:			
Rooms	$ 631,048	$ 635,932	$ 650,624
Food and beverage	184,097	183,049	194,756
Other	48,559	51,024	51,178
Total revenues	863,704	870,005	896,558
Operating Expenses:			
Rooms	158,078	158,534	159,151
Food and beverage	118,709	120,460	125,916
Management fees	22,159	21,969	30,143
Other hotel expenses	322,713	302,272	302,805
Depreciation and amortization	104,524	99,090	97,444
Impairment losses	—	3,209	—
Hotel acquisition costs	—	2,028	—
Corporate expenses	28,563	26,711	23,629
Business interruption insurance income	(19,379)	(4,051)	—
Gain on property insurance settlement	(1,724)	—	—
Total operating expenses, net	733,643	730,222	739,088
Interest and other income, net	(1,806)	(1,820)	(762)
Interest expense	40,970	38,481	41,735
Loss (gain) on sales of hotel properties, net	—	764	(10,698)
Loss on early extinguishment of debt	—	274	—
Total other expenses, net	39,164	37,699	30,275
Income before income taxes	90,897	102,084	127,195
Income tax expense	(3,101)	(10,207)	(12,399)
Net income	87,796	91,877	114,796
Less: Net income attributable to noncontrolling interests	(12)	—	—
Net income attributable to common stockholders	$ 87,784	$ 91,877	$ 114,796
Earnings per share:			
Net income per share available to common stockholders—basic	$ 0.43	$ 0.46	$ 0.57
Net income per share available to common stockholders—diluted	$ 0.43	$ 0.46	$ 0.57
Weighted-average number of common shares outstanding:			
Basic	205,462,911	200,784,450	201,079,573
Diluted	206,131,150	201,521,468	201,676,258

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

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DIAMONDROCK HOSPITALITY COMPANY

CONSOLIDATED STATEMENTS OF EQUITY
Years Ended December 31, 2018, 2017 and 2016
(in thousands, except share and per share amounts)

	Common Stock						
	Shares	Par Value	Additional Paid-In Capital	Accumulated Deficit	Total Stockholders' Equity	Noncontrolling interests	Total Equity
Balance at December 31, 2015	200,741,777	$2,007	$2,056,878	$(234,280)	$1,824,605	$ —	$1,824,605
Dividends of $0.50 per common share	—	—	358	(101,096)	(100,738)	—	(100,738)
Issuance and vesting of common stock grants, net	187,362	2	4,634	—	4,636	—	4,636
Share repurchases	(728,237)	(7)	(6,505)	—	(6,512)	—	(6,512)
Net income	—	—	—	114,796	114,796	—	114,796
Balance at December 31, 2016	200,200,902	$2,002	$2,055,365	$(220,580)	$1,836,787	$ —	$1,836,787
Dividends of $0.50 per common share	—	—	424	(101,106)	(100,682)	—	(100,682)
Issuance and vesting of common stock grants, net	105,831	1	5,662	—	5,663	—	5,663
Net income	—	—	—	91,877	91,877	—	91,877
Balance at December 31, 2017	200,306,733	$2,003	$2,061,451	$(229,809)	$1,833,645	$ —	$1,833,645
Dividends of $0.50 per common share	—	$—	465	(103,705)	(103,240)	—	(103,240)
Issuance and vesting of common stock grants, net	141,165	1	4,531	110	4,642	—	4,642
Issuance of OP units	—	—	—	—	—	7,784	7,784
Sale of common stock	7,472,946	75	92,173	—	92,248	—	92,248
Distributions to noncontrolling interests	—	—	—	—	—	(100)	(100)
Common stock repurchased and retired	(3,384,359)	(34)	(32,148)	—	(32,182)	—	(32,182)
Net income	—	—	—	87,784	87,784	12	87,796
Balance at December 31, 2018	204,536,485	$2,045	$2,126,472	$(245,620)	$1,882,897	$ 7,696	$1,890,593

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

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DIAMONDROCK HOSPITALITY COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2018, 2017 and 2016
(in thousands)

	2018	2017	2016
Cash flows from operating activities:			
Net income	$87,796	$91,877	$114,796
Adjustments to reconcile net income to net cash provided by operating activities:			
Real estate depreciation	104,524	99,090	97,444
Corporate asset depreciation as corporate expenses	216	95	66
Loss (gain) on sale of hotel properties, net	—	764	(10,698)
Loss on early extinguishment of debt	—	274	—
Non-cash ground rent	7,305	6,290	5,671
Non-cash amortization of financing costs and interest rate cap as interest	1,862	1,950	2,302
Impairment losses	—	43,993	—
Estimated recovery of impairment losses from insurance	—	(40,784)	—
Amortization of favorable and unfavorable contracts, net	(1,969)	(1,912)	(1,912)
Amortization of deferred income related to key money	(2,568)	(5,760)	(2,851)
Stock-based compensation	5,573	6,201	5,321
Deferred income tax expense	1,591	7,702	10,405
Changes in assets and liabilities:			
Prepaid expenses and other assets	28,657	(26,333)	17,007
Due to/from hotel managers	(5,686)	1,540	(1,056)
Accounts payable and accrued expenses	(7,997)	17,006	(20,969)
Net cash provided by operating activities	219,304	201,993	215,526
Cash flows from investing activities:			
Hotel capital expenditures	(115,171)	(97,424)	(102,861)
Hotel acquisitions	(259,883)	(93,795)	—
Proceeds from sale of properties, net	—	(764)	175,300
Proceeds from property insurance	30,742	10,042	—
Net cash (used in) provided by investing activities	(344,312)	(181,941)	72,439
Cash flows from financing activities:			
Scheduled mortgage debt principal payments	(13,612)	(12,417)	(11,198)
Repurchase of common stock and other	(33,113)	(537)	(7,197)
Proceeds from sale of common stock, net	92,679	—	—
Repayments of mortgage debt	—	(170,368)	(249,793)
Proceeds from senior unsecured term loan	50,000	200,000	100,000
Draws on senior unsecured credit facility	85,000	—	75,000
Repayments of senior unsecured credit facility	(85,000)	—	(75,000)
Payment of financing costs	(412)	(1,579)	(2,765)
Payment of cash dividends	(102,709)	(100,542)	(100,771)
Net cash used in financing activities	(7,167)	(85,443)	(271,724)
Net (decrease) increase in cash and cash equivalents, and restricted cash	(132,175)	(65,391)	16,241
Cash, cash equivalents, and restricted cash beginning of year	223,773	289,164	272,923
Cash, cash equivalents, and restricted cash, end of year	$91,598	$223,773	$289,164

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

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DIAMONDROCK HOSPITALITY COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS - (CONTINUED)
Years Ended December 31, 2018, 2017 and 2016
(in thousands)

Supplemental Disclosure of Cash Flow Information:	2018	2017	2016
Cash paid for interest	$38,548	$36,288	$40,345
Cash paid for income taxes	$2,208	$3,251	$1,973
Non-cash Investing and Financing Activities:			
Unpaid dividends and distributions declared	$26,339	$25,708	$25,567
Buyer assumption of mortgage debt on sale of hotel	$—	$—	$89,486
Issuance of OP units in connection with acquisition of hotel property	$7,784	$—	$—

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

	2018	2017	2016
Cash and cash equivalents	$43,863	$183,569	$243,095
Restricted cash (1)	47,735	40,204	46,069
Total cash, cash equivalents, and restricted cash	$91,598	$223,773	$289,164

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(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 consolidated financial statements.

