Report to Shareholders

We acquired the 200-room, full-service Bell Orchid Hotel in San Diego in 2005 and began operations in January 2006. During the first six months of operation of the Hotel, we are proud to state that we developed exceptional operating results for shareholders, exceeding the industry average for comparable hotels. We modestly increased room rates during the second quarter of operations, while continuing to control costs.

Renovations

We will invest $3 million to upgrade the hotel and look forward to strong annual returns as well as an increasing portion of the hotel business in San Diego. [[1]](#footnote-1)

Renovations will include an improved and modernized lobby with vaulted ceilings opening the area to abundant natural lights, an additional 1,500-square foot meeting room, a nine-hole golf course, as well as remodeling and upgrading most of the hotel’s 200 rooms. We will also be redesigning bar and restaurant facilities.

Because of our knowledge of this newly acquired property and the growing need for hotel rooms in San Diego, we believe we can maximize returns on the hotel by making a smart, limited-capital investment to reposition it within the market.

Seasonal and Group Promotions

Seasonal promotions aimed at leisure and business travelers have been very successful during the first six months of operation, and we expect this trend to continue. Our Sales and Marketing has implemented a marketing plan to increase the number of corporate and association events held at the hotel; we anticipate significant success in this endeavor by the end of the year.

Reservations

We continue to see a shift away from toll-free telephone numbers to the Internet as the primary tool for booking reservations. As a result, we have revamped our web site, <www.bellorchidhotel.com>, to improve functionality and enhance content for consumers. We foresee this trend continuing in the years ahead. Data collected through our central reservations system[[2]](#footnote-2) help us forecast and improve the hotel’s performance.

Rates and Occupancy

We are pleased to report that rooms sold by our sales team increased by 6.5% in the second quarter of 2006. This is an exceptional accomplishment, given the fact that the hotel has only been in operation six months.

While preserving optimal room rates and occupancy rates, we have managed to maximize profitability for shareholders. A breakdown of our rooms follows:

* Premium: Also known as "rack rate," these are rooms booked close to arrival during high demand periods. This is the highest rate category available. Room rates fluctuate depending on anticipated demand levels (e.g. seasonality, weekday vs. weekend stays).
* Corporate: This is the benchmark rate we offer to the general public. It is typically the second highest category, and is for travelers that do not have access to negotiate or discount rates.
* Special Corporate: this is a negotiated rate offered to companies and organizations that provide significant levels of room demand to the hotel. These rates are typically negotiated annually, at a discount to the anticipated corporate rate.
* Discount: This encompasses all discount programs, government per diem, rooms booked through internet distribution and wholesale channels, frequent guest program redemptions, and promotional rates and packages offered by the Hotel.

Guest Feedback

We have instituted a new Quality Assurance System that will involve direct guest feedback and should result in greater guest satisfaction and increased reservation levels.

Guests Breakdown

The majority of our guests fall into three broad groups: families, business, and groups.

Revenue:

|  |  |
| --- | --- |
| Rooms: | 60% |
| Food and beverage revenue: | 30 % |
| Other revenue: | 10 % |

Operating Costs and Expenses

Rooms: These include housekeeping, reservation systems, room supplies, laundry services, and front desk costs. Occupancy is the major driver of rooms expense. These costs can increase based on increases in salaries and wages, as well as the level of service and amenities that are provided: 17 %.

Food and Beverage: These include food, beverage, and labor costs. Occupancy and the type of customer staying at the hotel (i.e., catered functions generally are more profitable than outlet sales) are the major drivers of food and beverage expense, which correlates closely with food and beverage revenue: 26 %

Hotel Departmental Expense: These include labor and other costs associated with parking, golf courses, spas, telephones, entertainment, and other guest services, as well as labor and other costs associated with administrative departments, sales and marketing, repairs and maintenance, and utility costs: 30 %

Other property-level expenses: These include real and personal property taxes, ground rent, equipment rent and property insurance: 9 %

Depreciation and amortization expense: 11 %

Shares

|  |  |  |
| --- | --- | --- |
| Shares sold in 2006 | | |
| Series | Price/Share | # Sold |
| Series A | 25.50 | 67,500 |
| Series B | 20.00 | 110,000 |
| Series C | 17.85 | 105,000 |

Facing Our Future with Confidence

Since the Hotel opened six months ago, all departments have worked diligently to establish the Bell Orchid Hotel as a first-rate, full-service hotel here in San Diego. I believe we have succeeded in this endeavor. I have worked diligently to strengthen our balance sheet and increase shareholder value through targeted room rates and increased occupancy.

San Diego remains a top travel and business destination, and overall room rates were up by 8% during the first six months of 2006.

We believe our location in San Diego, close to major restaurants and business facilities, as well as the San Diego International Airport, will allow us to maintain room rate and occupancy premiums over our competitors. We also seek to maximize our earnings through aggressively marketed room sales as well as capital improvements.

We have decided, in addition to printing and mailing you this quarterly report, to present you with an on-line version as well! We hope you enjoy it!

**Bell Orchid Hotel**

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1. A Capital Expenditure Analysis on the renovations is currently being prepared by our Engineering Department. [↑](#footnote-ref-1)
2. Pegasus Solutions [↑](#footnote-ref-2)