Starwood Hotels and Resorts (HOT)

A Great Place to Stay! **June 4, 2009**

Contents

Investment Theme

- *Starwood has made significant progress in making permanent cost cuts*
- *Hotel occupancy should bottom in Q1 2010*
- *Starwood has over $48 per share in assets available for sale*
- *Cash generation will exceed $1 bln over the next 18 months*

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Executive Summary

We are initiating coverage of Starwood Hotels and Resorts with a Buy rating and a $60.00 price target.

Starwood Hotels is one of the world's largest hotel and leisure companies, with a portfolio of owned, leased, managed and franchised hotels totaling 942 properties (285,000 rooms) in over 100 countries at the end of 2008. The current economic slowdown has hit the hotel industry particularly hard, but we believe that room rates are beginning to stabilize and occupancy will increase YOY by the first quarter of 2010. Historically hotel shares rally several months before occupancy begins to recover. In addition, Starwood has made impressive efforts to enact permanent cost reductions that will fuel earnings growth in 2010 and beyond.

Starwood will generate over $1 bln in cash to pay down debt over the next 18 months. In fact, Starwood has $9.13 bln in assets ($7.03 bln in owned hotels, $1.26 bln in VOI properties, $500 mln in VOI receivables and $308 mln in net JV interests) that are essentially held for sale. If Starwood succeeds in liquidating these assets, they will have $34.23 in cash per share remaining after paying down all of their debt at the end of 2010. Despite the sale of their hotel assets, the management and franchise business would likely generate some $642 mln in EBITDA in 2013. At 8X EBITDA, this business would be valued at $5.14 bln, or $27.53 per share.

Financial Summary and Statistics

Current Price: $24.59	Book Value/Share:	$8.39
Price Target: $60.00	Sales/Share (ttm):	$32.64
Market Cap:$4,589 m	Forward PE (e):	25.09X

	F2008	F2009e	F2010e
Revenues	$ 5,907	$ 4,626	$ 5,290
Cost of Sales	$ 2,305	$ 1,747	$ 1,805
Gross Profit	$ 3,602	$ 2,879	$ 3,485
SG&A	$ 477	$ 359	$ 392
Other	$ 2,506	$ 2,156	$ 2,534
Operating Income	$ 619	$ 364	$ 560
Interest/JVs	$ (289)	$ (197)	$ (153)
Taxes	$ 76	$ 41	$ 102
Net Income	$ 254	$ 126	$ 305
EPS (Diluted)	$ 1.36	$ 0.70	$ 1.68
Shares out	186	181	181

Graph Courtesy of Bloomberg

Company Background

Starwood Hotels and Resorts Worldwide, Inc. is one of the world's largest hotel and leisure companies, with a portfolio of owned, leased, managed and franchised hotels totaling 942 properties (285,000 rooms) in over 100 countries at the end of 2008. Currently, 58.08% of their room portfolio is located in North America (including the Caribbean), 21.23% are located in Europe, Africa and the Middle East, 16.33% are located in Asia Pacific and 4.35% are located in Latin America. In addition, Starwood owns twenty six Vacation Ownership (timeshare) resorts in the United States, Mexico and the Bahamas. As of December 31, 2008, Starwood managed 436 hotels on behalf of third party owners (including entities in which Starwood had a minority interest) and received franchise fees from 437 hotels. The remaining sixty nine hotels were owned (at least a majority interest) or leased. Starwood focuses on luxury and upper upscale segment hotels. The Starwood portfolio includes 102 luxury hotel properties, 678 upper upscale hotels and 153 select service hotels, as can be seen on the following graphic:

Starwood Hotels company presentation

Starwood maintains a competitive advantage with their attention to detail and desire to create exceptional customer experiences. The Starwood loyalty program, Starwood Preferred Guest, has grown to include more than forty seven mln members. When a guest first arrives at a Starwood property, their initial experience is managed down to the smallest detail including lighting, music and scents. The valet and registration staff provide impeccable service - for example the W Hotels have a signature "Whatever/Wherever" service standard. Once a traveler reaches their room, they typically find a well laid-out space offering extra touches such as the "Heavenly Bed" and "Heavenly Bath" at the Westin, as well as available in-room spa treatments. Starwood also strives to align their properties with recent consumer trends. The bars and lounges in the W hotels, for example, are styled to be "on trend," the Westin offers a natural 'Superfoods' menu and the new Element hotels are all LEED certified, "depicting the importance of the environment in today's world."

Starwood's revenues and earnings are derived primarily from hotel operations. In 2007, prior to the current economic downturn, 39.48% of total revenues were generated by owned, leased and consolidated hotels, 16.67% were generated by Vacation Ownership and residential sales/services, 13.64% were management and franchise fees and 30.23% of revenues were direct costs related to the operations of managed hotels that were offset by an equal expense item. In the most recent quarter, 34.53% of revenues were generated by owned, leased and consolidated hotels (despite a 4.45% decline in the number of available rooms), 12.08% were generated by vacation ownership and residential sales/services, 14.76% were management and franchise fees (due to a 4.52% increase in the number of managed and franchised hotel rooms) and 38.64% of revenues were direct costs related to the management of hotels. Revenues tumbled by 21.87% from the first quarter of 2007 to the first quarter of 2009.

Allocating SG&A on a revenue basis, the owned, leased and consolidated hotels segment provided 27.42% of the total $1,218 mln 2007 EBITDA (ex-charges), the Vacation Ownership and residential sales/services segment generated 11.90% and the management and franchise business generated 60.67%. During the first quarter of 2009, the owned, leased and consolidated hotels segment provided a very slight EBITDA loss on this basis, the Vacation Ownership and residential sales/services segment generated 6.99% of EBITDA (ex-charges) and management and franchise fees generated 93.32% of total EBITDA in the first quarter of 2009. Total EBITDA (ex-charges) fell by 33.15% from the first quarter of 2007 to the first quarter of 2009, to $153 mln.

Starwood has a $4.73 bln market value with $76 mln in cash and $3.96 bln in debt, making the enterprise value $8.64 bln. Total assets at book value are $9.30 bln, which are comprised of 66.85% hotel-related assets, 24.04% Vacation Ownership/residential assets and 9.12% corporate assets.

The Big Picture

With any long idea, especially a somewhat controversial one like Starwood Hotels, it is often just as important to disprove the bear case as it is to prove the bull case. It is easy to see why investors are wary of Starwood shares: Starwood operates a large timeshare and residential sales unit; They actively engaged in the securitization of timeshare receivables; Starwood owns 67 Hotels amidst a global decline in real estate values; Domestic hotel occupancy is down more than 7% so far in 2009 while national room supply growth will peak this year at an estimated 2.9% increase and, finally, Starwood has loaned money to third party hotel operators.

The reality is that Starwood is actually pretty well positioned for the downturn and the management appears to be doing everything right. As we examine the 'Big Picture' and 'Unit Economics' of Starwood, we will address the bear case as well as highlight the opportunities that we see in owning the shares. Starwood is a relatively difficult company to come to terms with and model: There are basically three approaches to valuing Starwood and depending on the economic climate, 'the market' appears to favor one of the three methodologies to determine the share price. In an economic downturn, the market is concerned with cash generation and debt maturities. We believe the shares are currently being evaluated on this criteria. As conditions for the hotel industry stabilize (we believe this is already happening) and the economy finds its footing, cash flow concerns will fade and 'earnings power' or 'normalized earnings' will be the focus du jour. Finally, Starwood is an asset play and we believe the shares will eventually (late 2010?) trade based on the potential for asset disposals and the total net asset value relative to the enterprise value of the company.

Starwood shares fell from a high of $75.09 on July 13th, 2007 to a low of $9.52 on March 6th of this year, largely due to concerns that a liquidity crisis would emerge. With nearly $4 bln in total debt and a market cap of $2.4 bln at the lows, the balance sheet was clearly stretched. To make matters worse, the company had $3.54 bln (1.48X their market cap) in net PP&E, largely comprised of hotel and timeshare properties. Their most restrictive debt covenant stated that leverage could not exceed 4.5X trailing EBITDA. Management had guided that 2009 EBITDA would be around $800 mln, yielding $3.6 bln in borrowing capacity available by year-end based on their covenants - below the $3.96 bln in debt at the end of the first quarter. In addition, Starwood faced a $500 mln debt maturity on June 29, 2009.

Cash generation was also a concern to investors. Despite asset sales totaling $453 mln from 2007 to 2008, during a period of strong earnings, Starwood's total debt increased from $2.63 bln at the beginning of 2007 to the current $3.96 bln. The problem was that Starwood, like most hotel operators (see the Lodging Market Overview at the end of this report) was making significant investments in new properties. In 2008 Starwood invested $282 mln for improvements at their owned hotels after spending $211 mln in 2007. In addition, the company invested $363 mln in Vacation Ownership CapEx in 2008 and $448 mln in 2007. Lastly, as the ultimate sign of the times, Starwood tore down their Bal Harbor, Florida hotel at the end of 2007 and began construction of the massive $700+ mln St. Regis Resort and Residences property with 268 residences, 36 condo/hotel suites, 183 hotel rooms and 24 fractional ownership residences. Construction at the new St. Regis Resort is ongoing through 2010, with $47 mln being spent on the property in Q109 alone.