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DIAMONDROCK HOSPITALITY COMPANY

Notes to the Consolidated Financial Statements

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 many of our hotels are operated under a brand owned by one of the leading global lodging brand companies (Marriott International, Inc. (“Marriott”) or Hilton Worldwide (“Hilton”)). We are an owner, as opposed to an operator, of the hotels in our portfolio. As an owner, we receive all of the operating profits or losses generated by our hotels after we pay fees to the hotel managers, which are based on the revenues and profitability of the hotels.

As of December 31, 2018, we owned 31 hotels with 10,091 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 (2); Sedona, Arizona (2); Sonoma, California; South Lake Tahoe, California; Washington D.C. (2); St. Thomas, U.S. Virgin Islands; and Vail, Colorado. As of December 31, 2018, the Frenchman's Reef & Morning Star Beach Resort ("Frenchman's Reef") is currently 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, or subsidiaries of our operating partnership. The Company is the sole general partner of our operating partnership and owns either directly or indirectly 99.6% of the limited partnership units ("OP units") of our operating partnership. The remaining 0.4% of the OP units are held by third parties, otherwise unaffiliated with the Company. See Note 5 for additional disclosures related to OP units.

2. Summary of Significant Accounting Policies

Basis of Presentation

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. Our operating partnership meets the criteria of a variable interest entity. The Company is the primary beneficiary and, accordingly, we consolidate our operating partnership. The Company’s sole significant asset is its investment in its operating partnership, and consequently, substantially all of the Company’s assets and liabilities represent those assets and liabilities of its operating partnership. In addition, all of the Company's debt is an obligation of its 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.

Risks and Uncertainties

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

Fair Value Measurements

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

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

Property and Equipment

Following the adoption of FASB Accounting Standards Update ("ASU") No. 2017-01, investments in hotel properties, including related land, land improvements, building and furniture, fixtures and equipment and identifiable intangible assets are generally accounted for as asset acquisitions, which are recorded at total cost and allocated based on relative fair value. 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 property and related assets exceed the 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 property's estimated fair market value is recorded and an impairment loss is recognized.

We 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 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 cease recording depreciation expense, and classify the assets and related liabilities as held for sale on the balance sheet.

Cash and Cash Equivalents

We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Revenue Recognition

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

and resort fees. Rooms revenue is recognized over the length of stay that the hotel room is occupied by the customer. Food and beverage revenue is recognized at the point in time in which the goods and/or services are rendered to the customer, such as for restaurant dining services or banquet services. 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.

Advance deposits are recorded as liabilities 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.

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 consolidated statements of operations.

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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 REIT under the provisions of the Internal Revenue 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 existing taxable REIT subsidiary, or TRS, except for Frenchman’s Reef, which is owned by a Virgin Islands corporation, which we have elected to be treated as a TRS, and Cavallo Point, The Lodge at the Golden Gate ("Cavallo Point"), which is leased to a wholly owned subsidiary of the Company, which we have elected to be treated as a TRS.

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

Intangible Assets and Liabilities

Intangible assets or 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 contract 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.

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 stock grants 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.

Comprehensive Income

We do not have any comprehensive income other than net income. If we have any comprehensive income in future periods, such that a statement of comprehensive income would be necessary, such statement will be reported as one statement with the consolidated statement of operations.

Noncontrolling Interests

The noncontrolling interest is the portion of equity in our consolidated operating partnership not attributable, directly or indirectly, to the Company. Such noncontrolling interests are reported on the consolidated balance sheets within equity, separately from the Company’s equity. On the consolidated statements of operations, revenues, expenses and net income or loss from our less-than-wholly-owned operating partnership are reported within the consolidated amounts, including both the amounts attributable to the Company and noncontrolling interests. Income or loss is allocated to noncontrolling interests based on their weighted average ownership percentage for the applicable period. Consolidated statements of equity include beginning balances, activity for the period and ending balances for stockholders’ equity, noncontrolling interests and total equity.

Restricted Cash

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

Deferred Financing Costs

Financing costs are recorded at cost as a component of the debt carrying amount and consist of loan fees and other costs incurred in connection with the issuance of debt. Amortization of deferred financing costs is computed using a method that approximates the effective interest method over the remaining life of the debt and is included in interest expense in the accompanying consolidated statements of operations.

Due to/from Hotel Managers

The due from hotel managers consists of hotel level accounts receivable, periodic hotel operating distributions receivable from managers and prepaid and other assets held by the hotel managers on our behalf. The due to hotel managers represents liabilities incurred by the hotel on behalf of us in conjunction with the operation of our hotels which are legal obligations of the Company.

Key Money

Key money received in conjunction with entering into hotel management or franchise agreements or completing specific capital projects is deferred and amortized over the term of the hotel management agreement, the term of the franchise agreement, or other systematic and rational period, if appropriate. Deferred key money is classified as deferred income in the accompanying consolidated balance sheets and amortized as an offset to management fees or franchise fees.

Rental Income and Expense

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

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of our cash and cash equivalents. We maintain cash and cash equivalents with various financial institutions. We perform periodic evaluations of the relative credit standing of these financial institutions and limit the amount of credit exposure with any one institution.

Segment Reporting

Each one of our hotels is an operating segment. We evaluate each of our properties on an individual basis to assess performance, the level of capital expenditures, and acquisition or disposition transactions. Our evaluation of individual properties is not focused on property type (e.g. urban, suburban, or resort), brand, geographic location, or industry classification.

We aggregate our operating segments using the criteria established by U.S. GAAP, including the similarities of our product offering, types of customers and method of providing service. All of our properties react similarly to economic stimulus, such as business investment, changes in Gross Domestic Product, and changes in travel patterns. As such, all our operating segments meet the aggregation criteria, resulting in a single reportable segment represented by our consolidated financial results.

Accounting for Impacts 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, Hurricane Irma caused significant damage to Frenchman's Reef and Havana Cabana Key West. Frenchman's Reef was further impacted by Hurricane Maria. The Company has filed insurance claims for the remediation and repair of property damage and business interruption resulting from the hurricanes, as well as from the 2017 wildfires in Northern California that impacted The Lodge at Sonoma. In July 2018, the Company settled the insurance claims for Havana Cabana Key West and The Lodge at Sonoma. The Havana Cabana insurance claim was settled for $8.3 million, net of deductibles, and we recorded a gain of approximately $1.7 million related to the property damage. The Lodge at Sonoma claim was settled for $1.3 million, net of deductibles. The Frenchman’s Reef insurance claim is ongoing and we received $85.0 million and $10.0 million in insurance proceeds during the years ended December 31, 2018 and 2017, respectively.

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

	Year Ended December 31,	
	2018	2017
Frenchman's Reef	$16,090	$3,128
Havana Cabana Key West	2,137	923
The Lodge at Sonoma	1,152	—
Total	$19,379	$4,051

For the year ended December 31, 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 will be applied on a prospective basis and, therefore, it does not affect the accounting for any of our previous transactions. This standard is effective for annual periods beginning after December 15, 2017. We adopted ASU No. 2017-01 effective January 1, 2018. This standard does not affect the accounting for any of our transactions prior to January 1, 2018. Refer to Note 10 for more information about our three hotel property acquisitions during the year ended December 31, 2018, which were all accounted for as 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 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 consolidated statements of income or the 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 a material impact on our consolidated financial statements.

