HOST MARRIOTT CORP/
Form 424B5
May 28, 2004
Table of Contents

Filed Pursuant to Rule 424(b)5

Registration No. 333-113901

PROSPECTUS SUPPLEMENT

(To Prospectus dated April 19, 2004) May 26, 2004

4,000,000 Shares

8 7/8% Class E Cumulative Redeemable Preferred Stock

(Liquidation Preference $25.00 Per Share)

We are offering 4,000,000 shares of our 8 7/8% Class E Cumulative Redeemable Preferred Stock, or Class E preferred stock.

We will pay cumulative dividends on the Class E preferred stock from the date of issuance, in the amount of $2.21875 per share each year, which is equivalent to 8 7/8% of the $25.00 liquidation preference per share. Dividends on the Class E preferred stock will be payable quarterly in arrears beginning on July 15, 2004. We may not redeem the Class E preferred stock before June 2, 2009, except under limited circumstances intended to preserve our status as a real estate investment trust and the status of our operating partnership as a partnership for Federal income tax purposes. On and after June 2, 2009, we may, at our option, redeem the Class E preferred stock, in whole or in part, by paying $25.00 per share, plus accrued and unpaid dividends. The Class E preferred stock has no stated maturity, will not be subject to any sinking fund or mandatory redemption and will not be convertible into any of our other securities. Investors in the Class E preferred stock will not have general voting rights, but will have limited voting rights if we fail to pay dividends for six or more quarters and in certain other events.

We have applied to list the Class E preferred stock on the New York Stock Exchange under the symbol HMTPrE. If the application is approved, we expect trading of the Class E preferred stock will commence on the New York Stock Exchange within 30 days after the initial delivery of the Class E preferred stock.

Investing in the Class E preferred stock involves risks. Before buying any shares, you should carefully read the discussion of material risks of investing in our stock in Risk Factors beginning on page S-8 of this prospectus supplement and on page 1 of the accompanying prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public offering price (1)	$ 25.00	$ 100,000,000
Underwriting discounts and commissions	$ 0.7875	$ 3,150,000
Proceeds, before expenses, to Host Marriott Corporation	$ 24.2125	$ 96,850,000

(1) Plus accrued dividends, if any, from June 2, 2004.

We have granted the underwriters an option to purchase within 30 days from the date of this prospectus up to an additional 160,000 shares of Class E preferred stock at the public offering price per share, less the underwriting discounts and commissions, to cover over-allotments.

The underwriters are offering the shares of the Class E preferred stock as described in Underwriting. The shares of the Class E Preferred Stock will be made available for delivery, through the facilities of the Depositary Trust Company, on or about June 2, 2004.

Joint Book-Running Managers

UBS Investment Bank **Bear, Stearns & Co. Inc.**

Deutsche Bank Securities

Legg Mason Wood Walker
Incorporated

Stifel, Nicolaus & Company
Incorporated

Table of Contents

You should rely only on the information contained in or incorporated by reference in this prospectus supplement and the accompanying prospectus. Neither we nor the underwriters have authorized anyone to provide you with information different from that contained in this prospectus supplement and the accompanying prospectus. Neither we nor the underwriters are offering to sell the securities, or seeking offers to buy the securities, in any jurisdiction where offers or sales are not permitted. You should assume that the information contained in or incorporated by reference in this prospectus supplement or the accompanying prospectus is accurate only as of its respective date or on the date which is specified in those documents. Our business, financial condition, results of operations and prospects may have changed since any such date.

Unless otherwise indicated or unless the context requires otherwise, all references in this prospectus supplement and in the accompanying prospectus to we, us, our, or the Company means Host Marriott Corporation, including our consolidated subsidiaries. References to the Operating Partnership or to Host LP are to Host Marriott, L.P., a Delaware limited partnership.

Table of Contents

i

Table of Contents

About this prospectus supplement

This document is in two parts. The first part is this prospectus supplement, which describes the specific terms of the Class E preferred stock we are offering and certain other matters relating to us and the underwriters. The second part, the accompanying prospectus, gives more general information about securities we may offer from time to time, some of which do not apply to the Class E preferred stock we are offering. This prospectus supplement, or the information incorporated by reference herein, may add, update or change information in the accompanying prospectus. If information in this prospectus supplement, or the information incorporated by reference herein is inconsistent with the accompanying prospectus, this prospectus supplement or the information incorporated by reference herein, will apply and will supersede that information in the accompanying prospectus.

It is important for you to read and consider all information contained in this prospectus supplement, the accompanying prospectus and the information incorporated by reference herein and therein, in making your investment decision. Unless otherwise noted, the information in this prospectus supplement assumes no exercise of the underwriters over-allotment option.

Where you can find more information

We are subject to the informational requirements of the Securities Exchange Act of 1934 (the Exchange Act) and, in accordance therewith, file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission, or SEC. Such reports, proxy statements and other information can be inspected and copied at the Public Reference Room of the SEC located at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. Copies of such material can be obtained from the Public Reference Section of the SEC at prescribed rates. Such material may also be accessed electronically by means of the SEC s home page on the internet (http://www.sec.gov) and on our website (http://www.hostmarriott.com). You can also inspect reports and other information we file with the SEC at the office of the New York Stock Exchange, Inc., 20 Broad Street, New York, New York 10005.

We have filed a registration statement and related exhibits with the SEC under the Securities Act of 1933, as amended (the Securities Act). The registration statement contains additional information about us and our common stock and preferred stock. You can inspect or access electronically the registration statement and exhibits by the means described in the paragraph above.

The SEC allows us to incorporate by reference the information that we file with it, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is an important part of this prospectus supplement and the accompanying prospectus and the information that we file later with the SEC may update and supersede this information. Pursuant to the section of the accompanying prospectus entitled Where You Can Find More Information, we incorporate by reference the documents listed below and any filings made by us with the SEC pursuant to Section 13(a), 13(c), 14 or 15(d) of the Exchange Act after the date of this prospectus supplement and before we stop offering the securities under this prospectus supplement (in each case, other than information in such documents that is deemed not to be filed):

Ø

Annual Report on Form 10-K of Host Marriott Corporation for the fiscal year ended December 31, 2003 (including information specifically incorporated by reference therein from our Proxy Statement for our 2004 Annual Meeting);

Table of Contents

- Ø Current Report on Form 8-K of Host Marriott Corporation dated and filed on March 5, 2004;
- Ø Current Report on Form 8-K of Host Marriott Corporation dated March 9, 2004 and filed on March 11, 2004;
- Ø Current Report on Form 8-K of Host Marriott Corporation dated March 16, 2004 and filed March 17, 2004;
- Ø Quarterly Report on Form 10-Q of Host Marriott Corporation for the quarterly period ended March 26, 2004;
- Ø Current Report on Form 8-K of Host Marriott Corporation dated April 28, 2004 and filed on April 29, 2004;
- Ø Current Report on Form 8-K of Host Marriott Corporation dated and filed on May 25, 2004;
- Ø Description of our common stock included in Registration Statement on Form 8-A, as amended, of HMC Merger Corporation, filed November 18, 1998 (as amended on December 28, 1998); and
- Ø Description of rights included in Registration Statement on Form 8-A, as amended, of HMC Merger Corporation, filed December 11, 1998 (as amended on December 24, 1998).