It is clear why investors were (and are) worried about the liquidity situation at Starwood. We believe that investors are slowly becoming more comfortable with the cash generation prospects of Starwood, but is not yet entirely confident. On April 30th Starwood launched and priced a $500 mln debt offering to replace the debt due June 29th. The new senior notes, due Oct 15, 2014, have a coupon rate of 7.875% and a YTM of 8.75%. In addition, Starwood renegotiated the covenants on their existing credit agreement to increase the leverage requirement from 4.5X EBITDA to 5.5X EBITDA, without reducing the size of the facility, although they incurred a 200bp increase in the interest rate margins. In addition, EBITDA is now adjusted to exclude cash restructuring costs "up to a certain limit."

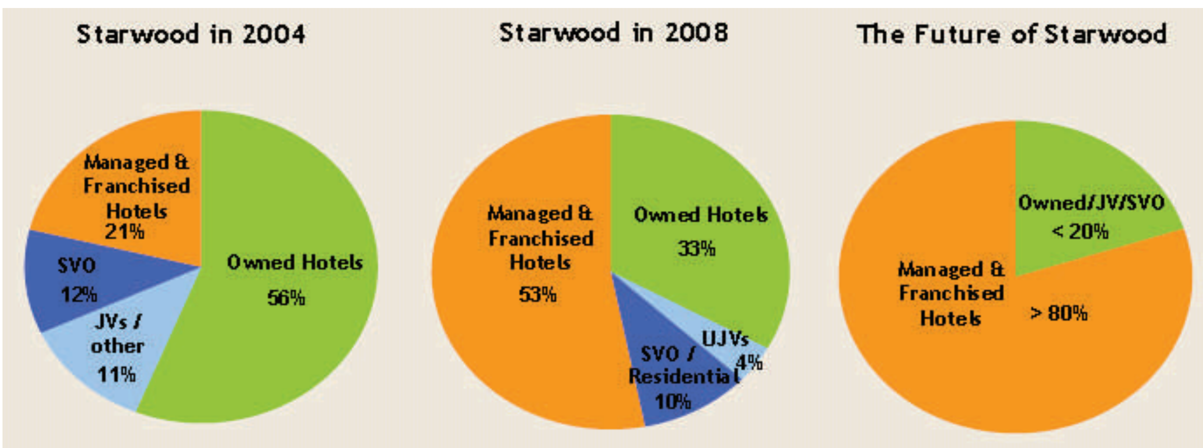
With the pending debt maturity and covenant issue out of the way, cash generation will be key. The upside to the spending spree of the past two years is that by the time Starwood opens their 1,000th managed/franchised/owned hotel at the end of 2009, 250 will be less than three years old and 350 will be freshly renovated. In fact, on the first quarter conference call Starwood management stated that 2009 CapEx would decline by 60% to $100 mln. Project spending will be $175 mln in 2009, largely due to ongoing construction at the St. Regis Bal Harbor. Management has guided that the owned hotel portfolio will provide 'significant' free cash flow in 2009 and the Vacation Ownership segment, despite a 30%+ decline in revenues, will throw off positive cash flow during the year.

In addition to the cash flow generation of the operating segments, Starwood is expecting to receive a $200 mln tax settlement from the IRS, relating to their 1998 disposal of ITT World Directories, before the end of the Summer. Starwood also expects to generate cash through the securitization of Vacation Ownership Interest (VOI) receivables. Prior to 2007, Starwood was able to securitize these receivables and generate cash immediately. As the debt markets froze, the VOI securitization market disappeared. Starwood believes that the securitization market has been reopened and expects to sell between $110 mln and $125 mln of VOI receivables 'at a small loss' within the next few weeks. During the fourth quarter Starwood held $446 mln in VOI receivables.

A combination of free cash flow generation, the pending $200 mln tax refund and a $110+ mln VOI receivable securitization will provide "$500 mln in debt pay-down in 2009." In addition, management has stated that they can increase their ability to pay down debt this year via owned hotel sales, additional VOI receivable securitizations, further cuts in capital spending and further hotel expense/SG&A cuts. On the first quarter conference call they stated rather confidently that they will raise another "$500 mln above and beyond the bond proceeds" over the next three to six months. Our model shows that their goal is easily attainable - we forecast that net debt should fall by $600+ mln during 2009. In 2010, with an additional $120 mln VOI receivable securitization, we forecast that net debt will fall by an additional $600 mln prior to any asset sales.

We believe that 'the market' will become confident over the next one to two quarters that Starwood will not face liquidity or covenant issues and the focus of investors will shift toward earnings. Over the past ten years - a period of extreme highs (2007) and lows (2002), the average PE of Starwood shares was 22.44X. During the same time period, the S&P500 PE averaged 18.97X. Starwood thus traded at a 18.29% premium to the overall market. In a world where market multiples will likely average 12X-15X going forward, Starwood should thus have a forward PE of 14.19X to 17.74X (15.97X at the midpoint). Our preliminary 2010 EPS estimate of $1.83 ex-charges (detailed in the 'Unit Economics' section of this report) incorporates a 7.2% recovery in RevPAR and 2% average GDP growth. A PE multiple of 15.97X would yield a price target of $29.23 - 15.17% above the current share price. In past recoveries, however, Starwood has traded at over 30X earnings as the prospects for the lodging market improved. In addition, remember that Starwood will pay down over $600 mln in debt in 2010, according to our forecasts, and continue to grow the total number of rooms in their network by nearly 6%. We think this is a compelling enough reason to buy the shares today.

As the hotel and debt markets stabilize, what becomes *really* interesting is the potential for Starwood to become an asset play. Starwood has been on a crusade to sell owned hotel assets over the past three years, retaining lucrative management and franchise rights, on their path to become an asset-lite company. Since 2006, Starwood has sold 56 hotels for approximately $5 bln. Their strategy and transformation is detailed in the following graphic, which shows EBITDA generation by segment over time:

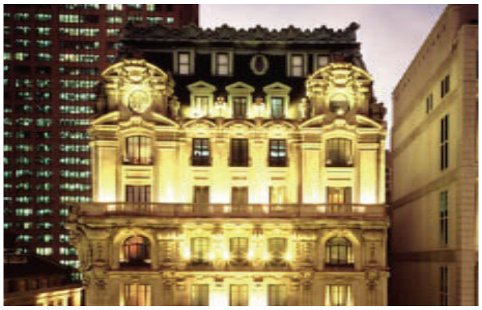


Starwood Hotels

Starwood currently owns and leases 67 hotels with a total of 22,834 rooms. We believe that three of these hotels (800 rooms) are on lease and the rest are owned. To determine the asset value of the 64 owned hotels (22,034 rooms), we combine three methodologies: The first is to estimate their value on a 'per key' (room) basis. Recent transactions have average $380,000 per key: three Monaco hotels in the U.S. were sold in September for $315,000 per key, HOST acquired six European hotels in late 2008 for $400,000 per key, the Starwood Lido sold in the fall of 2008 for over $500,000 per key and the Westin Turnberry was sold by Starwood in the fourth quarter for $452,000 per key. Keep in mind that the Starwood owned portfolio includes many trophy assets, as detailed on the following page, and that these benchmark valuations were all achieved in 2008.