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. 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 intend to adopt ASU No. 2016-02, along with its related clarifications and amendments, as of the effective date of January 1, 2019. We are finalizing our evaluation of the changes from adopting this standard to our future financial reporting and disclosures, as well as designing and implementing related processes and controls. We also intend to elect all of the new standard's available transition practical expedients. We expect the standard to result in an increase to both total assets and total liabilities of between $95 million and $125 million, before adjusting for existing deferred rent and favorable and unfavorable lease intangible amounts included on our balance sheet as of December 31, 2018. Any changes to discount rates, lease terms or other variables may have a significant effect on the calculation of this recorded amount. We do not expect the adoption of the standard to result in a cumulative effect adjustment, or that the adoption of the standard will have a material impact to our results of operations, cash flows, or liquidity.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). 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. We adopted the new standard effective January 1, 2018, under the cumulative effect transition method. No adjustment was recorded to the our opening balance of retained earnings on January 1, 2018, as there was no impact to net income for the Company.

3. Property and Equipment

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

	2018	2017
Land	$617,695	$602,879
Land improvements	7,994	7,994
Buildings	2,682,320	2,414,216
Furniture, fixtures and equipment	491,421	423,987
Construction in progress	38,623	31,906
	3,838,053	3,480,982
Less: accumulated depreciation	(893,436)	(788,696)
	$2,944,617	$2,692,286

During the year ended December 31, 2017, we recognized a $41.7 million impairment loss for property damage at Frenchman's Reef, the Havana Cabana Key West, and the Sheraton Suites Key West in connection with Hurricanes Irma and Maria. We recorded a reduction to the impairment loss and a corresponding receivable of $40.8 million reflecting the insurance proceeds that were probable of receipt up to the amount of the loss recorded. The receivable for insurance proceeds is included in prepaid and other assets on the accompanying consolidated balance sheets. We evaluate probable recovery by considering various factors, including discussions with our insurance providers, consideration of their financial strength, and review of our insurance provisions and limits. During 2017, we determined the carrying value of $1.8 million of construction in progress was not recoverable and we recorded a corresponding $1.8 million charge within impairment losses for the year ended December 31, 2017.

As of December 31, 2018 and 2017, we had accrued capital expenditures of $12.4 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 ground leases and tenant leases. Our favorable lease assets, net of accumulated amortization of $3.4 million and $2.7 million as of December 31, 2018 and 2017, respectively, consist of the following (in thousands):

	2018	2017
Cavallo Point Ground Lease	$17,908	$—
Hotel Palomar Phoenix Ground Lease	19,763	—
Westin Boston Waterfront Hotel Ground Lease	17,426	17,643
Orchards Inn Sedona Annex Sublease	8,757	8,925
Lexington Hotel Tenant Leases	91	122
	$63,945	$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. Amortization expense for the years ended December 31, 2018, 2017, and 2016, was $0.7 million, $0.4 million, and $0.3 million, respectively. Amortization expense is expected to total $1.1 million annually 2019 through 2023.

In connection with our acquisition of the Orchards Inn Sedona on February 28, 2017, we recorded a $9.1 million favorable lease asset. In connection with our acquisition of the Hotel Palomar Phoenix on March 1, 2018, we recorded a $20.0 million favorable lease asset. In connection with our acquisition of Cavallo Point on December 12, 2018, we recorded a $17.9 million favorable lease asset. We determined the value of these favorable lease assets using a discounted cash flow of the favorable difference between the contractual lease payments and estimated market rents. The market rents were estimated by applying a land capitalization rate to the estimated fee-simple value of the underlying land. The discount rate was estimated using a risk adjusted rate of return.

5. Equity

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 year ended December 31, 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. The full amount remains available under the Current ATM Program.

Our board of directors has approved a 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 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 will depend 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.

During the year ended December 31, 2018, we repurchased 3,384,359 shares of our common stock at an average price of $9.49 per share for a total purchase price of $32.2 million. Subsequent to December 31, 2018, we repurchased 3,143,922 shares of our common stock at an average price of $9.52 per share for a total purchase price of $30.0 million. We retired all repurchased shares on their respective settlement dates. As of February 26, 2019, we have $188.0 million of authorized capacity remaining under our share repurchase program.

Dividends

We have paid the following dividends to holders of our common stock for the years ended December 31, 2018 and 2017, and through the date of this report:

Payment Date	Record Date	Dividend per Share
April 12, 2017	March 31, 2017	$0.125
July 12, 2017	June 30, 2017	$0.125
October 12, 2017	September 29, 2017	$0.125
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
January 14, 2019	January 4, 2019	$0.125

Preferred Shares

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

Operating Partnership Units

In connection with the acquisition of Cavallo Point in December 2018, we issued 796,684 OP units to third parties, otherwise unaffiliated with the Company, at $11.76 per unit. Each OP unit is redeemable at the option of the holder beginning December 12, 2019. Holders of OP units have certain redemption rights, which enable them to cause our operating partnership to redeem their units in exchange for cash per unit equal to the market price of our common stock, at the time of redemption, or, at our option, for shares of our common stock on a one-for-one basis, subject to adjustment upon the occurrence of stock splits, mergers, consolidations or similar pro-rata share transactions. As of December 31, 2018, there were 796,684 operating partnership units held by unaffiliated third parties.

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 December 31, 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 consolidated statements of operations. A summary of our restricted stock awards from January 1, 2016 to December 31, 2018 is as follows:

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	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested balance at January 1, 2016	474,567	$ 12.72
Granted	461,281	8.94
Forfeited	(126,610)	10.08
Vested	(241,698)	11.83
Unvested balance at December 31, 2016	567,540	10.62
Granted	324,502	11.19
Forfeited	(16,669)	10.80
Vested	(244,411)	11.29
Unvested balance at December 31, 2017	630,962	10.66
Granted	349,091	10.19
Forfeited	(51,061)	10.44
Vested	(287,148)	11.02
Unvested balance at December 31, 2018	641,844	$ 10.25

The remaining share awards are expected to vest as follows: 310,117 during 2019, 215,368 during 2020, and 116,359 during 2021. As of December 31, 2018, the unrecognized compensation cost related to restricted stock awards was $4.0 million and the weighted-average period over which the unrecognized compensation expense will be recorded is approximately 21 months. For the years ended December 31, 2018, 2017, and 2016, we recorded $3.1 million, $3.1 million and $2.8 million, respectively, of compensation expense related to restricted stock awards.

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 2014 and 2015 and vested in 2017 and 2018, respectively, the actual number of shares of common stock issued to each executive officer was 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 is 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 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.

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 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. The determination of the grant-date fair values of outstanding awards based on our relative total stockholder return included the following assumptions:

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Award Grant Date	Volatility		Risk-Free Rate		Fair Value at Grant Date
February 26, 2016	24.3	%	0.93	%	$8.42
February 26, 2017	26.7	%	1.46	%	$10.89
March 2, 2018	26.9	%	2.40	%	$9.52
April 2, 2018	26.9	%	2.37	%	$9.00

A summary of our PSUs from January 1, 2016 to December 31, 2018 is as follows:

	Number of Units	Weighted-Average Grant Date Fair Value
Unvested balance at January 1, 2016	676,359	$ 11.41
Granted	310,398	8.54
Additional units from dividends	38,324	9.37
Vested (1)	(242,096)	9.85
Forfeited	(96,301)	10.74
Unvested balance at December 31, 2016	686,684	10.65
Granted	266,009	11.04
Additional units from dividends	33,478	11.17
Vested (2)	(200,374)	12.15
Unvested balance at December 31, 2017	785,797	10.42
Granted	293,111	9.82
Additional units from dividends	35,197	11.24
Vested (3)	(218,514)	11.98
Forfeited	(113,668)	9.86
Unvested balance at December 31, 2018	781,923	$ 11.19

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(1) The number of shares of common stock earned for the PSUs vested in 2016 was equal to 89.5% of the PSU Target Award.

(2) There was no payout of shares of our common stock for PSUs that vested on February 27, 2017, as our total stockholder return fell below the 30th percentile of the total stockholder returns of the peer group over the three-year performance period.