We will provide to each person, including any beneficial owner, to whom this prospectus is delivered a copy of any or all of the information that we have incorporated by reference into this prospectus but not delivered with this prospectus. To receive a free copy of any of the documents incorporated by reference in this prospectus, other than exhibits, unless they are specifically incorporated by reference in those documents, call or write to our Corporate Secretary, Host Marriott Corporation, 6903 Rockledge Drive, Suite 1500, Bethesda, Maryland, 20817 ((240) 744-1000).

You should rely only upon the information provided in this document or incorporated by reference in this prospectus and any supplement. We have not authorized anyone to provide you with different information.

Forward-looking statements

This prospectus supplement and the accompanying prospectus and the information incorporated by reference herein and therein contain certain forward-looking statements. These statements are included throughout this prospectus supplement, the accompanying prospectus and the information incorporated by reference herein and therein, including in the sections entitled Risk Factors and relate to, among other things, analyses and other information based on forecasts of future results and estimates of amounts not yet determinable. These forward-looking statements are identified by their use of terms and phrases such as anticipate, believe, could, estimate, expect, intend, may, plan, p will, continue, and other similar terms and phrases, including references to assumptions.

These forward-looking statements are subject to numerous assumptions, risks and uncertainties. Factors which may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by us in those statements include, among others, the following:

- Ø the reduction in our operating flexibility and the limitation on our ability to pay dividends resulting from restrictive covenants in our debt agreements, which limit the amount of distributions the

Table of Contents

Operating Partnership can make to us to only permitted REIT distributions if its EBITDA-to-interest coverage ratio under the indenture governing its senior notes (which measures the Operating Partnership s ratio of its pro forma consolidated EBITDA to pro forma consolidated interest expense) is less than 2.0 to 1.0, and other risks related to restricting covenants in our debt agreements, including the risk of default that could occur;

- national and local economic and business conditions and changes in travel patterns, including the effect of terror alerts and potential terrorist activity on travel, that will affect, among other things, demand for products and services at our hotels, the level of room rates and occupancy that can be achieved by such properties and the availability and terms of financing and our liquidity;
- changes in taxes and government regulations that influence or determine wages, prices, construction procedures and costs;
- our ability to maintain properties in a first-class manner, including meeting capital expenditure requirements;
- our ability to compete effectively in areas such as access, location, quality of accommodations and room rate;
- our ability to acquire or develop additional properties and the risk that potential acquisitions or developments may not perform in accordance with expectations;
- our degree of leverage, which may affect our ability to obtain financing in the future;
- government approvals, actions and initiatives, including the need for compliance with environmental and safety requirements, and changes in laws and regulations or the interpretation thereof;
- the effects of tax legislative action;
- our ability to continue to satisfy complex rules in order for us to maintain REIT status for Federal income tax purposes, the ability of the Operating Partnership to satisfy the rules to maintain its status as a partnership for Federal income tax purposes, the ability of certain of our subsidiaries to maintain their status as taxable REIT subsidiaries for Federal income tax purposes, and our ability and the ability of our subsidiaries to operate effectively within the limitations imposed by these rules;
- the effect of any rating agency downgrades on the cost and availability of new debt financings;
- the relatively fixed nature of our property-level operating costs and expenses;
- our ability to recover fully under our existing insurance for terrorist acts and our ability to maintain adequate or full replacement cost all-risk property insurance on our properties; and
- other factors discussed below under the heading Risk Factors and in our other filings with the SEC.

Although we believe the expectations reflected in our forward-looking statements are based upon reasonable assumptions, we can give no assurance that we will attain these expectations or that any deviations will not be material. Except as otherwise required by the Federal securities laws, we disclaim any obligation or undertaking to publicly release any updates or revisions to any forward-looking statement contained in this prospectus supplement, the accompanying prospectus and the information incorporated by reference herein and therein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Table of Contents

Prospectus supplement summary

The following summary may not contain all of the information that is important to you in deciding whether to invest in the Class E preferred stock. You should read this entire prospectus supplement and the accompanying prospectus, together with the information incorporated by reference herein and therein, including the financial data and related notes before making an investment decision.

ABOUT THE COMPANY

We are a Maryland corporation and we operate as a self-managed and self-administered real estate investment trust, or REIT. We own our properties and conduct our operations through Host Marriott, L.P., a Delaware limited partnership of which we are the sole general partner and in which we hold 93% of the partnership interests as of May 26, 2004.

As of May 26, 2004, our lodging portfolio consisted of 111 upper-upscale and luxury full-service hotels containing approximately 56,000 rooms. Our portfolio is geographically diverse with hotels in most of the major metropolitan areas in 28 states, Washington, D.C., Toronto and Calgary, Canada and Mexico City, Mexico. Our locations include central business districts of major cities, near airports and resort/convention locations. Our hotels are operated under such brand names as Marriott, Ritz-Carlton, Hyatt, Four Seasons, Hilton and Westin.

The address of our principal executive office is 6903 Rockledge Drive, Suite 1500, Bethesda, Maryland, 20817. Our phone number is (240) 744-1000. Our Internet website address is www.hostmarriott.com.

THE LODGING INDUSTRY

The lodging industry in the United States consists of both private and public entities which operate in an extremely diversified market under a variety of brand names. Competition in the industry is based primarily on the level of service, quality of accommodations, location and room rates. In order to cater to a wide variety of tastes and needs, the lodging industry is broadly divided into six groups: luxury, upper-upscale, upscale, midscale (with and without food and beverage service) and economy.

Supply and demand growth in the lodging industry and the markets in which we operate may be influenced by a number of factors, including growth of the economy, interest rates, unique local considerations and the relatively long lead time required to develop urban and resort/convention, upper-upscale and luxury hotels. Properties in the upper-upscale segment of the lodging industry benefited from a favorable imbalance between supply and demand during the early 1990 s, driven in part by low construction levels and high gross domestic product, or GDP growth. From 1998 through 2000, supply moderately outpaced demand, which caused slight declines in occupancy rates; however, the impact of the occupancy decline was more than offset by increases in the average daily rate during that period. In 2001, the weakening economy was significantly affected by the September 11 terrorist attacks leading to a significant decline in demand. In 2002 and 2003, demand growth was slowed primarily due to the threat of additional terrorist acts, the war in Iraq and, in 2002, continued weakness in the economy. We expect the rate of supply growth, which has declined significantly since 2000, to continue to be relatively low for at least 2004 and 2005 due to the limited availability of development financing for new construction. Demand growth began to accelerate during the first quarter of 2004, and we believe that demand growth will continue for the remainder of 2004, as the economy strengthens and business travel increases.