Starwood Owned Hotels

A Portfolio of Trophy Assets

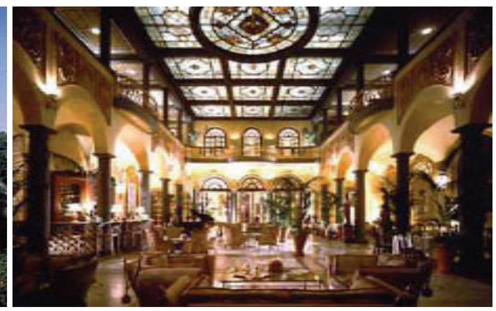

St. Regis New York


St. Regis Grand Rome


The Phoenician (Scottsdale)

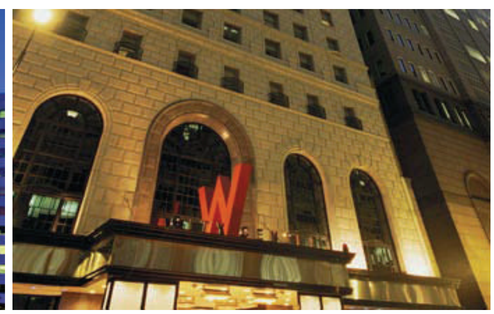

Gritti Palace - Venice


Hotel Alfonso XIII - Seville

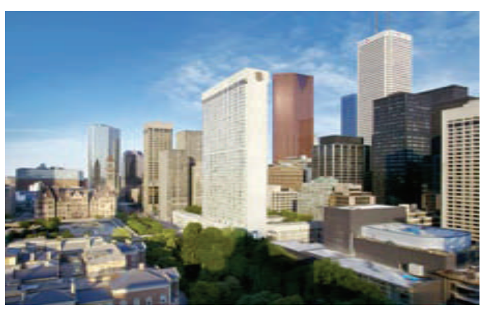

Grand Hotel - Florence

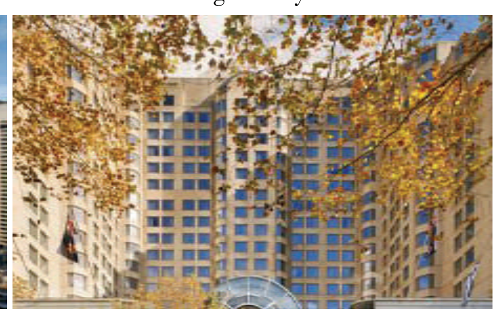

Westin Excelsior - Rome


W San Francisco


W Chicago - City Center


Park Lane Sheraton - London


Sheraton Centre - Toronto


Sheraton on the Park - Sydney

Applying a $380,000 per key valuation to the 22,034 owned rooms, the portfolio is worth some $8.37 bln, slightly below the current enterprise value of Starwood Hotels. The second valuation method uses the asset cap rate to value the owned hotels. According to PWC, the long-term average cap rate for full service hotels is 7.6% (although cap rates fell to under 6% in 2007 and early 2008). Based on our estimated $451 mln TTM EBITDA for the owned hotels segment, a 7.6% cap rate would yield a $5.93 bln net asset value for the owned portfolio. A third method of valuing hotel assets is to apply a historical average of 3.2X trailing revenues. Based on the current trailing twelve month (TTM) revenues of $2.09 bln, the Starwood owned portfolio is worth $6.67 bln. Using a three year average revenue base for the calculation, the portfolio value increases to $7.41 bln.

It is reasonable to expect that the net asset value of the owned portfolio is somewhere between $5.93 bln and $8.59 bln. The average of the three approaches, using TTM metrics, is $7.06 bln. While we believe that the owned hotel assets are more likely to be worth in excess of $8 bln, we will use $7 bln as the estimated asset value. The sale of these assets alone would be sufficient to pay down the forecasted $2.74 bln of debt outstanding at the end of 2010 and provide $23 per share in cash to Starwood shareholders. To pay down all of the anticipated end of 2010 debt, Starwood would need to sell only 39% of the owned hotel portfolio. To put the calculations another way, Starwood could realize a mere $124,000 per key on their owned hotel assets and still pay off all of their outstanding debt at the end of 2010. Every $10,000 per key delta equates to $1.18 in cash per share received from the liquidation of the owned hotel portfolio.

Starwood has previously stated that their Vacation Ownership business is worth 'at least the book value of $1.4 bln.' We note that the fee income from annual maintenance fees likely offset the expenses of operations and give no value to the financing income streams, as the receivables are generally securitized at book value, indicating that the average interest rate of 11.9% is a fair market rate. Starwood reported that they had $888 mln in vacation ownership inventories on the balance sheet in November of 2008. In addition, Starwood has revealed that sales and marketing expenses range from 30% to 40% of revenues, product costs are 25% to 35% and G&A ranges from 5% to 8% of revenues. Starwood has been very aggressive in cutting costs in the VO segment: As revenues declined by 30.4% in the first quarter of 2009, G&A costs fell by 45% and the sales force was reduced by 35%. We think it is reasonable to use the midpoint of the cost ranges as a percentage of revenues in an attempt to value the VOI business - 35% of sales for marketing expenses, 30% of sales for product costs and 6.5% of sales for G&A. As we know the total inventory cost, we can calculate that the total sales value of the current inventory is $2.96 bln. In order to completely liquidate the current VOI inventory, Starwood will spend $1.04 bln on marketing and sales expenses and $192 mln in G&A, leaving undiscounted cash flows of $1.73 bln. On average, sellout at VOI properties occurs over seven years, according to Starwood IR presentations. If we assume that the VO inventory sells over seven years (versus the current estimated run rate of 14.8 years), the annual undiscounted straight-line cash flow stream would be $247 mln per year. Using a discount rate of 12%, the rate that Starwood has historically charged their timeshare buyers on VOI loans, the NPV of the timeshare business is $1.26 bln, or $6.75 per share.

Our $1.26 bln VO asset valuation places no value on the 2,413 potential units that can be built based on owned land and average density in existing marketplaces. At $18,000 per average timeshare week, the revenue opportunity of these potential sites is $2.25 bln and the estimated potential undiscounted net cash flows available from the sale of these sites would be $644 mln.

Starwood currently has $500 mln in VOI receivables on the balance sheet. Some investors that we have spoken to question the value of these receivables, given the current credit environment and the obvious discretionary nature of timeshare purchases. On average, 52% of VOI sales are financed by Starwood. The average borrower makes a 24% down payment, pays a 12% interest rate and has a FICO score of 740. The expected life of the pre-payable notes is 94 months. Default rates have recently been running 6%, below the provision levels of 7.9%.

The pending securitization will go a long way toward establishing an independent valuation on these receivables. As is generally the practice, Starwood will retain a portion of the securitization (likely at least 10%) and their portion will become the first loss tranche. Starwood has the flexibility to do this as they actually hold the underlying asset and the value of asset does not deteriorate if the owner defaults. The 24% average down payment comes reasonably close to covering the sales and marketing expenses of 30% to 40% of revenues. In fact, a buyer that makes all of their payments for the first year of ownership, in addition to a 24% down payment, likely covers all of the fully-loaded expenses incurred by Starwood in the sale of the VOI. After the default, the VOI simply goes back into inventory to be resold.

Starwood owns an average of 25% of the 10,000 hotel rooms in which they have ownership through joint ventures. While these assets may be difficult to sell, especially if Starwood wishes to retain the management contracts, a special vehicle or publicly-traded REIT could be created to provide liquidity. At $380,000 per room, their interest is worth $950 mln. We believe it is prudent, however, to offset the asset value by the $642 mln in unconsolidated JV debt reported at the end of 2008, resulting in a net asset value for the JV hotels of $308 mln, or $1.65 per share.

In total, Starwood has $9.13 bln in assets ($7.03 bln in owned hotels, $1.26 bln in VOI properties, $500 mln in VOI receivables and $308 mln in net JV interests) that are essentially held for sale. After paying off the expected $2.74 bln in debt outstanding at the end of 2010, Starwood would have $6.39 bln, or $34.23 in cash per share remaining. Despite the sale of the majority of their assets, Starwood would be quite profitable hotel management and franchise company. The franchise fee business generated $730 mln in revenues in 2008, with 85% of fees coming from the topline revenues of the franchised hotels, making them significantly less volatile than traditional hotel earnings streams. Using the standard fee base of 4% to 5% of revenues, the sale of the owned hotel portfolio would add an additional $100 mln in incremental management fees as the sale agreements generally include provisions for Starwood to continue to manage the property. If the entire 2008 SG&A is allocated to the remaining businesses, the EBITDA that would have been generated by the current managed hotel and franchise business plus the additional earnings from the previously owned hotels would have generated $400 mln in EBITDA, according to Starwood. This cash stream would be growing by

4% per year due to long-term room rate appreciation. In addition, the current pipeline will expand fees, and earnings, by 40% through 2012. The management and franchise business would likely generate some $642 mln in EBITDA in 2013. At 8X EBITDA, this business would be valued at $5.14 bln, or $27.53 per share. Keep in mind that this valuation implies no recovery in industry RevPAR. EBITDA could easily be 25% higher if worldwide hotel RevPAR increases by 20%. The total value of the cash generated from asset sales, after paying down debt, plus the ongoing management and franchise business would be $60.63. This calculation is the source of our $60.00 price target.

It is important to note that unlike most NAV-based buy ideas, Starwood is actually in the process of selling off their existing assets. Since 2006, Starwood has sold 56 hotels for approximately $5 bln. They sold two hotel assets in late 2008 for a combined total of just over $300 mln and have indicated that they are always looking for opportunities to sell additional assets (they keep a list of their owned assets and locations on their website). Nearly 50% of the current VOI receivables will be securitized over the next twelve to eighteen months, by our estimates. Lastly, the Vacation Ownership division continues to actively sell and market their properties and reinvestment in VOI property will come to a virtual halt. We estimate that in 2007, the VOI group was able to sell over $600 mln in new VOI properties. Despite the current economic turmoil, we estimate that new VOI sales at Starwood are running at roughly $210 mln per year and that total VOI sales in 2009 and 2010 will be $440 mln. If Starwood sells a mere $300 mln in owned hotel assets in 2009 and 2010 combined, along with our forecast $210 mln in VOI receivable securitizations and roughly $380 in net VOI sales (there is some CapEx still occurring while VOI projects are being completed), Starwood will generate $890 mln from asset sales in total in 2009 and 2010. We view this as the *minimum* likely total asset sales and believe that actual asset sales will be significantly higher if debt markets continue to thaw and investors regain their appetite for hotel assets.