(3) 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 unvested target units are expected to vest as follows: 247,949 during 2019, 231,221 during 2020 and 302,753 during 2021. As of December 31, 2018, the unrecognized compensation cost related to the PSUs was $3.1 million and is expected to be recognized on a straight-line basis over a period of 22 months. For the years ended December 31, 2018, 2017, and 2016, we recorded approximately $1.9 million, $2.5 million, and $2.0 million, respectively, of compensation expense related to the PSUs.

The compensation expense recorded for the year ended December 31, 2016 includes the reversal of $0.4 million of previously recognized compensation expense resulting from the forfeiture of PSUs by our former Executive Vice President and Chief Operating Officer. The compensation expense for the year ended December 31, 2018 includes the reversal of $1.0 million of previously recognized compensation expense resulting from the forfeiture of PSUs by our former Executive Vice President and Chief Financial Officer.

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 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):

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	Years Ended December 31,		
	2018	2017	2016
Numerator:			
Net income attributable to common stockholders	$87,784	$ 91,877	$ 114,796
Denominator:			
Weighted-average number of common shares outstanding—basic	205,462,911	200,784,450	201,079,573
Effect of dilutive securities:			
Unvested restricted common stock	215,655	188,759	47,468
Shares related to unvested PSUs	452,584	548,259	549,217
Weighted-average number of common shares outstanding—diluted	206,131,150	201,521,468	201,676,258
Earnings per share:			
Net income per share available to common stockholders—basic	$0.43	$ 0.46	$ 0.57
Net income per share available to common stockholders—diluted	$0.43	$ 0.46	$ 0.57

The OP units held by the noncontrolling interest holders have been excluded from the denominator of the diluted earnings per share calculation as there would be no effect on the amounts since the OP units' share of income or loss would also be added or subtracted to derive net income (loss) available to common stockholders.

8. Debt

The following table sets forth information regarding the Company’s debt as of December 31, 2018 (dollars in thousands):

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Loan	Interest Rate		Maturity Date	Principal Balance as of December 31, 2018	2017
Salt Lake City Marriott Downtown mortgage loan	4.25	%	November 2020	$55,032	$56,717
Westin Washington D.C. City Center mortgage loan	3.99	%	January 2023	62,734	64,833
The Lodge at Sonoma, a Renaissance Resort & Spa mortgage loan	3.96	%	April 2023	27,633	28,277
Westin San Diego mortgage loan	3.94	%	April 2023	63,385	64,859
Courtyard Manhattan / Midtown East mortgage loan	4.40	%	August 2024	82,620	84,067
Renaissance Worthington mortgage loan	3.66	%	May 2025	82,540	84,116
JW Marriott Denver at Cherry Creek mortgage loan	4.33	%	July 2025	62,411	63,519
Boston Westin mortgage loan	4.36	%	November 2025	194,466	198,046
New Market Tax Credit loan (1)	5.17	%	December 2020	2,943	—
Unamortized debt issuance costs				(4,017)	(4,795)
Total mortgage and other debt, net of unamortized debt issuance costs				629,747	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
Unsecured term loan	LIBOR + 1.45% (3)		October 2023	50,000	—
Unamortized debt issuance costs				(1,781)	(1,847)
Unsecured term loans, net of unamortized debt issuance costs				348,219	298,153
Senior unsecured credit facility	LIBOR + 1.50%		May 2020 (4)	—	—
Total debt, net of unamortized debt issuance costs				$977,966	$937,792
Weighted-Average Interest Rate	4.01%				

(1) Assumed in connection with the acquisition of the Hotel Palomar Phoenix on March 1, 2018.
(2) The interest rate at December 31, 2018 was 3.80%.
(3) The interest rate at December 31, 2018 was 3.78%. We entered into an interest rate swap agreement in January 2019 to fix LIBOR at 2.41% through October 2023.
(4) The credit facility may be extended for an additional year upon the payment of applicable fees and the satisfaction of certain customary conditions.

The aggregate debt maturities as of December 31, 2018 are as follows (in thousands):

2019	14,195
2020	66,174
2021	116,461
2022	214,095

2023	194,649
Thereafter	378,190
	$983,764

Mortgage Debt

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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 pledged assets; however, in the event of fraud, misapplication of funds or other customary recourse provisions, the lender may seek payment from us. As of December 31, 2018, eight of our 31 hotel properties 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 December 31, 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.

On April 26, 2017, we repaid the mortgage loan secured by the Lexington Hotel New York with proceeds from a new unsecured term loan, which is discussed further below. The mortgage loan had an outstanding balance of $170.4 million at repayment.

Senior Unsecured Credit Facility

We are party to a $300 million senior unsecured credit facility with a maturity date of May 2020. The maturity date of the facility may be extended for an additional year upon the payment of applicable fees and the satisfaction of certain other customary conditions. 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 are 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 December 31, 2018
Maximum leverage ratio (1)	60%	27.5%
Minimum fixed charge coverage ratio (2)	1.50x	4.17x
Minimum tangible net worth (3)	$1.98 billion	$2.72 billion
Secured recourse indebtedness	Less than 45% of Total Asset Value	18.9%

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

(2) 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 interest expense, all regularly scheduled principal payments and payments on capitalized lease obligations, for the same most recently ending 12-month period.

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

As of December 31, 2018, we had no borrowings outstanding under the facility and the Company's leverage ratio was 27.5%. 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 $1.2 million, $1.0 million and $1.3 million for the years ended December 31, 2018, 2017 and 2016, respectively. Subsequent to December 31, 2018, we borrowed $45 million under the facility.

Unsecured Term Loans

We are party to a five-year $100 million unsecured term loan, a five-year $200 million unsecured term loan, and a new five-year $50 million unsecured term loan, entered into on October 18, 2018. On December 5, 2018, in connection with the acquisition closing of Cavallo Point, we drew down the full balance of the new $50 million term loan. In January 2019, we entered into an interest rate swap agreement to economically hedge variability in LIBOR-indexed interest payments at 2.41% through October 2023 for the $50 million unsecured term loan.

The financial covenants of the three term loans are consistent with the covenants on our senior unsecured credit facility, which are described above. The interest rate on the term loans is based on a pricing grid ranging from 140 to 220 basis points over LIBOR, based on the Company's leverage ratio, as follows:

Leverage Ratio	Applicable Margins $100 Million and $200 Million Term Loans	$50 Million Term Loan
Less than or equal to 25%	1.45%	1.40%
Greater than 25% but less than or equal to 35%	1.45%	1.45%
Greater than 35% but less than or equal to 45%	1.60%	1.55%
Greater than 45% but less than or equal to 50%	1.75%	1.75%
Greater than 50% but less than or equal to 55%	1.95%	1.95%
Greater than 55%	2.20%	2.20%

As of December 31, 2018, the Company's leverage ratio was 27.5%. We incurred interest on the term loans of $10.6 million, $6.2 million and $1.3 million for the years ended December 31, 2018, 2017 and 2016, respectively.

9. Dispositions

On June 8, 2016, we sold the 485-room Orlando Airport Marriott to an unaffiliated third party for a contractual sales price of $63 million. We received net proceeds of approximately $65.8 million from the transaction, which included credit for the hotel's capital replacement reserve. We recognized a pre-tax gain on sale of the hotel of approximately $3.7 million.

On June 30, 2016, we sold the 821-room Hilton Minneapolis to an unaffiliated third party for a contractual sales price of $140 million. The buyer assumed the $89.5 million mortgage loan secured by the hotel. We received net proceeds of approximately $54.8 million from the transaction, which included credit for the hotel's working capital. We recognized a pre-tax gain on sale of the hotel of approximately $4.9 million during the year ended December 31, 2016. We recognized an incremental pre-tax loss of $0.8 million during the year ended December 31, 2017 due to a post-closing adjustment for hotel expenses incurred under our ownership period.