Table of Contents

BUSINESS STRATEGY

Our primary business objective is to provide superior total returns to our stockholders through a combination of appreciation in net asset value per share, growth in earnings and dividends. In order to achieve this objective we seek to:

- maximize the value of our existing portfolio through aggressive asset management which includes working with the managers of our hotels to continue to minimize operating costs and increase revenues and by completing selective capital improvements designed to increase profitability;
- acquire upper-upscale and luxury hotels, including hotels operated by leading management companies;
- maintain a capital structure and liquidity profile that has an appropriate balance of debt and equity and provides flexibility given the inherent volatility in the lodging industry, and improving, over the next lodging cycle, our EBITDA-to-interest coverage ratio to greater than 3.0x; and
- opportunistically dispose of non-core assets, such as older assets with significant capital needs, assets that are at a competitive risk given potential new supply or assets in slower-growth markets.

We believe we are well-qualified to pursue our business strategies. Our management team has extensive experience in acquiring and financing lodging properties. We believe that management s industry knowledge, relationships and access to market information provide a competitive advantage with respect to identifying, evaluating, financing, acquiring and opportunistically disposing of lodging properties and that this competitive advantage carries over to the work we do to improve and maintain the quality of our assets. These efforts include maximizing the value of our existing portfolio by overseeing our managers in their efforts to reduce operating costs and to increase revenues at our hotels, monitoring property and brand performance, pursuing expansion and repositioning opportunities, overseeing capital expenditure budgets and forecasts, assessing return on capital expenditure opportunities and analyzing competitive supply conditions in each of our markets.

Our acquisition strategy focuses on hotels operating as upper-upscale and luxury hotels. We continue to believe there will be opportunities to acquire these hotels at attractive multiples of cash flow and at discounts to replacement cost. Our acquisition strategy continues to focus on:

- properties with unique locations in markets with high barriers to entry for prospective competitors, including hotels located in urban and resort/convention locations;
- properties operated under premium brand names, such as Marriott, Ritz-Carlton, Four Seasons, Hilton, Hyatt and Westin;
- larger hotels that are consistent with our portfolio objectives and may require significant investment, which narrows the competition for these acquisitions;
- underperforming hotels whose operations can be enhanced by conversion to high quality brands and/or by upgrading or adding to the existing facilities; and
- acquisitions through various structures, including transactions involving portfolios, single assets and through joint ventures.

From 1999 through mid-2003, our acquisitions were limited by the lack of suitable targets that complement our portfolio, inadequate returns and capital limitations due to weak investment markets. Consequently, our activity was primarily focused on acquiring the interests of limited or joint venture partners, consolidating our ownership of assets already included in our portfolio, and purchasing the lessee interests, which were created as part of our conversion to a REIT. Beginning in the second half of 2003, the outlook for lodging improved and suitable single asset and portfolio acquisition opportunities

Table of Contents

have become available; however, the number of competitive bidders for such opportunities has also correspondingly increased. We are actively pursuing acquisition opportunities and are in discussions with sellers of hotels that meet our investment objectives, but have not entered into any definitive agreements. Any acquisitions may be funded, at least in part, with the proceeds of equity offerings by Host Marriott, from the issuance of operating partnership units of the Operating Partnership or available cash, as well as proceeds from asset sales, the assumption of debt or draws under our credit facility. We can not be certain as to the size or timing of acquisition opportunities or of our ability to obtain additional acquisition financing, if needed.

We have not acquired hotels outside of the United States in recent years due to the difficulty in identifying opportunities that meet our return criteria. However, we intend to continue to evaluate acquisition opportunities in international locations, and will pursue these only when we believe they will offer satisfactory returns after adjustments for currency and country-related risks.

Table of Contents

The offering

Securities Offered	4,000,000 shares of 8 7/8% Class E Cumulative Redeemable Preferred Stock, par value $.01 per share. We may sell up to 160,000 additional shares of Class E preferred stock to the underwriters to cover over-allotments, if any.
Maturity	The Class E preferred stock does not have any maturity date and will not be subject to any sinking fund or mandatory redemption.
Dividends	Dividends on the Class E preferred stock issued in this offering will be cumulative from the date of issuance and are payable quarterly in arrears for the period covering the preceding calendar quarter on or before the 15th day of January, April, July and October of each year, commencing July 15, 2004, at a rate of 8 7/8% per year of the $25.00 per share liquidation preference (equivalent to $2.21875 per year per share). Dividends on the Class E preferred stock will accrue regardless of whether we have earnings, whether there are funds legally available for the payment of such dividends and whether such dividends are declared. Because the first dividend payment date is July 15, 2004, the dividend payable on each share of Class E preferred stock on that date will be less than the amount of a full quarterly dividend.
Optional Redemption	We may not redeem the Class E preferred stock prior to June 2, 2009, except under limited circumstances intended to preserve our status as a real estate investment trust and the Operating Partnership s status as a partnership for Federal income tax purposes. On and after June 2, 2009 we may, at our option, redeem the Class E preferred stock, in whole or from time to time in part, for cash in the amount of $25.00 per share, plus accrued and unpaid dividends to, but not including, the date of redemption.
Liquidation Preference	If we liquidate, dissolve or wind up, holders of the Class E preferred stock will have the right to receive $25.00 per share, plus accrued and unpaid dividends to, but not including, the date of payment. Payment of this liquidation preference must be made before any payment is made to the holders of our common stock with respect to the

Table of Contents

distribution of assets upon our liquidation, dissolution or winding up.

Ranking

The Class E preferred stock will rank, with respect to the payment of dividends and the distribution of assets upon our liquidation, dissolution or winding up:

(1) senior to our common stock, senior to our Series A junior participating preferred stock and senior to any other class or series of our capital stock other than as discussed below;

(2) on a parity with our 10% Class A Cumulative Redeemable Preferred Stock, par value $.01 per share, our 10% Class B Cumulative Redeemable Preferred Stock, par value $.01 per share, our 10% Class C Cumulative Redeemable Preferred Stock, par value $.01 per share, and our 10% Class D Cumulative Redeemable Preferred Stock, par value $.01 per share, and any other class or series of our capital stock the terms of which specifically provide that such class or series of capital stock ranks on parity with the Class E preferred stock as to the payment of dividends and the distribution of assets upon our liquidation, dissolution or winding up; and

(3) junior to all of our existing and future indebtedness and to any class or series of our capital stock the terms of which specifically provide that such class or series of capital stock ranks senior to the Class E preferred stock as to the payment of dividends and the distribution of assets upon our liquidation, dissolution or winding up.

Voting Rights

Holders of Class E preferred stock will generally have no voting rights. However, if we do not pay dividends on the Class E preferred stock for six or more quarterly dividend periods (whether or not consecutive), the holders of the Class E preferred stock, voting as a class with the holders of any other class or series of our capital stock which has similar voting rights, will be entitled to vote for the election of two additional directors to serve on our board of directors until we pay all dividends which we owe on the Class E preferred stock and any

Table of Contents

other class or series of our capital stock with similar voting rights. In addition, the affirmative vote of the holders of at least two-thirds of the outstanding shares of Class E preferred stock is required for us to issue capital stock ranking senior to the Class E preferred stock or to amend our charter in a manner that materially and adversely affects the Class E preferred stock.