The Unit Economics

Starwood's revenues and earnings are derived primarily from hotel operations. In 2007, prior to the current economic downturn, 39.48% of total revenues were generated by owned, leased and consolidated hotels, 16.67% were generated by Vacation Ownership and residential sales/services, 13.64% were management and franchise fees and 30.23% of revenues were direct costs related to the operations of managed hotels that were offset by an equal expense item. In the most recent quarter, 34.53% of revenues were generated by owned, leased and consolidated hotels (despite a 4.45% decline in the number of available rooms), 12.08% were generated by vacation ownership and residential sales/services, 14.76% were management and franchise fees (due to a 4.52% increase in the number of managed and franchised hotel rooms) and 38.64% of revenues were direct costs related to the management of hotels. Revenues tumbled by 21.87% from the first quarter of 2007 to the first quarter of 2009.

Allocating SG&A on a revenue basis, the owned, leased and consolidated hotels segment provided 27.42% of the total 2007 EBITDA ($1,218 mln ex-charges), the Vacation Ownership and residential sales/services segment generated 11.90% and the management and franchise business generated 60.67%. During the first quarter of 2009, the owned, leased and consolidated hotels segment provided a very slight EBITDA loss, the Vacation Ownership and residential sales/services segment generated 6.99% of EBITDA (ex-charges) and management and franchise fees generated 93.32% of first quarter 2009 EBITDA. Total EBITDA (ex-charges) fell by 33.15% from the first quarter of 2007 to the first quarter of 2009 to $153 mln.

The owned/leased hotel segment has a straightforward business model: the company earns revenues based on rented rooms and incurs the expenses of operating, selling and marketing said rooms. These 67 owned/leased hotels, with a total of 22,834 rooms, are quite upscale assets as they include 4,674 Westin rooms (20.47%), 3,174 W Hotel rooms (13.90%), 1,651 Luxury Collection rooms (7.23%), 957 Four Points rooms (4.19%) and 839 St Regis Rooms (3.63%). The remaining rooms are primarily Sheraton-branded. On average, we calculate that the owned hotel rooms earn a 54% RevPAR premium to the overall worldwide system-wide RevPAR reported by Starwood. The number of owned/leased rooms is stable, with the exception of asset sales, making the revenue line almost entirely driven by RevPAR changes. The U.S. dollar effects the RevPAR of owned hotels, with some 35% of owned hotels being outside North America. Worldwide, system-wide RevPAR in USD fell by 11.25% YOY in the fourth quarter of 2008 to $164.46 and by 26.71% YOY in the first quarter of 2009 to $117.78. There are signs that RevPAR is stabilizing (hence the recent rally in hotel stocks). In fact, MGM recently spoke of raising rates in their most recent conference call. In addition, the U.S. dollar has weakened considerably over the past few weeks, aiding international RevPAR in USD.

We have modeled that RevPAR at Starwood will increase slightly to $118.15 (-35.46% YOY) in the second quarter before recovering to $123.66 in the third quarter and slowly climbing to $134.98 by the end of 2010, with 2/3 of the gain fueled by a projected 10% decline in the value of the U.S. dollar from first quarter levels. It is important to note that rates do not necessarily need to increase to meet our RevPAR forecast. A likely scenario is that rates only increase slightly (one to two percent) through the end of 2010 and occupancy improves by three to four percentage points. Any combination of rates and occupancy will allow RevPAR to reach our forecast. Our outlook is based on the belief that we will not see a strong economic recovery in 2010 (2%ish U.S. GDP growth) and that recent cost cutting by hotel operators will permanently decrease average room rates going forward as the entire industry has been successful in cutting costs. Excluding any further asset sales, we forecast that revenues from owned/leased hotels will fall from $2.43 bln in 2007 and $2.26 bln in 2008 to $1.56 bln in 2009 and $1.66 bln in 2010.

We estimate that fixed direct owned/leased hotel operating costs are currently $260 mln per quarter and that variable direct costs currently vary by 52% of incremental RevPAR. As direct owned/leased hotel operating costs have fallen from $440-$460 mln per quarter in late 2007 and the first half of 2008 to $334 mln in the most recent quarter, the variability of direct operating costs is disappearing as some 78% of direct operating are now estimated to be fixed costs. Owned/leased hotel revenues fell from $560 mln in the prior year first quarter to $386 mln in the first quarter of 2009 - a decline of $174 mln, or 31.1%. Direct expenses at owned/leased hotels fell from $438 mln to $393 mln - a decline of only $45 mln, or 25.8%. For those investors that think in percentages, operating costs as a percentage of revenues have increased from a range of 72.71% - 78.00% between Q1 2007 and Q4 2008 (as revenues varied from $559 mln to $634 mln per quarter) to 86.53% of revenues in the first quarter of 2009. With only a slight RevPAR recovery expected at owned hotels before the end of 2010, direct expenses will average 84.49% of revenues in 2009 (up from 76.23% in 2008) and 81.97% in 2010. Gross profits from owned/leased hotels is expected to fall from $537 mln in 2008 to $242 mln in 2009 and recover to $301 mln in 2010. Net income is further leveraged to this segment as the majority of the expected 2009 depreciation expense of $265 mln can be allocated to the owned/leased hotel segment. Starwood does not disclose the breakdown of depreciation expenses, but in the most recent quarter the hotel segment held 66.8% of total company assets and the allocation of corporate assets to the owned/leased hotel group would bring the total asset share to 71.9%. It is important to note that this segment will be the key to earnings variability going forward as it is largely a fixed cost business at this point. We forecast that a 1% change in RevPAR in owned/leased hotels in 2009 (from a base estimate of $186) will impact operating earnings by an estimated $7.9 mln pre-tax and fully-taxed EPS by $.0306. A 1% change in RevPAR in owned/leased hotels in 2010 (from a base estimate of $200) will impact operating earnings by an estimated $8.0 mln in and fully-taxed EPS by $.032.

The Vacation Ownership and residential sales segment has been the most affected by the economic downturn. Revenues in the first quarter were $135 mln, a decrease of 30.05% from the prior year first quarter and a decline of 41.81% from the first quarter of 2007. We estimate that $50 mln of the $135 mln in revenue recognized during the first quarter 2009 was from the actual resale of Vacation Ownership Interests (VOIs). The remainder was primarily ongoing annual maintenance fees for VOI holders. VOI sales declined by 50% YOY in the first quarter, according to Starwood management. The actual number of contracts were lower by 34.6% and the average sales price fell by 24.6%, to approximately $18,000. Starwood management is quick to point out that the decline in sales price was primarily due to a mix shift rather than extensive discounting.

Starwood has made significant investments in VOI inventory over the past three years. The company held $888 mln in VOI inventories in November of 2008 with an estimated sales potential of $3 bln. While we do not forecast that VOI sales will reach the euphoric levels seen during the past couple of years, there have been signs that the timeshare market has stabilized and we predict that new VOI sales will increase from the current level of $50 mln per quarter, on average, to $65 mln per quarter by the end of 2010. Starwood's VOI inventory would cover 14.8 years of sales at the current $209 mln annual rate. We forecast that total VOI segment revenues will be $556 mln in 2009 and $583 mln in 2010.

The expenses for the VOI and residential sales/services segment are a combination of the operating expenses for the VOI properties (offset by annual maintenance fees paid by VOI owners) and sales/marketing costs related to sales of new timeshare interests. In the first quarter of 2009, Starwood recorded $106 mln in total VOI/residential expenses. We estimate that $85 mln was related to providing the ongoing services at the VOI properties (and were offset by a roughly equal maintenance fee income) and $20 mln was spent on sales and marketing of VOI and residential properties. Starwood has been very aggressive in cutting costs in the VOI segment: As revenues declined by 30.4% in the first quarter, G&A costs fell by 45% and the sales force was reduced by 35%. The segment provided $52 mln in gross profits in the first quarter of 2009, down 42% from $122 mln in the first quarter of 2008 as VOI sales revenues declined by 50%. We expect VOI/residential expenses to total $428 mln in 2009 (down from $583 mln in 2008) and $441 mln in 2010. Gross profits should be $128 mln in 2009 (down from $166 mln in 2008) and $142 mln in 2010. The key to earnings in the VOI/residential sales segment will be new VOI sales. The current incremental profit margin on the sale of a VOI is 65%. We forecast that a 1% change in VOI sales revenue in 2009 (from a base estimate of $209 mln) will impact operating earnings by an estimated $1.36 mln pre-tax and fully-taxed EPS by $.0055. In 2010, a 1% change in VOI sales revenue from our base estimate of $233 mln will impact operating earnings by an estimated $1.52 mln and fully-taxed EPS by $.0061.