On July 7, 2016, we sold the 169-room Hilton Garden Inn Chelsea/New York City to an unaffiliated third party for a contractual sales price of $65.0 million. We received net proceeds of approximately $63.3 million from the transaction. We recognized a pre-tax gain on sale of the hotel of approximately $2.0 million.

We had no dispositions during the years ended December 31, 2017 and 2018.

Our consolidated statements of operations include the following pre-tax income (loss), inclusive of the gains and losses on sale, from the hotel properties sold during 2016 (in thousands):

	2018	2017	2016
Orlando Airport Marriott	$ —	$—	$8,225
Hilton Minneapolis	—	(764)	4,872
Hilton Garden Inn Chelsea/New York City	—	—	3,107
Total pre-tax (loss) income	$ —	$(764)	$16,204

10. Acquisitions

2018 Acquisitions (Accounted for as Asset 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, direct acquisition costs were capitalized.

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 were capitalized.

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. Refer to Note 13 for additional information about this lease. 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 comparable market ground lease. Accordingly, we allocated $20.0 million of the total acquisition cost to a 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 extension options. 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 allocated $4.6 million of the total acquisition cost to an unfavorable agreement liability that will be amortized over the remaining term of the parking agreement, including all extension options.

On December 12, 2018, we acquired the 142-room Cavallo Point for a total contractual purchase price of $152 million. The acquisition was funded through a combination of corporate cash, proceeds from the new $50 million unsecured term loan and the issuance of OP units. The acquisition is accounted for as an acquisition of assets; accordingly, our direct acquisition costs were capitalized.

Cavallo Point is subject to a long-term ground lease agreement with the United States National Park Service that expires in 2066. Refer to Note 13 for additional information about this lease. We reviewed the terms of the ground lease and concluded that the terms of the ground lease are favorable to us compared with a comparable market ground lease. Accordingly, we allocated $17.9 million of the total acquisition cost to a favorable ground lease asset that will be amortized over the remaining term of the ground lease.

2017 Acquisitions (Accounted for as Business Combinations)

On February 28, 2017, we acquired the 88-room L'Auberge de Sedona and the 70-room Orchards Inn Sedona, each located in Sedona, Arizona, for a total contractual purchase price of $97 million. The acquisition was funded with corporate cash.

We lease the buildings and sublease the underlying land containing 28 of the 70 rooms at the Orchards Inn Sedona, which expires in 2070, including all extension options. We reviewed the terms of the annex sublease in conjunction with the hotel acquisition accounting and concluded that the terms are favorable to us compared with a comparable market lease. As a result, we recorded a $9.1 million favorable lease asset that will be amortized through 2070.

Acquired properties are included in our results of operations from the date of acquisition. The following pro forma financial information for the years ended December 31, 2017, and 2016, present our results of operations (in thousands, except per share

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data) as if the hotels acquired in 2017 and accounted for a business combinations were acquired on January 1, 2016. The hotels acquired in 2018 are accounted for as asset acquisitions and are not included in the information presented below. The pro forma information is not necessarily indicative of the results that actually would have occurred nor does it indicate future operating results.

	Year Ended December 31,	
	2017 (unaudited)	2016 (unaudited)
Revenues	$ 873,427	$ 924,806
Net income	$ 91,602	$ 118,232
Earnings per share:		
Net income per share available to common stockholders—basic	$ 0.46	$ 0.59
Net income per share available to common stockholders—diluted	$ 0.45	$ 0.59

For the years ended December 31, 2018 and 2017, our consolidated statements of operations includes $34.7 million and $29.3 million of revenues, respectively, and $6.9 million and $5.9 million of net income, respectively, related to the operations of the hotels acquired in 2017 under business combination accounting.

The following table summarizes the assets acquired and liabilities assumed in our 2017 and 2018 acquisitions (in thousands):

	Cavallo Point	Landing Resort & Spa	Hotel Palomar Phoenix	L'Auberge de Sedona	Orchards Inn Sedona
Land	$—	$ 14,816	$—	$ 39,384	$9,726
Building and improvements	123,100	24,351	59,703	22,204	10,180
Furniture, fixtures and equipment	10,470	3,346	5,207	4,376	1,982
Construction in progress	1,734	—	—	—	—
Total fixed assets	135,304	42,513	64,910	65,964	21,888
Favorable lease asset	17,907	—	20,012	—	9,065
Unfavorable lease liability	—	—	(4,644)	—	—
New Market Tax Credit loan assumption	—	—	(2,943)	—	—
Other assets and liabilities, net	(5,083)	(658)	497	(2,710)	(412)
Total	$148,128	$41,855	$77,832	$ 63,254	$30,541

11. Income Taxes

We have elected to be treated as a REIT under the provisions of the Internal Revenue 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 are subject to federal, state, local and/or foreign income taxes.

Our provision for income taxes consists of the following (in thousands):

	Year Ended December 31,		
	2018	2017	2016
Current - Federal	$66	$622	$—
State	984	1,221	1,297
Foreign	460	662	697
	1,510	2,505	1,994
Deferred - Federal	1,857	6,432	9,779
State	178	425	1,324
Foreign	(444)	845	(698)
	1,591	7,702	10,405
Income tax provision	$3,101	$10,207	$12,399

A reconciliation of the statutory federal tax provision to our income tax provision is as follows (in thousands):

	Year Ended December 31,		
	2018	2017	2016
Statutory federal tax provision (1)	$19,089	$35,729	$44,518
Tax impact of REIT election	(14,439)	(22,277)	(31,101)
State income tax provision, net of federal tax benefit	705	1,652	1,703
Foreign income tax benefit	(2,927)	(430)	(3,080)
Tax reform impact on U.S. taxes	—	(2,143)	—
Tax reform impact on foreign taxes	—	(2,076)	—
Other	673	(248)	359
Income tax provision	$3,101	$10,207	$12,399

(1) Beginning January 1, 2018, the U.S. federal income tax rate decreased from 35% to 21%.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation, H.R. 1, originally known as the Tax Cuts and Jobs Act (the "Tax Act"). Among other changes to the U.S. tax code, the Tax Act reduces the U.S. federal corporate income tax rate to 21%, and requires companies to pay a one-time transition tax on certain unrepatriated earnings (where applicable) of foreign subsidiaries with an election option to defer the transition tax over eight years. Accordingly, our federal net deferred tax liabilities as of December 31, 2017 have been remeasured using a U.S. federal income tax rate of 21% that is effective beginning on January 1, 2018, to reflect the effects of the enacted changes in tax rates at the date of enactment based on the applicable enacted tax rate when the temporary differences and carryforwards are expected to reverse. The impact of this remeasurement is a decrease to net deferred tax liabilities and a decrease to the deferred income tax provision in 2017 of approximately $4.2 million. Additionally, we elected to defer the transition tax inclusion of approximately $17.8 million into REIT taxable income related to the deemed mandatory repatriation of foreign earnings and profits of the Frenchman's Reef & Morning Star Beach Resort (located in the U.S. Virgin Islands) over the eight-year period allowed under the Tax Act. The transition tax increased our 2017 REIT taxable income in 2017 by approximately $1.5 million. The remaining deferred transition tax inclusion was included in our 2018 REIT taxable income.

We are required to pay franchise taxes in certain jurisdictions. We recorded approximately $0.4 million of franchise taxes during each of the years ended December 31, 2018, 2017 and 2016, which are classified as corporate expenses in the accompanying consolidated statements of operations.