Listing	We have applied to list the Class E preferred stock on the New York Stock Exchange under the symbol HMTPrE. If the application is approved, we expect that trading of the Class E preferred stock will commence on the NYSE within 30 days after the initial delivery of the Class E preferred stock.
Restrictions on Ownership and Transfer	The Class E preferred stock will be subject to certain restrictions on ownership and transfer intended to assist us in maintaining our status as a REIT for Federal income tax purposes and the status of the Operating Partnership as a partnership for Federal income tax purposes. In general, no person may own, or be deemed to own under the attribution rules of the Internal Revenue Code, more than 9.8% of the lesser of the number or value of the issued and outstanding shares of any class or series of preferred stock or other capital stock. Our board of directors may grant an exemption from the restrictions on ownership of Class E preferred stock to one or more purchasers in the offering if it is satisfied, based, in part, on representations by such purchaser(s), that such exemption would not jeopardize Host Marriott s status as a REIT. A detailed description of these restrictions is contained in the accompanying prospectus under Restrictions on Ownership and Transfer.
Conversion	The Class E preferred stock will not be convertible into or exchangeable for any other securities or property.
Further Issues	We may from time to time, without the consent of the holders of the Class E preferred stock, issue additional shares of preferred stock having the same liquidation preference and other terms as the Class E preferred stock except for the issue price and issue date. See Description of the Class E Preferred Stock Further Issuances.

Table of Contents

Use of Proceeds	We will contribute the net proceeds from the offering of the Class E preferred stock to the Operating Partnership in exchange for Class E preferred partnership interests in the Operating Partnership which will have economic terms substantially similar to those of the Class E preferred stock. We intend for the Operating Partnership to use these proceeds and available cash to redeem all $104 million of aggregate principal amount of 10% Class A Cumulative Redeemable Preferred Units held by us. In turn, we intend to use the funds from the Operating Partnership to redeem all of our $104 million of aggregate amount of 10% Class A Cumulative Redeemable Preferred Stock at $25.00 per share; and we will pay all accumulated and unpaid dividends on such shares to the redemption date. Any proceeds not used for such purpose will be used by the Operating Partnership for general corporate purposes.

Risk factors

You should carefully consider the matters set forth under Risk Factors beginning on page S-8 of this prospectus supplement and page 1 of the accompanying prospectus.

Risk factors

An investment in the Class E preferred stock involves risks, including those described below, in the accompanying prospectus and in our most recent Annual Report on Form 10-K. Prospective investors should carefully consider such risk factors and the other information included or incorporated by reference in this prospectus supplement and the accompanying prospectus before you decide to purchase Class E preferred stock.

Our ability to pay dividends on our Class E preferred stock may be limited or prohibited by the terms of our indebtedness.

We and our subsidiaries, including the Operating Partnership are, and may in the future become, parties to agreements and instruments which, among other things, restrict or prevent the payment of dividends on our classes and series of capital stock. For example, under the terms of our credit facility and our senior notes indenture, distributions to us by the Operating Partnership, which we depend upon in order to obtain the cash necessary to pay dividends, are permitted only to the extent that, at the time of the distributions, the Operating Partnership can satisfy certain financial covenant tests and meet other requirements which are summarized below in Description of the Class E Preferred Stock Dividend and Redemption Restrictions Under Debt Instruments. At any time during which it fails to meet these requirements, the Operating Partnership will only be able to make cash distributions to us in the amounts required to maintain our qualification as a REIT (subject to the limitations on the Operating Partnership s ability to pay these permitted REIT distributions described below in Description of the Class E Preferred Stock Dividend and Redemption Restrictions Under Debt Instruments).

Beginning in the third quarter of 2002 and continuing through the fiscal quarter ended March 26, 2004, the Operating Partnership was prohibited from making distributions and other restricted payments, other than permitted REIT distributions, because the Operating Partnership s EBITDA-to-interest coverage ratio as calculated under its indenture governing its senior notes (which measures the Operating Partnership s ratio of its pro forma consolidated EBITDA to pro forma consolidated interest expense) was below 2.0 to 1.0. Accordingly, during this period, the Operating Partnership was only able to make distributions to us, and we only have been able to pay dividends, to the extent that we have had taxable income and were required to make distributions to maintain our status as a REIT. Our income distribution requirements for 2002 were satisfied, in part, by the full payment of regular dividends on our outstanding classes of preferred stock in 2002 and in the first three quarters of 2003. We did not generate any taxable income from regular operations during 2003; however, taxable income generated by our insurance recovery on the World Trade Center and Financial Center hotels was sufficient to allow us to pay the regular quarterly dividend due on our outstanding classes of preferred stock for the fourth quarter of 2003 and the first quarter of 2004. We expect that the taxable income generated by the insurance recovery will be sufficient to allow us to pay the regular quarterly dividend on our outstanding classes of preferred stock during the second and third quarters of 2004.

Currently, our EBITDA-to-interest coverage ratio is slightly above 2.0 to 1.0, based upon our results of operations for the four fiscal quarters ended March 26, 2004, and after giving effect to: (i) the transactions described below in Capitalization and (ii) the re-designation by the Operating Partnership of JWDC Limited Partnership, a Delaware limited partnership through which we own the JW Marriott hotel in Washington D.C., as a restricted subsidiary under the senior notes indenture. Under the terms of the senior notes indenture, the ability to consider the pro forma effect of the transactions described in clauses (i) and (ii) of the previous sentence had the effect of improving the Operating Partnership s EBITDA-to-interest coverage ratio.

S-8

As a result, and because we expect operations to continue to improve, we currently expect to be able to pay dividends on the Class E preferred stock, and on our outstanding classes of preferred stock which rank on a parity with the Class E preferred stock, without regard to whether we generate any taxable income. However, a decline in our operations or an increase in our consolidated interest expense, or any combination thereof, or, if the Operating Partnership is required to give pro forma effect to any other transactions that have a similar effect, could cause the Operating Partnership s EBITDA-to-interest coverage ratio to again fall below 2.0 to 1.0, which could once again limit the amount of the Operating Partnership s distributions to us (and our payment of dividends on our capital stock, including the Class E preferred stock) to only permitted REIT distributions. Since, based on current estimates, we do not currently expect to generate taxable income during 2004, if the Operating Partnership s EBITDA-to-interest coverage ratio again falls below 2.0 to 1.0, or the Operating Partnership is otherwise limited in the amount of distributions it can make to us under the terms of the senior notes indenture, we cannot assure you that we would be able to pay dividends on the Class E preferred stock and on the classes of preferred stock ranking on a parity with the Class E preferred stock. Notwithstanding the foregoing, dividends will accrue on the Class E preferred stock regardless of whether we are permitted to declare or pay such dividends.

Our ability to continue paying dividends on our outstanding classes of preferred stock will depend on several factors outside of our control, such as our liquidity, the extent of our taxable income or loss from operations in 2004 and thereafter, and our ability to meet the minimum EBITDA-to-interest coverage ratio and to satisfy the other requirements for making distributions set forth in the senior notes indenture and our credit facility. Moreover, the Class E preferred stock ranks on parity with our other classes of outstanding preferred stock. Under the terms of such outstanding classes of preferred stock, and of the Class E preferred stock, we are not permitted to pay dividends on the Class E preferred stock unless we also contemporaneously pay dividends on each other outstanding class of preferred stock. Therefore, during any period that the Operating Partnership does not meet the EBITDA-to-interest coverage ratio, any dividends resulting from our required income distributions will have to be allocated on a pro rata basis to all outstanding classes of preferred stock (including the Class E preferred stock and any subsequently issued classes of preferred stock which is on parity with the outstanding classes of preferred stock).