Management and franchise fees are the core focus of the Starwood strategy going forward. The franchise business generated $730 mln in revenues in 2008. Roughly 85% of these fees were based on the top-line revenues of the franchised hotels (Starwood generally earns 4% to 6% of hotel revenues), making this revenue stream significantly less volatile than traditional hotel earnings. RevPAR is thus very important to the management and franchise segment, as is the U.S. dollar: 39.2% of franchise fees came from outside the United States in 2008 and 63.9% of management fees were from outside the Untied States. Total revenues for the management and franchise segment were $857 mln in 2008.

While management and franchise fees have no offsetting expense item on the income statement, in valuation examples Starwood management encourages that the company's entire SG&A be expensed to the management and franchise fee revenues. This is probably aggressive, as SG&A expenses should be allocated to the other divisions, but we believe that management wants to make every effort to disguise the profitability of the management and franchise business. The total company-wide SG&A in 2008 was $477 mln, making the estimated gross profit of the management and franchise fee business $380 mln after allocating 100% of SG&A to this segment. If SG&A were allocated based on revenues, the estimated gross profit of the management and franchise fee business would have been $788 mln in 2008. The truth is likely in between these figures.

Starwood management has stated that despite a roughly 50% hedging policy for the forward 12 months, a 1% change in the trade-weighted USD impact overall EBITDA by $5 mln. We believe that the majority of this impact is in the management and franchise business due to the large profit contribution and the nature of the costs being dollar based. Using company-wide SG&A as the cost basis for the management and franchise business, gross profits were $326 mln in 2007, $380 mln in 2008 and we project that they will be $324 in 2009 and $450 mln in 2010.

Our 2010 gross profit forecast seems aggressive at first, but Starwood is on track to take $100 mln in annual expenses out their businesses and SG&A has been declining faster than revenues over the past few quarters. In fact, in 2006 and 2007, SG&A averaged 63.99% of management and franchise revenue versus 56.36% in the most recent quarter. We believe that SG&A as a percentage of management and franchise revenue will fall to 50.17% by the third quarter of 2009 and remain at these levels through 2010.

In addition to expense cuts, the number of hotels under management or franchise agreement is continuing to grow. In 2008, eighty seven hotels were added to this segment, providing 10% gross unit additions. In 2009, 80-100 new openings will occur (65% outside the United States). We expect that managed and franchised hotels will realize net room growth of 6.33% in 2009 and 5.61% in 2010. It was encouraging that in the first quarter of this year Starwood signed eighteen new hotel management and franchise agreements totaling 4,900 new rooms. A strong new-build market is not required for growth as Starwood can convert existing hotels into their network. When credit markets are difficult, Starwood has the ability to provide capital to hotel owners to pay for renovations to convert to Starwood brands as well as modernize facilities. The current 95,000 room management and franchise segment pipeline (35.64% of the current 266,586 rooms) does not require capital investments by Starwood in 'roughly 99% of cases,' according to Starwood.

Other revenues from managed and franchised properties are reimbursed costs booked as revenues, but exactly offset by the related expense on the income statement. These expenses are billed to the hotels that Starwood provides services to at cost. This includes a significant portion of their pension expense as well.

As we put the model together, we forecast total revenues of $1,107 mln in the coming second quarter (vs. $1,056 mln cons) and EPS ex-charges of $.14 ($.08 headline EPS after securitization and restructuring charges), versus $.17 consensus. While we generally are uncomfortable being below consensus estimates with any buy idea, we believe investors will look beyond the current quarter as there are increasingly signs that RevPAR is stabilizing and hotel/lodging stocks generally anticipate the stabilization by several months, as you can read in our Lodging Market Overview beginning on page 18 of this report. In addition, if the sharp decline in the U.S. dollar continues, there will be upside to second quarter earnings versus our estimate. Our full-year estimates for 2009 predict $4,626 mln in revenues ($4,283 mln cons) and $1.10 in EPS, ex-charges ($.80 headline EPS), versus $.77 EPS consensus (ex charges). In 2010 we forecast $5,290 mln in revenues and $1.83 in EPS, ex-charges ($1.70 headline EPS) versus consensus estimates of $4,239 mln in revenues and $.75 in EPS. We should note that if we adjust consensus estimates for our projection of a 10% weaker USD versus Q109 by the end of 2010, consensus EPS would increase to roughly $1.01 in 2010.

Financials

Model Inputs												
Owned Rooms	22,834	22,834	22,834	22,834	22,834	22,834	22,834	22,834	23,600	24,366	24,366	24,700
Managed/Franchised Rooms	293,319	289,342	285,418	281,548	277,731	273,965	270,250	266,586	261,200	258,375	255,550	252,725
WorldWide System-Wide RevPAR	134.98	133.19	124.84	126.85	125.32	123.66	118.15	117.78	164.46	169.54	183.05	160.70
WorldWide System-Wide RevPAR YOY	7.70%	7.70%	5.67%	7.70%	-23.80%	-27.06%	-35.46%	-26.71%	-11.25%	-0.25%	6.75%	9.34%
Trade Weighted Dollar	71.00	70.00	72.00	74.00	76.00	76.00	78.71	82.51	81.55	73.47	70.86	71.97

Income Statement	Q4 2010e	Q3 2010e	Q2 2010e	Q1 2010e	Q4 2009e	Q3 2009e	Q2 2009e	Q1 2009	Q4 2008	Q3 2008	Q2 2008	Q1 2008
REVENUES												
Owned, leased and Consolidated JV Hotels	432	426	399	406	401	396	378	386	504	575	620	560
Vacation ownership and residential sales/services	153	147	142	142	146	140	135	135	136	226	194	193
Management fees, franchise fees and other	210	206	187	185	178	173	160	165	211	218	218	210
Other revenues from managed and franchised properties	604	598	535	519	490	477	434	432	482	516	541	503
Total Revenues	1,398	1,377	1,263	1,252	1,215	1,186	1,107	1,118	1,333	1,535	1,573	1,466
COSTS AND EXPENSES												
Owned, leased and consolidated JV Hotels	349	346	333	336	333	331	321	334	393	437	454	438
Vacation ownership and residential sales/services	114	111	108	108	110	107	104	106	111	155	159	158
Selling, general, administrative and other	107	101	93	91	89	88	89	93	92	113	138	134
Restructuring and other special (credits) charges, net	5	5	5	5	5	3	3	17	109	22	1	9
Depreciation	54	57	59	60	63	66	68	70	75	73	72	71
Amortization	7	7	7	7	7	7	7	7	6	10	9	7
Other expenses from managed and franchised properties	604	598	535	519	490	477	434	432	482	516	541	503
Total Costs and Expenses	1,241	1,225	1,138	1,126	1,098	1,078	1,027	1,059	1,268	1,326	1,374	1,320
Operating Income	158	152	125	125	117	108	81	59	65	209	199	146
Equity earnings and g/l from unconsolidated Ventures, net	3	2	(1)	(3)	(4)	(4)	(5)	(5)	2	3	5	6
Interest expense, net of interest income	(35)	(35)	(37)	(37)	(37)	(38)	(46)	(43)	(57)	(48)	(55)	(47)
Gain on asset dispositions and impairments, net	-	-	-	(10)	-	-	(10)	(5)	(86)	(12)	1	(1)
Income from continuing ops before taxes and minority equity	126	119	87	75	76	66	20	6	(76)	152	150	104
Income tax (expense)/benefit	(31)	(30)	(22)	(19)	(19)	(16)	(5)	(1)	30	(38)	(42)	(26)
Minority equity in net loss	-	-	-	-	-	-	-	-	-	(1)	(1)	1
Income from continuing operations	94	89	65	56	57	49	15	22	(46)	113	107	79
Gain (loss) on dispositions, net of tax	-	-	-	-	-	-	-	(1)	124	-	(2)	(47)
Cumulative effect of accounting change, net of tax	-	-	-	-	-	-	-	-	-	-	-	-
Net Income	94	89	65	56	57	49	15	21	78	113	105	32
Earnings (Loss) per Share - Basic												
Continuing operations	0.527	0.499	0.363	0.314	0.318	0.275	0.082	0.123	(0.254)	0.628	0.582	0.429
Discontinued operations	-	-	-	-	-	-	-	(0.006)	0.685	-	(0.011)	(0.255)
Cumulative effect of accounting change	-	-	-	-	-	-	-	-	-	-	-	-
Net Income per share	0.527	0.499	0.363	0.314	0.318	0.275	0.082	0.117	0.431	0.628	0.571	0.174
Earnings (Loss) per Share - Diluted												
Continuing operations	0.521	0.493	0.359	0.310	0.315	0.272	0.081	0.122	(0.249)	0.617	0.569	0.418
Discontinued operations	-	-	-	-	-	-	-	(0.006)	0.670	-	(0.011)	(0.249)
Cumulative effect of accounting change	-	-	-	-	-	-	-	-	-	-	-	-
Net Income per share	0.521	0.493	0.359	0.310	0.315	0.272	0.081	0.116	0.422	0.617	0.559	0.169
Weighted average number of shares	179	179	179	179	179	179	179	179	181	180	184	184
Weighted average dilluted number of shares	181	181	181	181	181	181	181	181	185	183	188	189