Deferred income taxes are recognized for temporary differences between the financial reporting bases of assets and liabilities and their respective tax bases and for operating loss and tax credit carryforwards based on enacted tax rates

expected to be in effect when such amounts are paid. However, deferred tax assets are recognized only to the extent that it is more likely than not that they will be realizable based on consideration of available evidence, including future reversals of existing taxable temporary differences, projected future taxable income and tax planning strategies. Deferred tax assets are included in prepaid and other assets and deferred tax liabilities are included in accounts payable and accrued expenses on the accompanying consolidated balance sheets. The total deferred tax assets and liabilities are as follows (in thousands):

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	2018	2017
Federal		
Net operating loss carryforwards	$1,983	$3,099
Deferred income related to key money	2,465	2,549
Alternative minimum tax credit carryforwards	103	169
Other	326	355
Depreciation and amortization	(9,188)	(8,889)
Federal - Deferred tax (liabilities) assets, net	$(4,311)	$(2,717)
State		
Net operating loss carryforwards	$2,975	$3,126
Deferred income related to key money	780	801
Alternative minimum tax credit carryforwards	80	81
Other	103	111
Depreciation and amortization	(2,906)	(2,803)
Less: Valuation allowance	(700)	(400)
State - Deferred tax assets, net	$332	$916
Foreign (USVI)		
Deferred income related to key money	$—	$95
Depreciation and amortization	(255)	(796)
Other	—	1
Land basis recorded in purchase accounting	(2,617)	(2,617)
Foreign - Deferred tax liabilities, net	$(2,872)	$(3,317)

As of December 31, 2018, we had deferred tax assets of $5.0 million consisting of federal and state net operating loss carryforwards. The federal loss carryforwards of $2.0 million generally expire in 2029 through 2034 if not utilized by then. We believe that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the deferred tax asset related to federal loss carryforwards prior to their expiration and have determined that no valuation allowance is required. The state loss carryforwards of $3.0 million generally expire in 2020 through 2034 if not utilized by then. The Company analyzes state loss carryforwards on a state by state basis and records a valuation allowance when we deem it more likely than not that future results will not generate sufficient taxable income in the respective state to realize the deferred tax asset prior to the expiration of the loss carryforwards. As of December 31, 2018, we have a $0.7 million valuation allowance on the deferred tax asset related to the Illinois state loss carryforward. The remaining deferred tax assets of $3.9 million are expected to be recovered against reversing existing taxable temporary differences.

The Frenchman's Reef & Morning Star Beach Resort is owned by a subsidiary that has elected to be treated as a TRS, and is subject to U.S. Virgin Islands ("USVI") income taxes. We are party to a tax agreement with the USVI that reduces the income tax rate to approximately 7%. This agreement expires in February 2030.

12. Relationships with Managers and Franchisors

We are party to hotel management agreements for each of our hotels owned. Under our hotel management agreements, the hotel manager receives a base management fee and, if certain financial thresholds are met or exceeded, an incentive management fee. The base management fee is generally payable as a percentage of gross hotel revenues for each fiscal year. The incentive management fee is generally based on hotel operating profits, but the fee

only applies to that portion of hotel operating profits above a negotiated return on our invested capital, which we refer to as the owner's priority. We refer to this excess of operating profits over the owner's priority as “available cash flow.”

The following is a summary of management fees for the years ended December 31, 2018, 2017 and 2016 (in thousands):

	Year Ended December 31,		
	2018	2017	2016
Base management fees	$20,467	$22,265	$24,480
Incentive management fees	5,805	6,259	7,810
Amortization of deferred income related to key money	(2,398)	(4,840)	(432)
Amortization of unfavorable contract liabilities	(1,715)	(1,715)	(1,715)
Total management fees, net	$22,159	$21,969	$30,143

Nine of our hotels earned incentive management fees for the year ended December 31, 2018. Ten of our hotels earned incentive management fees for the year ended December 31, 2017. Nine of our hotels earned incentive management fees for the year ended December 31, 2016.

Performance Termination Provisions

Our management agreements provide us with termination rights upon a manager's failure to meet certain financial performance criteria and manager's decision not to cure the failure by making a cure payment.

Key Money

Our managers and franchisors have contributed to us certain amounts in exchange for the right to manage or franchise hotels we have acquired and in connection with the completion of certain brand enhancing capital projects. We refer to these amounts as “key money.” Key money is classified as deferred income in the accompanying consolidated balance sheets and amortized against management fees or franchise fees on the accompanying consolidated statements of operations. We amortized $2.6 million of key money during the year ended December 31, 2018, $5.8 million during the year ended December 31, 2017, and $2.9 million during the year ended December 31, 2016.

In connection with a change in hotel manager of the Courtyard Manhattan/Midtown East, we recognized $1.9 million of accelerated amortization in 2017 of key money provided to us by the previous hotel manager. In connection with the termination of the management agreement for Frenchman's Reef, we accelerated the amortization of key money received from the hotel manager from the date of our notice of termination in 2017 through the effective termination date of February 20, 2018. We recognized an additional $2.6 million of amortization of key money during the year ended December 31, 2017 in connection with this acceleration. The remaining $2.2 million was amortized during the first quarter of 2018.

During 2015, Starwood provided us with $3.0 million of key money in connection with our renovation associated with the brand conversion of the hotel formerly known as the Conrad Chicago to The Gwen, a Luxury Collection Hotel. The key money was amortized against franchise fees over the period of the renovation—January 2016 through April 2017.

Franchise Agreements

We have franchise agreements for 13 of our hotels. Pursuant to these franchise agreements, we pay franchise fees based on a percentage of gross room sales, and, under certain agreements, a percentage based on gross food and beverage sales. Further, we pay certain other fees for marketing and reservation services.

The following is a summary of franchise fees for the years ended December 31, 2018, 2017 and 2016 (in thousands):

Year Ended December 31,

	2018	2017	2016
Franchise fees	$26,348	$24,890	$24,237
Amortization of deferred income related to key money	(170)	(920)	(2,420)
Total franchise fees, net	$26,178	$23,970	$21,817

Total franchise fees are included in other hotel expenses on the accompanying consolidated statements of operations.

13. Commitments and Contingencies

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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

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. Though the guest satisfaction scores have improved, the Company remains in default under the franchise agreement. While the franchisor has reserved all of its rights under the franchise agreement, no action to terminate the franchise agreement has been taken by the franchisor and no accrual was recorded as of December 31, 2018 or 2017.
If the Company is not successful in resolving the matter, 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.
Restricted Cash

As of December 31, 2018 and 2017, we had $47.7 million and $40.2 million, respectively, of restricted cash, which consists of reserves for replacement of furniture and fixtures generally held by our hotel managers and cash held in escrow pursuant to lender requirements.
Ground Leases

Seven of our hotels are subject to ground lease agreements that cover all of the land underlying the respective hotel:

- The Bethesda Marriott Suites hotel is subject to a ground lease that runs until 2087. There are no renewal options.

- The Courtyard Manhattan/Fifth Avenue is subject to a ground lease that runs until 2085, inclusive of one 49-year renewal option.

- The Salt Lake City Marriott Downtown is subject to two ground leases: one ground lease covers the land under the hotel and the other ground lease covers the portion of the hotel that extends into the adjacent City Creek Project. We own a 21% interest in the land under the hotel. The term of the ground lease covering the land under the hotel runs through 2056, inclusive of renewal options. The term of the ground lease covering the extension into the City Creek Project was amended during 2017 to run coterminously with the term of the ground lease covering the land under the

hotel. As such, the term now runs through 2056, inclusive of renewal options.