The Class E preferred stock is a new issuance and does not have an established trading market, which may negatively affect its market value and your ability to transfer or sell your shares, and the Class E preferred stock has no stated maturity date.

The Class E preferred stock is a new issue of securities with no established trading market. Because the Class E preferred stock does not have a stated maturity date, investors seeking liquidity will be limited to selling their shares in the secondary market. We have applied to list the Class E preferred stock on the NYSE; however, we cannot assure you that the Class E preferred stock will be approved for listing. If the application is approved, trading of the Class E preferred stock on the NYSE is not expected to begin until a 30-day period after the date of initial delivery of the Class E preferred stock, and, in any event, an active trading market on the NYSE for the Class E preferred stock may not develop or, even if it does develop, may not last, in which case the trading price of the Class E preferred stock could be adversely affected and your ability to trade your shares may be limited. We have been advised by the underwriters that they intend to make a market in the Class E preferred stock, but the underwriters are not obligated to do so and may cease market-making activities, if commenced, at any time.

The market value of the Class E preferred stock could be substantially affected by various factors.

As with other publicly traded securities, the trading price of the Class E preferred stock will depend on many factors, which may change from time to time, including:

[Table of Contents](#)

Risk factors

- prevailing interest rates, increases in which may have an adverse effect on the trading price of the Class E preferred stock;
- the market for similar securities;
- general economic and financial market conditions;
- the attractiveness of securities of REITs in comparison to other companies, taking into account, among other things, the higher tax rates imposed on dividends paid by REITs;
- the market s perception of our growth potential and potential future cash dividends and whether or not we are current on our dividend payments;
- ratings of the Class E preferred stock, as determined by national ratings agencies;
- government action or regulation; and
- our financial condition, performance, and prospects.

The Class E preferred stock will be subordinate to our indebtedness, and our indebtedness could prevent us from fulfilling our obligations under the Class E preferred stock.

As adjusted to give effect to certain transactions described in Capitalization below, our total indebtedness was approximately $5.6 billion at March 26, 2004. We may also borrow substantial additional secured or unsecured indebtedness in the future. The repayment of the principal and interest on our indebtedness may prevent us from being able to make dividend payments on the Class E preferred stock. In addition, in the event of bankruptcy, liquidation, dissolution, reorganization or similar proceeding with respect to us, our indebtedness will rank senior to the Class E preferred stock, and the holders of any indebtedness will be entitled to satisfaction of any amounts owed them prior to payment of the liquidation preference of any capital stock, including the Class E preferred stock.

Ratio of earnings to combined fixed charges and preferred stock dividends

The following table sets forth our ratio of earnings to combined fixed charges and preferred stock dividends on a historical basis for the periods indicated (in millions, except ratios).

	Quarter Ended		Year Ended December 31,				
	March 26, 2004	March 28, 2003	2003	2002	2001	2000	1999
Ratio of earnings to combined fixed charges and preferred stock dividends (1).					1.1x	1.1x	1.4x
Deficiency of earnings to combined fixed charges and preferred stock dividends (2).	$ 34	$ 40	$ 239	$ 61			

(1) The ratio of earnings to combined fixed charges and preferred stock dividends is computed by dividing income from continuing operations (after depreciation expense) before income taxes and fixed charges and preferred stock dividends by total fixed charges and preferred stock dividends. Fixed charges represent interest expense (including capitalized interest), the amortization of premiums, discounts and capitalized expenses related to indebtedness, and the portion of rental expense that represents interest.

(2) For the first quarters ended March 26, 2004 and March 28, 2003 and for fiscal years 2003 and 2002, the deficiency of earnings to combined fixed charges and preferred stock dividends includes depreciation expense of $83 million, $84 million, $367 million and $358 million, respectively.

Table of Contents

Use of proceeds

After deducting underwriting discounts and commissions and the estimated expenses of this offering, we expect that the net proceeds from this offering will be approximately $97 million (approximately $101 million if the underwriters option is exercised in full).

We will contribute the net proceeds from the offering of the Class E preferred stock to the Operating Partnership in exchange for Class E preferred partnership interests in the Operating Partnership which will have economic terms substantially similar to those of the Class E preferred stock. On or about August 3, 2004, we intend for the Operating Partnership to use these proceeds and available cash to redeem all $104 million of its 10% Class A Cumulative Redeemable Preferred Units held by us. On or about August 3, 2004, in turn, we intend to use the funds from the Operating Partnership to redeem all of our $104 million aggregate amount of 10% Class A Cumulative Redeemable Preferred Stock at $25.00 per share; and we will pay all accumulated and unpaid dividends on such shares to the redemption date.

In the event the Operating Partnership was restricted by the terms of any future or existing indebtedness from redeeming its 10% Class A preferred units, then we would not be able to redeem our 10% Class A Cumulative Redeemable Preferred Stock prior to the August 3, 2004 redemption date, and the Operating Partnership would use the proceeds from this offering to repay indebtedness or for general corporate purposes. See Description of the Class E Preferred Stock Dividend and Redemption Restrictions Under Debt Instruments elsewhere in this prospectus supplement.

We will invest the net proceeds in short-term, interest-bearing, investment grade obligations until they are applied as described above.

Table of Contents

Dividend policy

We are required to distribute to our stockholders at least 90% of our taxable income in order to qualify as a REIT, including taxable income we recognize for tax purposes but, with regard to which, we do not receive corresponding cash. Funds we use to pay dividends on our common and preferred stock are provided through distributions from the Operating Partnership. For every share of common and preferred stock we have outstanding, the Operating Partnership has issued to us a corresponding common Operating Partnership unit (common OP unit) or preferred Operating Partnership unit (preferred OP unit), respectively. As of May 26, 2004, we are the owner of substantially all of the preferred OP units and approximately 93% of the common OP units. The remaining 7% of the common OP units are held by various third-party limited partners. As a result of their minority position in the Operating Partnership common OP units, these holders share, on a pro rata basis, in amounts being distributed by the Operating Partnership to us on its common OP units. As a general rule, we obtain the cash necessary to pay a common or preferred dividend from an equivalent per unit distribution to us by the Operating Partnership on all common or corresponding preferred OP units. For example, if we pay a five cent per share dividend on our common stock, it would be based on payment of a five cent per common OP unit distribution by the Operating Partnership to us and to all other common OP unit holders.