Balance Sheet	Q4 2010e	Q3 2010e	Q2 2010e	Q1 2010e	Q4 2009e	Q3 2009e	Q2 2009e	Q1 2009	Q4 2008	Q3 2008	Q2 2008	Q1 2008
Current assets												
Cash and cash equivalents	404	428	373	278	309	248	171	76	389	127	128	214
Restricted cash	17	21	27	34	42	52	66	82	96	194	172	240
Accounts receivable, net of ada	266	265	265	267	382	386	392	513	552	630	626	625
Inventories	1,164	1,154	1,141	1,123	1,103	1,081	1,057	1,025	986	948	896	804
Prepaid expenses and other	143	170	172	168	143	170	172	168	143	170	172	163
Total current assets	1,995	2,038	1,978	1,870	1,980	1,938	1,857	1,864	2,166	2,069	1,994	2,046
Investments	210	226	243	261	281	302	325	359	372	384	429	425
Plant, property and equipment - net	2,751	2,859	2,958	3,053	3,178	3,308	3,427	3,540	3,599	3,717	3,810	3,840
Assets held for sale	-	-	-	-	-	-	10	10	10	164	183	101
Goodwill and intangible assets, net	2,155	2,165	2,175	2,185	2,195	2,205	2,215	2,225	2,235	2,263	2,279	2,295
Deferred tax assets	761	729	700	678	659	640	624	619	639	723	699	747
Other assets	565	565	565	565	565	565	565	685	682	573	541	519
TOTAL ASSETS	8,437	8,583	8,618	8,612	8,858	8,959	9,023	9,302	9,703	9,893	9,935	9,973
Current liabilities												
Short-term borrowings and current debt maturities	5	5	5	5	5	5	5	5	506	541	571	4
Accounts payable	179	176	162	160	155	152	142	173	171	198	185	190
Accrued expenses	1,340	1,323	1,229	1,216	1,185	1,165	1,109	1,099	1,274	1,171	1,164	1,152
Accrued salaries, wages and benefits	396	417	392	288	370	389	366	269	346	364	342	317
Accrued taxes and other	391	343	301	365	391	343	301	365	391	343	301	376
Total current liabilities	2,311	2,264	2,089	2,034	2,107	2,054	1,922	1,911	2,688	2,617	2,563	2,039
Long-term debt	2,742	2,792	2,992	3,142	3,392	3,392	3,492	3,953	3,502	3,533	3,483	4,111
Deferred income taxes	26	28	32	30	26	28	32	30	26	28	32	29
Other liabilities	1,695	1,713	1,731	1,749	1,767	1,785	1,803	1,821	1,843	1,812	1,839	1,826
TOTAL LIABILITIES	6,774	6,797	6,844	6,955	7,292	7,259	7,249	7,715	8,059	7,990	7,917	8,005
Minority interest	21	21	21	21	21	21	21	21	23	25	26	25
Commitments and contingencies	-	-	-	-	-	-	-	-	-	-	-	-
Stockholders' equity												
Common stock, $.01 par	2	2	2	2	2	2	2	2	2	2	2	2
Additional paid-in capital	490	490	490	490	490	490	490	490	493	490	602	679
Accumulated other comprehensive income (loss)	(625)	(625)	(550)	(600)	(629)	(400)	(277)	(449)	(391)	(217)	(102)	(123)
Retained earnings	2,093	1,898	1,809	1,744	1,688	1,587	1,538	1,523	1,517	1,603	1,490	1,385
TOTAL STOCKHOLDERS' EQUITY	1,960	1,765	1,751	1,636	1,551	1,679	1,753	1,566	1,621	1,878	1,992	1,943
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	8,755	8,583	8,616	8,612	8,864	8,959	9,023	9,302	9,703	9,893	9,935	9,973

Financials

Statement of Cash Flows	Q4 2010e	Q3 2010e	Q2 2010e	Q1 2010e	Q4 2009e	Q3 2009e	Q2 2009e	Q1 2009	Q4 2008	Q3 2008	Q2 2008	Q1 2008
OPERATING ACTIVITIES												
Net income	94	89	65	56	57	49	15	4	79	113	105	32
Adjustments to net income:												
Discontinued operations:												
Gain (loss) on dispositions, net	-	-	-	-	-	-	-	1	(124)	-	2	47
Depreciation and amortization	61	64	66	67	70	73	75	77	81	83	81	78
Amortization of deferred gains	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(21)	(21)	(21)
Non-cash portion of restructuing and charges	-	-	-	-	-	-	-	1	69	4	1	-
Provisions for doubtful accounts	-	-	-	-	-	-	-	-	64	-	-	-
Gain on asset dispositions and impairments, net	2	2	2	2	2	2	2	5	86	12	(1)	1
Cumulative effect of accounting change	-	-	-	-	-	-	-	-	-	-	-	-
Stock-based compensation expense	24	24	24	24	24	24	16	11	12	16	22	18
Excess stock-based compensation tax benefit	-	-	-	-	-	-	-	-	(1)	3	(18)	-
Equity earnings, net of distributions	-	-	-	-	-	-	-	11	5	4	4	8
Gain on sale of VOI note receivable	-	-	-	(10)	-	-	(10)	(1)	-	-	-	-
Non-cash portion of income tax expense (benefit)	(7)	1	15	1	(7)	1	15	1	(7)	1	15	15
Other non-cash adjustments to net income	9	9	9	9	9	9	9	7	8	2	19	1
Decrease in restricted cash	4	5	7	8	10	13	16	14	99	(21)	68	(44)
Other changes in working capital	15	122	99	24	14	73	161	(115)	(77)	37	(54)	(65)
VOI notes receivable activity, net	-	-	-	120	-	-	110	(19)	215	(72)	(73)	(74)
Accrued and deferred income taxes and other	-	-	-	-	-	-	200	(9)	(310)	60	49	51
CASH FROM OPERATING ACTIVITIES	183	296	266	282	160	224	588	(32)	179	221	199	47
INVESTING ACTIVITIES												
Purchases of plant, property and equipment	(52)	(40)	(35)	(62)	(65)	(51)	(44)	(62)	(139)	(121)	(107)	(109)
Proceeds from asset sales, net	-	-	-	-	-	-	-	-	306	14	-	-
Collection of notes receivable, net	-	-	-	-	-	-	-	-	1	-	(2)	4
Acquisitions, net of acquired cash	-	-	-	-	-	-	-	-	-	-	-	-
Purchases of investments, net	-	-	15	-	15	-	15	-	(61)	8	1	15
Proceeds from investments, net	-	-	-	-	-	-	-	5	39	-	-	-
Other, net	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(6)	(5)	(3)	4	(17)
CASH FROM (USED FOR) INVESTING ACTIVITIES	(57)	(45)	(25)	(67)	(55)	(56)	(34)	(63)	141	(102)	(104)	(107)
FINANCING ACTIVITIES												
Revolving credit facility and short-term borrowings, net							(166)	(47)	(69)	33	(1,037)	503
Long-term debt issued	(50)	(200)	(150)	(250)	-	(100)	(300)	-	9	-	977	-
Long-term debt repayments							-	(2)	(1)	(1)	(1)	(1)
Dividend and distributions paid	(100)	-	-	-	(44)	-	-	(164)	-	-	-	(172)
Proceeds from employee stock option exercises	-	-	-	-	-	-	-	-	-	3	50	67
Excess stock-based compensation tax benefit	-	-	-	-	-	-	-	-	1	(3)	18	-
Share repurchases	-	-	-	-	-	-	-	-	-	(134)	(182)	(277)
Other, net	-	-	-	-	-	-	-	(3)	-	(3)	(7)	(16)
CASH USED FOR FINANCING ACTIVITIES	(150)	(200)	(150)	(250)	(44)	(100)	(466)	(216)	(60)	(105)	(182)	104
Exchange rate effect on cash and cash equivalents	-	4	4	4	-	9	6	(2)	13	(15)	1	8
INCREASE (DECREASE) IN CASH AND EQUIVALENTS	(23)	54	95	(31)	61	77	95	(313)	273	(1)	(86)	52

Critical Accounting Policies

From 2008 10K:

Revenue Recognition - Starwood recognizes revenues from their owned, leased and consolidated joint venture properties when rooms are occupied and when services are rendered. Revenues in the Vacation Ownership and residential sales segment are recognized when the buyer has demonstrated a sufficient level of initial and continuing investment, the period of cancellation with refund has expired and any receivables are deemed collectible. Starwood determines the portion of sales to be recognized from properties under construction using the percentage of completion revenue recognition method. Management and franchise revenues are recognized as they are earned. Incentive fees from managed and franchised hotels may be revised during the year as conditions alter the potential incentive fee to be recognized at year end.