- The Westin Boston Waterfront is subject to a ground lease that runs until 2099. There are no renewal options.
- The Shorebreak Hotel is subject to a ground lease that runs until 2100, inclusive of two renewal options of 25 years each and one 24-year renewal option. We own a 95.5% undivided interest in the land underlying the hotel and lease the remaining 4.5% under the ground lease.
- The Hotel Palomar Phoenix is subject to a ground lease that runs until 2085, inclusive of three renewal options of five years each.

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- Cavallo Point is subject to a ground lease with the United States National Park Service that runs until 2066. There are no renewal options.

A portion of the parking garage relating to the Renaissance Worthington is subject to three ground leases that cover, contiguously with each other, approximately one-fourth of the land on which the parking garage is constructed. Each of the ground leases has a term that runs through July 2067, inclusive of three 15-year renewal options. The remainder of the land on which the parking garage is constructed is owned by us in fee simple.

A portion of the JW Marriott Denver at Cherry Creek is subject to a ground lease that covers approximately 5,500 square feet. The term of the ground lease runs through December 2030, inclusive of two 5-year renewal options. The lease may be indefinitely extended thereafter in one-year increments. The remainder of the land on which the hotel is constructed is owned by us in fee simple.

We lease the buildings and sublease the underlying land containing 28 of the 70 rooms at the Orchards Inn Sedona, which expires in 2070, including all extension options. The remainder of the land underlying the hotel is owned by us in fee simple.

These ground leases generally require us to make rental payments (including a percentage of gross receipts as percentage rent with respect to the Courtyard Manhattan/Fifth Avenue, Westin Boston Waterfront Hotel, Salt Lake City Marriott Downtown, and Cavallo Point ground leases). Most of our ground leases require us to make payments for all charges, costs, expenses, assessments and liabilities, including real property taxes and utilities. Furthermore, these ground leases generally require us to obtain and maintain insurance covering the subject property.

Ground rent expense was $11.6 million, $10.2 million and $12.7 million for the years ended December 31, 2018, 2017 and 2016, respectively. Cash paid for ground rent was $4.7 million, $4.1 million and $7.0 million for the years ended December 31, 2018, 2017 and 2016, respectively.

The following table reflects the current and future annual rents under our ground leases:

Property	Term (1)	Annual Rent
Bethesda Marriott Suites	Through 4/2087	$781,366 (2)
Courtyard Manhattan/Fifth Avenue (3)	10/2007 - 9/2017	$906,000
	10/2017 - 9/2027	$1,132,812
	10/2027 - 9/2037	$1,416,015
	10/2037 - 9/2047	$1,770,019
	10/2047 - 9/2057	$2,212,524
	10/2057 - 9/2067	$2,765,655
	10/2067 - 9/2077	$3,457,069
	10/2077 - 9/2085	$4,321,336
Salt Lake City Marriott Downtown (Ground lease for hotel) (4)	Through 12/2056	Greater of $132,000 or 2.6% of annual gross room sales
Salt Lake City Marriott Downtown (Ground lease for extension)	1/2013 - 12/2016	$11,305
	1/2017 - 12/2017	$13,000
	1/2018 - 12/2056 (5)	$13,500
Westin Boston Waterfront Hotel (6) (Base rent)	1/2016 - 12/2020	$750,000
	1/2021 - 12/2025	$1,000,000
	1/2026 - 12/2030	$1,500,000
	1/2031 - 12/2035	$1,750,000
	1/2036 - 5/2099	No base rent
Westin Boston Waterfront Hotel (Percentage rent)	Through 5/2015	0% of annual gross revenue
	6/2016 - 5/2026	1.0% of annual gross revenue
	6/2026 - 5/2036	1.5% of annual gross revenue
	6/2036 - 5/2046	2.75% of annual gross revenue
	6/2046 - 5/2056	3.0% of annual gross revenue
	6/2056 - 5/2066	3.25% of annual gross revenue
	6/2066 - 5/2099	3.5% of annual gross revenue
JW Marriott Denver at Cherry Creek	1/2015 - 12/2020	$50,000
	1/2021 - 12/2025	$55,000
	1/2026 - 12/2030 (7)	$60,000
Shorebreak Hotel	Through 4/2016	$115,542
	5/2016 - 4/2021 (8)	$126,649
Orchards Inn Sedona	Through 6/2018	$117,780
	7/2018 - 12/2070	$121,078 (9)
Hotel Palomar Phoenix (Base Rent)	Through 3/2020	$16,875
	4/2020 - 3/2021	$33,750
	4/2021 - 3/2085	$34,594 (10)
Hotel Palomar Phoenix (Government Property Lease Excise Tax) (11)	1/2022 - 12/2023	$390,000
	1/2024 - 12/2033	$312,000
	1/2034 - 12/2043	$234,000
	1/2044 - 12/2053	$156,000
	1/2054 - 12/2063	$78,000

	1/2064 - 3/2085	$—
Cavallo Point (Base Rent)	Through 12/2018	$1
	1/2019 - 12/2066	$67,034 (12)
Cavallo Point (13) (Percentage Rent)	Through 12/2018	1.0% of adjusted gross revenue over threshold
	1/2019 - 12/2023	2.0% of adjusted gross revenue over threshold
	1/2024 - 12/2028	3.0% of adjusted gross revenue over threshold
	1/2029 - 12/2033	4.0% of adjusted gross revenue over threshold
	1/2034 - 12/2066	5.0% of adjusted gross revenue over threshold
Cavallo Point (14) (Participation Rent)	Through 12/2066	10.0% of adjusted gross revenue over threshold

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Property	Term (1)	Annual Rent
Renaissance Worthington garage ground lease	8/2013 - 7/2022	$40,400
	8/2022 - 7/2037	$46,081
	8/2037 - 7/2052	$51,763
	8/2052 - 7/2067	$57,444

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(1) These terms assume our exercise of all renewal options.

(2) Represents rent for the year ended December 31, 2018. Rent increases annually by 5.5%.

(3) The total annual rent includes the fixed rent noted in the table plus a percentage rent equal to 5% of gross receipts for each lease year, but only to the extent that 5% of gross receipts exceeds the minimum fixed rent in such lease year. There was no such percentage rent earned during the year ended December 31, 2018.

(4) We own a 21% interest in the land underlying the hotel and, as a result, 21% of the annual rent under the ground lease is paid to us by the hotel.

(5) Rent will increase from the prior year's rent based on a Consumer Price Index calculation on each January 1, beginning January 1, 2019 and through the end of the lease.

(6) Total annual rent under the ground lease is capped at 2.5% of hotel gross revenues during the initial 30 years of the ground lease.

(7) Beginning January 2031, we have the right to renew the ground lease in one-year increments at the prior year's annual rent plus 3%.

(8) Rent will increase on May 1, 2021 and every five years thereafter based on a Consumer Price Index calculation.

(9) Represents rent from July 2018 through June 2019. On July 1, 2018, rent increased based on a Consumer Price Index calculation, and will continue to do so annually through the end of the lease.

(10) Represents rent from April 2021 through March 2022. Rent increases annually each April by 2.5%.

(11) As lessee of government property, the hotel is subject to a Government Property Lease Excise Tax ("GPLET") under Arizona state statute with payments beginning in 2022.

(12) Base rent increases in January 2019 and resets every five years based on the average of the previous three years of adjusted gross revenues, as defined in the ground lease, multiplied by 75%.

(13) Percentage rent is applied to annual adjusted gross revenues, as defined in the ground lease, between $30 million and the participation rent threshold. Base rent is deducted from the percentage rent.