We and our subsidiaries, including the Operating Partnership are, and may in the future become, parties to agreements and instruments which, among other things, restrict or prevent the payment of dividends on our classes and series of capital stock. For example, under the terms of our credit facility and our senior notes indenture, the ability of the Operating Partnership to make distributions to us which we depend upon in order to obtain the cash necessary to pay dividends on our capital stock, is subject to various prohibitions and limitations. For a discussion of these restrictions, see Description of the Class E Preferred Stock Dividend and Redemption Restrictions Under Debt Instruments and Risk Factors Our ability to pay dividends on our Class E preferred stock may be limited or prohibited by the terms of our indebtedness, elsewhere in this prospectus supplement.

Our policy on dividends generally is to distribute at least 90% of our taxable income in order to satisfy the above REIT distribution requirements. However, we currently intend to pay dividends on our preferred stock (including the Series E preferred stock) regardless of the amount of our taxable income, so long as we are not restricted in doing so by the terms of our debt instruments.

Table of Contents

Capitalization

The following table sets forth our actual capitalization as of March 26, 2004 and our capitalization as of March 26, 2004, as adjusted to give effect to:

- The estimated net proceeds from this offering, after deducting underwriters discounts and commissions and our estimated expenses, of approximately $97 million;
- the redemption of $104 million of our Class A preferred stock with the estimated net proceeds of this offering and available cash;
- the redemption of $494 million of Series B senior notes on April 15, 2004 with restricted cash and available cash;
- the redemption of $65 million of Series B senior notes on May 3, 2004 with available cash;
- the acquisition of the Embassy Suites Chicago Downtown-Lakefront Hotel on April 27, 2004; and
- the sale of the Dallas/Fort Worth Airport Marriott on May 10, 2004.

	As of March 26, 2004	
	Actual	As Adjusted (1)
	(in thousands)	
Cash and cash equivalents	$ 526	$ 389(2)
Debt		
Senior notes, including $490 million, net of discount, of exchangeable senior debentures	$ 3,459	$ 2,900(3)
Mortgage debt	2,109	2,109
Exchangeable subordinated debentures	492	492
Other	100	100
Total debt	6,160	5,601
Minority interest	218	217(4)
Stockholders equity		
10% Class A Cumulative Redeemable Preferred Stock, 4,160,000 and 0 shares outstanding, actual and as adjusted, respectively(5)	100	(6)
10% Class B Cumulative Redeemable Preferred Stock, 4,000,000 shares outstanding(5)	96	96
10% Class C Cumulative Redeemable Preferred Stock, 5,980,000 shares outstanding(5)	143	143

10% Class D Cumulative Redeemable Preferred Stock, 33,182 shares outstanding		
8 7/8% Class E Cumulative Redeemable Preferred Stock, 0 and 4,000,000 shares outstanding, actual and as adjusted, respectively(5)		97
Total cumulative redeemable preferred stock	339	336
Common Stock, $0.01 par value; 750 million shares authorized; 321,897,490 shares outstanding	3	3
Additional paid-in capital	2,619	2,619
Accumulated other comprehensive income	26	26
Deficit	(891)	(907)(7)
Total stockholders equity	2,096	2,077
Total capitalization	$ 8,474	$ 7,895

S-14

Table of Contents

Capitalization

(1) As adjusted financial information reflects the adjustments noted above.
(2) As adjusted, cash reflects the following:

Actual cash balance as of March 26, 2004	$ 526
Estimated net proceeds from this offering	97
Redemption of all $104 million of our Class A preferred stock, including the related accrued dividends	(105)
Principal repayment of $65 million of 7 7/8% Series B senior notes	(65)
Payment of call premiums related to the redemption of $494 million and $65 million of our Series B senior notes	(22)
Payment of accrued interest on the Series B senior notes	(12)
Purchase of the Embassy Suites Chicago Downtown Lakefront Hotel	(89)
Proceeds from the sale of the Dallas/Fort Worth Airport Marriott Hotel	59
As adjusted cash balance at March 26, 2004	$ 389

(3) On April 15, 2004 and May 3, 2004, we redeemed $494 million and $65 million, respectively, of our Series B senior notes. The April 15, 2004 redemption was funded principally with the cash provided by the March issuance of $500 million of Exchangeable Senior Debentures, the net proceeds of which were included in restricted cash on our consolidated balance sheet as of March 26, 2004. The May 3, 2004 redemption was funded with cash and cash equivalents.
(4) Minority interest decreased as a result of the increase to the deficit as a result of the redemption of the Series B senior notes and the sale of the Dallas/Fort Worth Airport Marriott.
(5) Amounts are presented net of original issuance costs, in accordance with generally accepted accounting principles.
(6) We intend to call for redemption all 4,160,000 shares of our Class A preferred stock at a redemption price of $25.00 per share, plus all accumulated and unpaid dividends on such shares to the redemption date. We expect to set August 3, 2004 as the redemption date. See Use of Proceeds.
(7) Deficit increased $4 million as a result of the treatment of the original issuance costs on the Series A preferred stock redeemed. This represents the difference between the carrying amount of the Series A preferred stock and the fair value of the consideration transferred. While the original issuance costs do not represent an expense for purposes of calculating net income, they are treated as a deduction to earnings available to common stockholders at redemption for purposes of calculating earnings per share in accordance with applicable accounting standards.

As adjusted, the deficit reflects the following:

Deficit at March 26, 2004	$ (891)
Call premiums on the Series B senior notes repaid in the second quarter of 2004	(22)
Write-off of deferred financing fees and discounts on the Series B senior notes repaid	(8)
Interest expense prior to the redemption of the Series B senior notes	(2)
Write off of origination costs of Class A preferred stock	(4)
Gain on the sale of the Dallas/Fort Worth Airport Marriott Hotel	19
Decrease to minority interest expense as a result of the changes to the income statement	1
As adjusted deficit at March 26, 2004	$ (907)

Description of the Class E preferred stock

This description of material terms of the 8 7/8% Class E Cumulative Redeemable Preferred Stock, par value $.01 per share, offered hereby supplements and, to the extent inconsistent therewith, replaces, the description of certain general terms and provisions of our preferred stock, par value $.01 per share, set forth in the accompanying prospectus. As used under this caption Description of the Class E preferred stock and in the accompanying prospectus under Description of Capital Stock Preferred Stock, all references to Host Marriott or the company mean Host Marriott Corporation, excluding, unless otherwise expressly stated or the context otherwise requires, our subsidiaries.

The following summary of material terms of the Class E preferred stock does not purport to be complete and is subject to, and qualified in its entirety by reference to, all of the provisions of our charter and the form of articles supplementary classifying the Class E preferred stock, which have been, or will be, filed as exhibits to, or incorporated by reference in, the registration statement of which the accompanying prospectus is a part. You may obtain copies of these documents in the manner described under Where You Can Find More Information.

Prospective investors should carefully review the information in the accompanying prospectus under Description of Capital Stock Restrictions on Ownership and Transfer for important information concerning the restrictions on ownership and transfer applicable to the Class E preferred stock.