Frequent Guest Program - The SPG frequent guest program generates a liability for Starwood as the members of the program earn points that may be redeemed for future stays, among other rewards. The total actuarial determination of this liability is performed by a third party using historical and projected timing of reward redemptions, cost of reimbursing hotels and other third parties for point redemptions and estimates of points that will never be redeemed.

Long-Lived Assets - The carrying value of long-lived assets is evaluated for impairment based on comparing the undiscounted expected future cash flows of the asset to the current book value on the balance sheet.

Loan Loss Reserves - In the Vacation Ownership and residential segment, Starwood records an estimate of the expected uncollectibility on the VOI notes receivable as a reduction of revenue at the time they recognize the profit on the sale of a vacation ownership interest. Uncollectibility is assessed on pools of receivables using static pool analysis, which tracks the uncollectible notes for each year's sales over the life of the respective notes and projects an estimated default rate. In the hotel segment, Starwood evaluates the impairment of a loan based on the present value of expected future cash flows discounted at the loans original effective interest rate or the estimated fair value of the collateral. The loan impairment policy is applied individually to all loans in the portfolio. At Dec. 31, 2008 the average estimated default rate for the receivable pools was 7.9%.

Assets Held for Sale - Starwood considers a property as an assets held for sale when management approves and commits to a formal plan to actively market the property or group of property. Upon designation as an asset held for sale, they record the carrying value of each property or group of properties at the lower of its carrying value which includes allocable segment goodwill, less estimated costs to sell. Starwood also stops recording depreciation expense. The operations of the properties held for sale prior to the sale date are recorded in discontinued operations unless Starwood will have continuing involvement after the sale.

Inventories - Inventories are principally VOIs ($729 mln at Dec. 31, 2008) and residential inventory ($203 mln at Dec 31, 2008) which is carried at the lower of cost or net realizable value. VOI and residential inventories include capitalized interest expense. Hotel inventories include operating food and supplies, as well as linens, china, glass, uniforms and guest room items.

Investments - When the company has a 20% to 50% ownership interest in a joint venture or exercises significant influence over the venture it is accounted for under the equity method. If the company's interest exceeds 50%, or in some cases, if the company exercises control over the venture, the results of the joint venture are consolidates herein. All other investments are generally accounted for under the cost method.

Plant, Property and Equipment - The cost of improvements to extend the life of plant, property and equipment are capitalized. These capitalized costs may include structural improvements, equipment and fixtures. Costs for normal repairs and maintenance are expensed as incurred.

Depreciation - Depreciation is recorded on a straight-line basis over the estimated useful economic lives of 15 to 40 years for buildings and improvements; 3 to 10 years for furniture, fixtures and equipment; 3 to 7 years for IT software and equipment.

Foreign Currency Translations - Balance sheet accounts are translated at the exchange rates in effect at each period end and income and expense accounts are translated at the average rates of exchange prevailing throughout the year. Gains and loses related to foreign exchange rate changes on intercompany receivables are reported currently in costs and expenses.

The Lodging Market

In the first quarter of 2009, Smith Travel Research, Inc (STR) estimated that there were 49,857 hotels in the United States with a total of 4.6 mln rooms. The Bureau of Labor and Statistics (BLS) estimated in 2006 that there were approximately 62,000 establishments 'providing overnight accommodations' with total employment of 1.8 mln jobs. The BLS estimates that 55.4% of lodging providers, or approximately 34,348 are small establishments with less than nine employees. The hotels that most business travelers are accustomed to, large hotels with 50+ employees and 100+ rooms, only represent 4.8% of the number of establishments (approximately 2,976 hotels) but represent over 50% of the total available rooms and 57.9% of total lodging employment. This is the segment of the market that we are most interested in as investors.

The Average Daily Rate (ADR) paid by those seeking lodging in the first quarter was $100.13, according to STR, down 10.9% from the prior year first quarter. Occupancy, or utilization of rooms, was 51.4%, making the Revenue Per Available Room (RevPAR) $51.44 nationally in the first quarter, down 17.7% from the prior year, again according to STR. This resulted in total first quarter industry revenues of $21.5 bln, a decline of 15.1%.

Hotels are generally classified as offering either full-service or limited services. Full-service properties generally offer a variety of services to their guest including food and beverage service, retail shops and boutiques, concierge and valet services, fitness centers and health spas. Limited-service hotels generally have few amenities other than a person at the front desk (who was often dead asleep one minute before you began to check in), housekeeping and perhaps a vending machine or two. Virtually all of the larger hotels, which are of interest to equity investors, are full-service hotels.

Full-service hotels can be further divided by their distinguishing features or additional services: Conference hotels provide meeting and banquet rooms as well as food service and event coordination services. These hotels generally receive more than 50% of their overall revenues from conference-related guests. Resort hotels offer a wide variety of on-site entertainment and facilities such as swimming pools, golf courses, health spas and scheduled social activities and entertainment. Extended-stay hotels provide more home-like rooms which often include kitchen areas and office space to accommodate long-term guests. Lastly, Casino hotels combine lodging, entertainment and gaming in an attempt to extract the maximum revenues out of each guest.

Typically full service hotels receive 65% to 70% of their revenues from their room fees. In general, the smaller the hotel, the greater the percentage of overall revenue comes from the room fees. The large, 300+ room hotels that are typically in a portfolio of a public company generally earn close to 65% of their revenues from room fees. Miscellaneous revenues and rentals (wifi, gift sales, bag fees, ticket charges, porn rentals, etc) are relatively constant across all classifications and sizes of hotels at 5% of overall revenues. The remaining 25% to 30% of revenues come from food and beverage. The larger the hotel, in general, the higher the percentage of revenues from food and beverage.

The bulk of the operating profits at a hotel come from the room fees. Smaller hotels typically have direct room costs (largely housekeeping) equal to 22% to 25% of the room rates. Large hotels (300+ rooms), perhaps surprisingly, have higher direct room costs - often 26% to 28% of room revenues. Food and Beverage operations typically have only 20% to 25% gross margins while other departments and services generally break even or provide a small loss, depending on the nature and the mix of services. Hotel overhead (administrative services, sales, marketing, utilities, common-area upkeep) expenses typically range from 24% to 28% of total revenues. If the overhead is allocated on a revenue basis, the food and beverage operations at hotels basically break even while the miscellaneous revenues and services generate losses. This provides 20% to 22% operating margins at the hotel level, prior to chain marketing, management fees, corporate overhead and financing costs.

Chain hotels are generally divided into five segments, as can be seen on the following table:

Segment	Average Daily Rate	Typical Brands
Luxury	$245.00	Trump, Ritz Carlton, Four Seasons
Upper Upscale	$160.00	Hyatt Regency, Marriott, Sheraton
Upscale	$115.00	Courtyard, Hilton Garden Inn
Midscale	$80.00	Quality Inn, HolidayInn Express, Comfort Inn
Economy	$55.00	Econolodge, Red Roof

Various company filings, Unit Economics 2008 rate estimates

Equity investors are generally focused on the luxury, upper upscale and upscale segments. These hotel assets tend to be located in major urban centers and suburbs and typically provide private equity buyers with the prestige of ownership they enjoy and equity market participants with the cyclicality that they crave.

The top ten hotel markets represent 950,000 rooms, or 20.64% of the U.S. total. The top ten markets are:

Market	Rooms
Las Vegas, NV	157,700
Orlando, FL	114,900
Chicago, IL	106,600
Washington, DC	98,200
LA-Long Beach	95,400
Atlanta, GA	92,500
New York, NY	87,900
Dallas, TX	74,100
Houston, TX	64,800
Phoenix, AZ	57,300

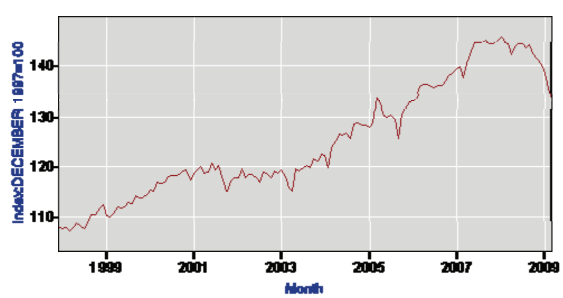
STR/TWR

There is obviously a great deal of diversity within the top ten markets. The two largest markets, Las Vegas and Orlando, are largely convention and tourist-oriented and have felt a greater impact from the current downturn than many urban hotel markets. MGM reported that average room rates in the fourth quarter of 2008 fell by 15% at their Las Vegas Strip resorts, from $156 to $133. Occupancy decreased from 93% in the fourth quarter of 2008 to 85%. Like many hotel operators, MGM was very aggressive in reducing room rates in the first quarter of 2009. By April, room rates at the MGM Mirage had fallen by 30% YOY, but occupancy was back to 2008 (pre-downturn) levels at 97%. Business-oriented destinations such as New York City have seen occupancy rates decline by 10%-14% in early 2009 with room rates declining an average of 8%. Overall RevPAR is thus down 18% to 22% in the first three months of the year.

