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www.mhihospitality.com

\*A publicly traded company on the American Stock Exchange ("AMEX") under the symbol MDH



2006 Annual Report

# Celebrating 50 Years of Hospitality Excellence



# PORTFOLIO





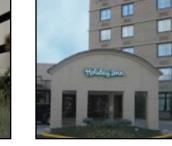




Hilton Philadelphia Airport, Philadelphia, PA



Shell Island Resort, Wrightsville Beach, NC



Hilton Savannah DeSoto,

Savannah, GA

Holiday Inn Laurel, Laurel, MD



Hilton Wilmington Riverside, Wilmington, NC



Crowne Plaza SIAN Resort, Hollywood Beach, FL



Sheraton Louisville Riverside, Jeffersonville, IN

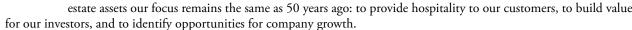
## SHAREHOLDER LETTER

## Building Blocks to Growth

To Our Shareholders:

We completed a productive second year as a public company in 2006. Of greater significance is that 2007 marks the 50th anniversary of my family's entry into the hospitality industry. The cornerstones of our company – service, value and opportunity – have their roots in a small 12-room motel purchased by my father, Edgar

Sims, in the flourishing Washington, DC suburbs in 1957. The successor entity to that first small hotel, MHI Hospitality Corporation, owns a portfolio of hotels in well-located markets. With ownership of approximately \$225.0 million in real



In 2006 we put the building blocks in place to accommodate future growth:

- We expanded management resources externally and internally;
- We substantially increased our financial capacity; and
- We achieved milestones in portfolio repositioning and performance.

During the year we forged an alliance with hotel management company Coakley & Williams which provides access to additional management resources and an independent operator with a long history of hospitality industry experience. In 2006 we also added Chief Operating Officer David Folsom to our team. Dave's transactional and capital markets expertise round out our team's strong skill sets and are of value as we seek to execute our growth strategy.

During the year we also increased our credit line to \$60 from \$23 million, and we augmented our existing banking relationship with BB&T with the addition of three financial institutions, KeyBank, Regions and M&T Bank, creating a well-rounded consortium of banks for the company.

I am very pleased to report that our research coverage expanded in 2006 with the addition of analysts from Robert W. Baird and Hilliard Lyons, joining BB&T and Ferris Baker Watts in our coverage universe.

#### 2006 Performance

The company delivered strong performance in 2006, generating increases of 21.7% in total revenue, 32% in net income, and 18.9% in Funds from Operations (FFO). We also achieved our eighth consecutive quarter-over-quarter increases in RevPAR and ADR, with gains of 6.5% and 7.6%, respectively. In 2006 we delivered a total return to investors of 11% and a dividend yield of 6.9%. Our dividend yield remains one of the highest in the REIT hospitality sector.

## Portfolio Positioning

In 2006 we enhanced our real estate platform with a key acquisition and other initiatives to build growth and long-term value. With the purchase of a 186-room hotel in the Louisville, Kentucky market for \$7.7 million, we increased our portfolio to seven hotel assets in seven well-located markets. I am also pleased to report that we executed our first franchise license with Starwood Hotels and Resorts for this property. The hotel will be branded as the Sheraton Louisville Riverside Hotel and is currently the only Starwood branded product in this market. Our Louisville asset is undergoing extensive repositioning and is expected to open as an upper upscale hotel in the first quarter of 2008.

We sourced additional hotel investment opportunities during the year and submitted offers to acquire 14 hotels with a total value in excess of \$400 million. Following extensive due diligence and in line with the company's rigorous underwriting standards, when it became clear that the price to acquire these assets was no longer accretive, and therefore no longer in the best interests of the shareholders, we elected not to pursue.

In 2006 we engaged in a variety of repositioning initiatives portfolio-wide. One I would like to highlight is a hotel condominium conversion project at the full service Crowne Plaza Sian Resort. The flagging of this resort with the Crowne Plaza brand is the first time Intercontinental Hotels Group has entered into a condominium hotel franchise project in the U.S. with a third-party operator. The 310 hotel condominium units will be individually owned and our affiliated management group, MHI Hotels Services, will operate the hotel and a rental program for unit owners electing to participate. We plan to purchase the resort common space upon project completion. And we have executed an agreement with the developer to acquire up to 100 of the condominium units. We anticipate commencing operations this spring at this resort.