GENERAL

Our charter provides that the total number of shares of stock, which we refer to as capital stock, of all classes which we are authorized to issue is 800,000,000, 750,000,000 of which initially were classified as common stock, par value $.01 per share, and 50,000,000 of which initially were classified as preferred stock, par value $.01 per share. Of the 50,000,000 shares of preferred stock, (1) 4,600,000 shares are classified as Class A Cumulative Redeemable Preferred Stock, par value $.01 per share, (2) 4,600,000 shares are classified as Class B Cumulative Redeemable Preferred Stock, par value $.01 per share, (3) 5,980,000 shares are classified as Class C Cumulative Redeemable Preferred Stock, par value $.01 per share, (4) 40,000 shares are classified as Class D Cumulative Redeemable Preferred Stock, par value $.01 per share and (5) 650,000 shares are classified as Series A Junior Participating Preferred Stock, par value $.01 per share. Under our charter, our board of directors is authorized, without a vote of the stockholders, to classify or reclassify any unissued shares of capital stock by setting or changing the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications or terms or conditions of redemption of such shares of capital stock. The board of directors also has the power to classify or reclassify any unissued shares of capital stock (including shares initially classified as common stock or preferred stock) into any other class or series of capital stock, and to divide and classify shares of any class into one or more series of such class. Thus, the board of directors could authorize the issuance of a class or series of capital stock with terms and conditions which could have the effect of delaying, deferring or preventing a transaction or a change in control of Host Marriott that might involve a premium price for holders of shares of common stock, Class A preferred stock, Class B preferred stock, Class C preferred stock, Class D preferred stock or Class E preferred stock or otherwise be in their respective best interests.

We have previously authorized the issuance of shares of Class A preferred stock, Class B preferred stock, Class C preferred stock and Class D preferred stock. As of the date of this prospectus supplement, there

Description of the Class E preferred stock

were 4,160,000 shares of Class A preferred stock, 4,000,000 shares of Class B preferred stock, 5,980,000 shares of Class C preferred stock and 33,182 shares of Class D preferred stock issued and outstanding. We have previously authorized the issuance of shares of Series A junior preferred stock in connection with our stockholder rights plan. As of the date of this prospectus supplement, no shares of Series A junior preferred stock were outstanding, although we have reserved for issuance 650,000 shares of Series A junior preferred stock. For a description of our stockholder rights plan, see the accompanying prospectus under Description of Capital Stock Common Stock Stockholder Rights Plan/Preferred Stock Purchase Rights.

We have authorized the issuance of a class of preferred stock, consisting of 8,000,000 shares designated as the 8 7/8% Class E Cumulative Redeemable Preferred Stock.

We have applied to list the Class E preferred stock on the New York Stock Exchange under the symbol HMTPrE. If the application is approved, we expect that trading of the Class E preferred stock will commence on the New York Stock Exchange within 30 days after the initial delivery of the Class E preferred stock.

The Class E preferred stock does not contain any provisions affording holders of the Class E preferred stock protection in the event of a highly leveraged or other transaction that might adversely affect holders of the Class E preferred stock, except to the limited extent described below under Voting Rights.

The transfer agent, registrar and paying agent for the Class E preferred stock will be EquiServe Trust Company N.A. The articles supplementary for the Class E preferred stock will provide that we will at all times maintain an office or agency in the Borough of Manhattan, The City of New York, where shares of Class E preferred stock may be surrendered for payment (including upon redemption, if any), registration of transfer or exchange.

FURTHER ISSUANCES

We may from time to time, without the consent of the holders of the Class E preferred stock, issue additional shares of Class E preferred stock having the same ranking and the same liquidation preference and other terms as the Class E preferred stock except for the issue price and issue date. Any such additional shares of Class E preferred stock will, together with the shares offered hereby, constitute a single class of preferred stock under our charter and will vote together on limited matters under the charter as set forth below under Voting Rights.

RANKING

The Class E preferred stock will rank, with respect to the payment of dividends and the distribution of assets upon our liquidation, dissolution or winding up: (1) senior to our common stock, senior to our Series A junior preferred stock, and senior to any other class or series of our capital stock other than capital stock referred to in clauses (2) and (3) of this sentence; (2) on a parity with our Class A preferred stock, Class B preferred stock, Class C preferred stock and Class D preferred stock and on a parity with any class or series of our capital stock the terms of which specifically provide that such class or series of capital stock ranks on a parity with the Class A, Class B, Class C, Class D and Class E preferred stock as to the payment of dividends and the distribution of assets upon our liquidation, dissolution or winding up; and (3) junior to any class or series of our capital stock the terms of which specifically provide that

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Table of Contents

Description of the Class E preferred stock

such class or series of capital stock ranks senior to the Class E preferred stock as to the payment of dividends and the distribution of assets upon our liquidation, dissolution or winding up. The term capital stock does not include convertible debt securities. The description of the ranking of the Class E preferred stock set forth in this paragraph supersedes and replaces, insofar as it concerns the Class E preferred stock, the discussion set forth in the accompanying prospectus under Description of Capital Stock Preferred Stock Rank.

Our board of directors may, from time to time, without stockholder approval, authorize the issuance of one or more additional classes or series of capital stock ranking on a parity with the Class E preferred stock or classify additional shares of preferred stock as Class E preferred stock. See General above and Voting Rights below. In addition, with the affirmative vote or consent of the holders of at least two-thirds of the shares of Class E preferred stock outstanding at the time, as described below under Voting Rights, we may issue one or more classes or series of capital stock which rank senior to the Class E preferred stock as to the payment of dividends and/or the distribution of assets upon our liquidation, dissolution or winding up, and the rights of holders of Class E preferred stock to receive dividends and amounts due upon our liquidation, dissolution or winding up will be subject to the preferential rights of any such senior class or series of our capital stock. However, no such senior capital stock is currently outstanding.

In addition, because our operations are conducted primarily through the Operating Partnership and its subsidiaries, our cash flow and our consequent ability to pay dividends on our capital stock (including the payment of dividends to holders of the Class E preferred stock) are dependent upon the results of operations of those subsidiaries and the distribution of monies by those subsidiaries to us.

DIVIDEND AND REDEMPTION RESTRICTIONS UNDER DEBT INSTRUMENTS

We and our subsidiaries are, and may in the future become, parties to agreements and instruments which restrict or prevent the payment of dividends on, or the purchase or redemption of, Class E preferred stock and any other class or series of our capital stock, including indirect restrictions (for example, through covenants requiring maintenance of specified levels of net worth) and direct restrictions.

The Operating Partnership s Credit Facility

The Operating Partnership s credit facility, to which we are a party, provides that distributions may only be paid to holders of equity interests of the Operating Partnership, including Host Marriott as a partner of the Operating Partnership, and we may only pay dividends on our capital stock, including the Class E preferred stock, so long as (1) no default or event of default under the credit facility exists at the time of the payment or would exist immediately after giving effect to such payment and (2) we qualify or have taken all actions necessary to qualify as a REIT for Federal income tax purposes. Assuming the foregoing conditions are met, the Operating Partnership may distribute quarterly to us and the other holders of the units of the Operating Partnership, and we may pay dividends to our stockholders (including the payment of dividends to holders of the Class E preferred stock), in an amount not to exceed (I) the greater of (A) 100% of cash available for distribution (as defined in the credit facility), (B) 100% of taxable income (as defined in the credit facility) and (C) the minimum amount necessary for us to maintain our tax status as a real estate investment trust and to satisfy the distribution required to be made by Notice 88-19 under the Internal Revenue Code of 1986 (or Treasury regulations issued pursuant thereto) by reason of our having made the election provided for therein, or (II) if the Operating

S-18

Table of Contents

Description of the Class E preferred stock

Partnership s consolidated interest coverage ratio (as defined in the credit facility) is greater than 2.0 to 1.0, 85% of our funds from operations (as defined and adjusted in the credit facility) for the current fiscal year.