Part of the regional variation in room rates and occupancy is due to the local supply situation. In general, it takes 48 to 64 months to complete a hotel project after the pre-planning stages are comlpete. Invariably, given the average seven year (84 month) business cycle, maximum hotel supply growth tends to occur at the worst possible times for the industry. The total U.S. room supply was growing at a 4% annual rate in 1989 as the housing market and economy began to turn south. After the growth rate in rooms fell to 1% in 1994, a gradual increase in optimism lifted the rate to nearly 4% in early 2000 - in time for the NASDAQ crash and just prior to 9/11. The hotel industry was quite fortunate that 2005 to 2006 brought no overall supply growth and negative supply growth in some markets as condo developers bid away building sites and hotel operators made selective conversions to condos. In 2008 and 2009, various predictions cluster around slightly less than 3% growth in rooms. By 2010, and likely continuing through 2013 or 2014, the room growth rate should be less than 1% per annum.

Over the past twenty years, the average annual increase in hotel room demand has been 3.5%. The current room construction up-cycle, which will peak in dramatic fashion in mid-2009, was the first cycle in the twenty years of available data during which the peak supply growth rate in did not exceed the *average* demand growth rate over a full cycle. We view this as incredibly positive for the hotel group in general.

The supply/demand environment for hotel rooms has an exaggerated effect on hotel operator revenues. As demand (and occupancy) falls, room rates decline. The inverse is also true. The following chart, using BLS data, displays average room rates, in seasonally-adjusted 1997 dollars, over the past ten years:



An interesting aspect of the current downturn is that rates have fallen quite significantly while room demand is down only 3.3% nationally (versus 4.8% in the post-9/11 period.) Hotel operators have been willing to accept lower rates in order to maintain occupancy levels, as we discussed with MGM on the previous page, and focus on cost-cutting to maintain profitability. Hotel operators have been able to reduce operating leverage over the past two year by selling hotel assets to private equity funds who were eager to put money to work, while the hotelier maintained the operating and management contracts.

The share prices of public hotel operators have a tendency to fall hard and early in a downturn before churning along the bottom while the overall economy finds its footing, limiting downside. The hotel shares also tend to make their final bottom four to six months before occupancy begins to increase YOY; or stated differently, demand growth for rooms exceeds supply growth. In the 1991 recession, occupancy began to grow in the third quarter of 1992. Starwood Hotels shares bottomed in May of 1992 at $2.61 and rallied by a total of 689% over the next thirty-six months. The Hilton Group (formerly HLT) saw their shares climb by 107% over the same period and MGM shares increased by 178% over the same period. The S&P lodging index increased by 141%. Following 9/11, occupancy began sustained growth in the second quarter of 2003. The hotel shares bottomed in October of 2002 (excluding 9/11 lows) and HOT, HLT and MGM realized thirty-six month price increases of 174%, 115% and 146% respectively. The S&P hotel index increased by 117% during this period. In fact, several studies have shown that the hotel and lodging group is the best performing sub-sector during an economic recovery.

While we are not believers that a major economic recovery is imminent, we are currently expecting that hotel occupancy will begin to climb on a YOY basis in the first quarter of 2010. There is a chance that this could be delayed until the second quarter if further economic weakness occurs. There is, however, a win/win aspect to further economic weakness: With the current economic cycle being a credit cycle rather than a traditional demand/inventory driven economic cycle, the longer the current economic situation stays lousy, the better the long-term outlook for the hotel industry becomes. Very few projects will be funded in the current environment. In fact, even projects nearing completion often have to fight for final funding.

As you know, we at Unit Economics believe that the 'real' money to be made from equity markets comes from taking a two or three year, non-consensus view, sticking with it and being right. We also appreciate that companies must have upside to their coming earnings expectations to be timely (and profitable) investments. The hotel group has demonstrated an amazing ability to reduce costs in the current downturn, as we discuss in this report, providing the needed potential for positive earnings surprises in the coming quarters (after Q2) to make us excited about owning the shares today. The overall supply/demand picture should ensure that over the next two to three years the industry does well, regardless of the strength of a potential economic recovery.

PM Brief

The Company

Starwood Hotels and Resorts Worldwide, Inc. is one of the world's largest hotel and leisure companies, with a portfolio of owned, leased, managed and franchised hotels totaling 942 properties (285,000 rooms) in over 100 countries at the end of 2008. Currently, 58.08% of their total room portfolio is located North America (including the Caribbean), 21.23% are located in Europe, Africa and the Middle East, 16.33% are located in Asia Pacific and 4.35% are located in Latin America. In addition, Starwood owns 26 Vacation Ownership (timeshare) resorts in the United States, Mexico and the Bahamas. As-of December 31, 2008, Starwood managed 436 hotels on behalf of third party owners (including entities in which Starwood had a minority interest) and received franchise fees from 437 hotels. The remaining 69 hotels are owned (at least a majority interest) or leased. Starwood focuses on luxury and upper upscale segment hotels.

Catalysts/Earnings Drivers

We believe that room rates are beginning to stabilize and occupancy will increase YOY by the first quarter of 2010. Historically hotel shares rally several months before occupancy begins to recover. In addition, Starwood has made impressive efforts to enact permanent cost reductions that will fuel earnings growth in 2010 and beyond.

Starwood will generate over $1 bln in cash to pay down debt over the next 18 months. In fact, Starwood has $9.13 bln in assets ($7.03 bln in owned hotels, $1.26 bln in VOI properties, $500 mln in VOI receivables and $308 mln in net JV interests) that are essentially held for sale. If Starwood succeeds in liquidating these assets, they will have $34.23 in cash per share remaining after paying down all of their debt at the end of 2010. Despite the sale of their hotel assets, the management and franchise business would likely generate some $642 mln in EBITDA in 2013 after their room pipeline generates 40% room growth versus today with little capital investment required. At 8X EBITDA, this business would be valued at $5.14 bln, or $27.53 per share.

Current Price: $24.59	Book Value/Share: $8.39
Price Target: $60.00	Sales/Share (ttm): $32.64
Market Cap:$4,589 m	Forward PE (e): 25.09X

	F2008	F2009e	F2010e
Revenues	$ 5,907	$ 4,626	$ 5,290
Cost of Sales	$ 2,305	$ 1,747	$ 1,805
Gross Profit	$ 3,602	$ 2,879	$ 3,485
SG&A	$ 477	$ 359	$ 392
Other	$ 2,506	$ 2,156	$ 2,534
Operating Income	$ 619	$ 364	$ 560
Interest/JVs	$ (289)	$ (197)	$ (153)
Taxes	$ 76	$ 41	$ 102
Net Income	$ 254	$ 126	$ 305
EPS (Diluted)	$ 1.36	$ 0.70	$ 1.68
Shares out	186	181	181

Graph Courtesy of Bloomberg

The Hotel Market

Over the past twenty years, the average annual increase in hotel room demand has been 3.5%. The current hotel new build cycle, which will peak in 2009, was the first cycle in twenty years during which the peak supply growth rate in did not exceed the average demand growth rate over a full cycle. We view this as incredibly positive for the hotel group in general.

Timetable

July 24, 2009 - Second Quarter Earnings (estimated)

Starwood 2010 Earnings Matrix

WW/SW RevPAR	2010 EPS
119	2.09
118	2.02
117	1.95
116	1.87
115	1.80
114	1.73
113	1.65
112	1.58
111	1.51
110	1.43
109	**1.36**
108	1.29
107	1.21
106	1.14
105	1.07
104	0.99
103	0.92
102	0.85
101	0.77
100	0.70
99	0.63

The Risks:

- Pricing may not recover as operators fight to fill empty capacity and consumers be accustomed to lower price points
- Timeshare sales continue to trend downwards
- Asset sales are not possible due to the continuing credit crunch or asset values decline

The Rewards:

- Hotel occupancy should bottom in the first quarter of 2010. historically a great time to own hotel share
- Starwood has over $48 per share in assets available for sale
- Starwood can generate in excess of $1 bln in cash to pay down debt over the next 18 months

Questions to Torture your Analysts With:

- What is the projected room supply growth in the U.S.?
- Are projects under construction still being financed?
- Is airline capacity increasing?
- When will occupancy begin to increase YOY?
- Have there been any recent hotel asset sales? If so, at what value per room?

Online Resources:

http://www.starwoodhotels.com/corporate/investor_relations.html

http://www.hotelinteractive.com/home.aspx

http://www.hotelnewsnow.com/Home.aspx

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