(14) Participation rent is applied to annual adjusted gross revenues, as defined in the ground lease, over $40 million in 2018, $42 million in 2019, and $42 million plus an annual increase based on a Consumer Price Index calculation for 2020 and every year thereafter through the end of the lease term.

Future minimum annual rental commitments under all non-cancelable operating leases as of December 31, 2018 are as follows (in thousands):

2019	$5,232
2020	4,866
2021	6,132
2022	5,122
2023	5,096
Thereafter	636,770
	$663,218

14. Fair Value of Financial Instruments

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

	December 31, 2018		December 31, 2017	
	Carrying Amount (1)	Fair Value	Carrying Amount (1)	Fair Value
Debt	$977,966	$960,447	$937,792	$942,529

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

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

15. Quarterly Operating Results (Unaudited)

	2018 Quarter Ended			
	March 31	June 30	September 30	December 31
	(In thousands, except per share data)			
Total revenue	$181,530	$237,949	$220,818	$223,407
Total operating expenses	168,011	200,012	176,589	189,031
Operating income	$13,519	$37,937	$44,229	$34,376
Net income	$4,338	$28,009	$31,443	$24,006
Net income attributable to common stockholders	$4,338	$28,009	$31,443	$23,994
Net income per share available to common stockholders—basic	$0.02	$0.14	$0.15	$0.12
Net income per share available to common stockholders—diluted	$0.02	$0.14	$0.15	$0.12

	2017 Quarter Ended			
	March 31	June 30	September 30	December 31
	(In thousands, except per share data)			
Total revenue	$196,210	$243,272	$223,486	$207,037
Total operating expenses	176,914	192,621	189,168	171,519
Operating income	$19,296	$50,651	$34,318	$35,518
Net income	$8,887	$36,595	$21,623	$24,772
Net income attributable to common stockholders	$8,887	$36,595	$21,623	$24,772
Net income per share available to common stockholders—basic	$0.04	$0.18	$0.11	$0.12
Net income per share available to common stockholders—diluted	$0.04	$0.18	$0.11	$0.12

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DiamondRock Hospitality Company
Schedule III - Real Estate and Accumulated Depreciation
As of December 31, 2018 (in thousands)

		Initial Cost		Costs Capitalized Subsequent to	Gross Amount at End of Year				
Description	Encumbrances	Land	Building and Improvements	Acquisition	Land	Building and Improvements	Total	Accumulated Depreciation	Net Book Value
Atlanta Alpharetta Marriott	$—	$3,623	$33,503	$2,534	$3,623	$36,037	$39,660	$(11,696)	$27,964
Bethesda Marriott Suites	—	—	45,656	5,345	—	51,001	51,001	(16,740)	34,261
Boston Westin Waterfront	(194,466)	—	273,696	26,091	—	299,787	299,787	(88,210)	211,577
Cavallo Point	—	—	123,100	—	—	123,100	123,100	(308)	122,792
Chicago Marriott Downtown	—	36,900	347,921	93,281	36,900	441,202	478,102	(121,187)	356,915
The Gwen Chicago	—	31,650	76,961	22,243	31,650	99,204	130,854	(25,029)	105,825
Courtyard Denver	—	9,400	36,180	2,978	9,400	39,158	48,558	(7,003)	41,555
Courtyard Manhattan/Fifth Avenue	—	—	34,685	4,485	—	39,170	39,170	(13,359)	25,811
Courtyard Manhattan/Midtown East	(82,620)	16,500	54,812	5,199	16,500	60,011	76,511	(20,284)	56,227
Frenchman's Reef & Morning Star Beach Resort	—	17,713	50,697	17,949	17,713	68,646	86,359	(15,230)	71,129
Havana Cabana Key West	—	32,888	13,371	5,513	32,888	18,884	51,772	(1,491)	50,281
Hilton Boston Downtown	—	23,262	128,628	12,877	23,262	141,505	164,767	(22,112)	142,655
Hilton Burlington	—	9,197	40,644	2,006	9,197	42,650	51,847	(6,954)	44,893
Hilton Garden Inn/New York Times Square Central	—	60,300	88,896	472	60,300	89,368	149,668	(9,702)	139,966
Hotel Emblem	—	7,856	21,085	(36)	7,856	21,049	28,905	(3,231)	25,674
Hotel Palomar Phoenix	(2,943)	—	59,703	(171)	—	59,532	59,532	(1,281)	58,251
JW Marriott Denver	(62,411)	9,200	63,183	1,488	9,200	64,671	73,871	(12,250)	61,621
The Landing at Lake Tahoe	—	14,816	24,351	(241)	14,816	24,110	38,926	(531)	38,395
L'Auberge de Sedona	—	39,384	22,204	293	39,384	22,497	61,881	(1,592)	60,289
Lexington Hotel New York	—	92,000	229,368	22,796	92,000	252,164	344,164	(45,686)	298,478
Orchards Inn Sedona	—	9,726	10,180	102	9,726	10,282	20,008	(511)	19,497

Renaissance Charleston	—	5,900	32,511	5,208	5,900	37,719	43,619	(7,135)	36,484
Renaissance Worthington	(82,540)	15,500	63,428	18,037	15,500	81,465	96,965	(23,086)	73,879
Salt Lake City Marriott Downtown	(55,032)	—	45,815	5,701	855	50,661	51,516	(16,944)	34,572
Sheraton Suites Key West	—	49,592	42,958	742	49,592	43,700	93,292	(3,996)	89,296
Shorebreak Hotel	—	19,908	37,525	3,332	19,908	40,857	60,765	(3,847)	56,918
The Lodge at Sonoma, a Renaissance Resort and Spa	(27,633)	3,951	22,720	8,601	3,951	31,321	35,272	(12,233)	23,039
Vail Marriott Mountain Resort & Spa	—	5,800	52,463	17,335	5,800	69,798	75,598	(18,695)	56,903
Westin Fort Lauderdale Beach Resort	—	54,293	83,227	8,767	54,293	91,994	146,287	(8,929)	137,358
Westin San Diego	(63,385)	22,902	95,617	9,123	22,902	104,740	127,642	(16,454)	111,188
Westin Washington, D.C City Center	(62,734)	24,579	122,229	11,802	24,579	134,031	158,610	(21,162)	137,448
Total	$(633,764)	$616,840	$2,377,317	$313,852	$617,695	$2,690,314	$3,308,009	$(556,868)	$2,751,1

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Notes:

A) The change in total cost of properties for the fiscal years ended December 31, 2018, 2017 and 2016 is as follows (in thousands):

Balance at December 31, 2015	$3,125,051
Additions:	
Acquisitions	—
Capital expenditures	61,823
Deductions:	
Dispositions and other	(269,240)
Balance at December 31, 2016	2,917,634
Additions:	
Acquisitions	81,494
Capital expenditures	$68,573
Deductions:	
Dispositions and other	(42,612)
Balance at December 31, 2017	3,025,089
Additions:	
Acquisitions	221,970
Capital expenditures	60,950
Deductions:	
Dispositions and other	—
Balance at December 31, 2018	$3,308,009

B) The change in accumulated depreciation of real estate assets for the fiscal years ended December 31, 2018, 2017 and 2016 is as follows (in thousands):

Balance at December 31, 2015	$419,309
Depreciation and amortization	65,490
Dispositions and other	(42,847)
Balance at December 31, 2016	441,952
Depreciation and amortization	60,023
Dispositions and other	(9,104)
Balance at December 31, 2017	492,871
Depreciation and amortization	63,997
Dispositions and other	—
Balance at December 31, 2018	$556,868

C) The aggregate cost of properties for Federal income tax purposes (in thousands) is approximately $3,151,650 as of December 31, 2018.