Turning to other 2006 portfolio initiatives:

- We reflagged and completed \$3.0 million in renovations at our Crowne Plaza Jacksonville Riverfront Hotel. While performance for the year reflected the stress of extensive renovations coupled with a brand change we are enthusiastic about prospects for this repositioned asset going forward.
- Planning for the Hilton Wilmington Riverside's 2007 renovation actually began in late 2006. The hotel experienced sound top line growth for the year. And we have extended our franchise with Hilton until 2018.
- The Hilton Philadelphia Airport profited from an ambitious 2005 renovation, achieving a significant increase in ADR in 2006, and remains our top-performing asset.
- The Hilton Savannah DeSoto continued to perform at a high level for the year, albeit with slightly slowing top line growth due to additional Hilton branded product in the market.
- Following thorough renovations and a rebranding in 2005, the Holiday Inn Laurel completed its first full year of operations in 2006 and performance is well in line with our expectations.
- With strong improvements in RevPAR and operating margins, the Holiday Inn Brownstone Hotel & Conference Center in Raleigh performed at its highest level ever in 2006.

We continue to source attractive lodging acquisition opportunities, although cap rates remain low and prices very high in this overheated market. We believe the industry has reached a plateau. The pace of growth is slowing, and demand and supply are nearly in balance, although there is sufficient new building planning activity to expect a continued increase in mid-term supply. Within this environment we are maintaining a disciplined and highly selective investment strategy while we await more attractive pricing. We continue to consider alternative noncore investments and other opportunities that meet our return criteria.

Looking ahead we have established the following goals to drive continued growth and to build value for shareholders.

- In terms of performance we have raised FFO guidance targets for 2007. We also reaffirm our commitment to pay an above market
- Regarding portfolio initiatives, we will continue to source well-located underperforming hotel assets, while maintaining a disciplined investment approach. In 2007 we plan to acquire two or more hotel properties. And we will continue repositioning our core assets.
- In order to further enhance our financial capacity and to create a fee income stream, we intend to complete a joint venture with a private equity partner. We also will refinance the company's fixed rate debt to lower interest expense.

In 2006 we put important building blocks in place for future growth. We bolstered management and financial resources, and we continued to implement creative repositioning strategies at our assets. In our second full year as a public company we delivered solid performance results. And since our IPO in December 2004 we have achieved significant growth. Room sales and total sales were over 40% greater in 2006 than 2004. RevPAR has increased over 19% during that time frame. And since 2004 the market value of our assets has doubled and the equity in the company has grown by 80%.

We believe we are well-positioned for continued and accelerating growth. And as managers of our shareholders' capital we remain committed to building long-term value. We pursue this endeavor being mindful of the original cornerstones of our company: hospitality, value and opportunity. On behalf of our senior management team, I want to thank our shareholders, Board of Directors, and employees for their continued support. We look forward to another successful year in 2007.

Andrew M. Sims Chairman and CEO

Sincerely,

MHI Hospitality Corporation

## **CORPORATE PROFILE**

## **BOARD OF DIRECTORS**











**OFFICERS** 





### EXECUTIVE STAFF









ADR: Average daily room rate.

FFO: Funds from Operations. Commonly reported measure of REIT operating performance equal to net income, excluding gains or losses from sales of

Hospitality: The friendly reception and treatment of guests.

Hotel: An establishment that provides lodging and usually meals and other services for travelers and other paying guests. An inn of the better sort (1765).

Kev: Hotel room.

Lodging REIT: Company dedicated to investing in and owning hotel properties. Investing in a lodging REIT such as MHI Hospitality Corporation is a liquid, dividend-paying means of participating in the commercial real estate

RevPAR: Revenue per available room. Performance metric typically calculated by multiplying hotel's average daily room rate (ADR) by occupancy rate.

Upscale Hotel: Full service lodging with room rates in the highest 25%-30% of all hotels within market.

Upper Upscale Hotel: Branded or independent full service property realizing

## **CORPORATE OFFICES**

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Independent Auditors PKF Witt Mares 4801 Courthouse Street Suite 200 Williamsburg, VA 23188 Phone: 757-229-7180 Fax: 757-229-5452



## Glossary

property, and adding back real estate depreciation.

top 10%-15% room rates within local market.