The Operating Partnership s Senior Notes Indenture

In addition, the senior notes indenture governing the Operating Partnership s outstanding 7 7/8% Series B senior notes due 2008, 8 3/8% Series E senior notes due 2006, 9¼% Series G senior notes due 2007 and 9½% Series I senior notes due 2007 provides that no distributions may be made to holders of its equity interests, including Host Marriott as a partner of the Operating Partnership, during the continuance of defaults or events of defaults under the senior notes indenture or if the Operating Partnership could not incur at least $1.00 of indebtedness (as defined) under the terms of the indebtedness covenant of the senior notes indenture. The Operating Partnership s ability to incur indebtedness under the senior notes indenture s indebtedness covenant is subject to various financial tests and requirements, including that the Operating Partnership s EBITDA-to-interest coverage ratio (which measures the ratio of its pro forma consolidated EBITDA to its pro forma consolidated interest expense, as these terms are defined in the senior notes indenture) be 2.0 to 1.0 or greater. In addition, the aggregate amount of all of the Operating Partnership s indebtedness must be less than or equal to 65% of its total assets plus accumulated depreciation.

The senior notes indenture also provides that distributions may not be made to holders of the Operating Partnership s equity interests, including Host Marriott, if all distributions and other restricted payments (as defined) made since August 5, 1998 (the initial issue date of debt securities under the senior notes indenture) generally exceed the sum of (a) 95% of the Operating Partnership s aggregate funds from operations (as defined) beginning on the first day of the fiscal quarter in which debt securities were first issued under the senior notes indenture, (b) 100% of the net cash proceeds from the permitted issuance of certain equity interests of the Operating Partnership and from the issuance of specified convertible indebtedness upon conversion thereof, or otherwise received as capital contributions (as defined), (c) the total net reduction in certain investments resulting from payments to the Operating Partnership or the sale of those investments, (d) the fair market value of noncash tangible assets or capital stock (other than that of the Operating Partnership or Host Marriott) acquired in exchange for qualified capital stock (as defined), and (e) fair market value of noncash tangible assets or capital stock (other than that of the Operating Partnership or Host Marriott) contributed to the Operating Partnership as a capital contribution (as defined). The aggregate amount of distributions and other restricted payments that the Operating Partnership is permitted to make pursuant to clause (3) of the preceding sentence is sometimes referred to as the Operating Partnership s restricted payments basket.

Notwithstanding the foregoing restrictions on distributions by the Operating Partnership, it is permitted under the senior notes indenture to make distributions as required to allow us to make all dividend payments necessary to maintain our status as a REIT for Federal income tax purposes (which we call permitted REIT distributions) unless (1) it is during the continuance of a default or event of default under the senior notes indenture or (2) the aggregate principal amount of all outstanding indebtedness of the Operating Partnership and its restricted subsidiaries (as defined in the senior notes indenture) (other than the Operating Partnership s obligations under our 6¾% Convertible Subordinated Debentures) at such time is equal to or greater than 80% of the value of the Operating Partnership s adjusted total assets (as defined in the senior notes indenture).

Table of Contents

Description of the Class E preferred stock

The senior notes indenture governing the Operating Partnership s outstanding 7 1/8% Series K senior notes due 2013 contains limitations on distributions that may be made to holders of the Operating Partnership s equity interests that are substantially similar to those governing the Operating Partnership s other outstanding senior notes, provided, that, the covenants governing distributions and other restricted payments in the indenture for the Series K senior notes provides that, for the purposes of determining whether the Operating Partnership may make a declaration or payment of any dividend or other distribution in respect of its preferred stock, the EBITDA-to-interest coverage ratio must be 1.7 to 1.0 or greater, rather than 2.0 to 1.0 or greater and the permitted REIT distributions definition provides that the Operating Partnership may make distributions to us without limitation in the amount necessary to permit us to distribute to our shareholders (1) 100% of the real estate investment trust taxable income within the meaning of the Internal Revenue Code or (2) such amounts necessary to maintain our status as a REIT or to enable us to avoid the payment of any tax that could be avoided by reason of such distribution. Our ability to make permitted REIT distributions under the indenture for the Series K senior notes is otherwise subject to similar conditions to those in the indenture governing the Operating Partnership s other outstanding senior notes.

Restrictions under our Convertible Subordinated Debentures

We are the obligor under $550 million aggregate principal amount of 6¾% convertible subordinated debentures due 2026, which are held by our subsidiary, Host Marriott Financial Trust, in connection with its 6¾% convertible quarterly income preferred securities. Under the terms of the indenture governing our convertible subordinated debentures, we may defer interest payments on the convertible subordinated debentures for a period not to exceed 20 consecutive quarters. To the extent that we defer the payment of interest on the convertible subordinated debentures, we will not be permitted to declare or pay any cash distributions with respect to our capital stock, including the Class E preferred stock, or debt securities that rank on a parity with, or junior to, the convertible subordinated debentures.

The terms of the credit facility and the senior notes indenture governing the Operating Partnership s senior notes and our convertible subordinated debentures discussed above, as well as, the terms of the debt instruments or agreements to which we or our subsidiaries in the future may become parties, could limit or prohibit the payment of dividends on shares of Class E preferred stock and any other class or series of our capital stock. For a discussion of this risk, see Risk Factors Our ability to pay dividends on Class E preferred stock may be limited or prohibited by the terms of our indebtedness.

Our ability to make permitted REIT distributions under the credit facility and the senior notes indenture is subject to the limitations noted above. If we fail to pay dividends as required by the Internal Revenue Code, whether as a result of restrictive covenants in debt instruments or otherwise, we would lose our status as a REIT for Federal income tax purposes. As described in the accompanying prospectus in Risk Factors Adverse consequences would apply if we failed to qualify as a REIT, this loss of our status as a REIT would likely have a material adverse effect on us.

DIVIDENDS

Subject to the preferential rights of holders of any class or series of our capital stock ranking senior to the Class E preferred stock as to dividends, holders of the Class E preferred stock will be entitled to receive, when, as and if authorized by our board of directors and declared by us, out of our funds legally available for the payment of dividends, cumulative cash dividends at the rate of 8 7/8% per annum of the $25.00 per share liquidation preference (equivalent to an annual rate of $2.21875 per share). Dividends will accrue and be cumulative from the date of issuance and will be payable quarterly in arrears on January 15, April 15, July 15 and October 15 of each year or, if such day is not a Business

Day, as defined in the articles supplementary for the Class E preferred stock, the next succeeding Business Day. Notwithstanding any provision to the contrary contained in the articles supplementary classifying the Class E preferred stock, each outstanding share of Class E preferred stock will be entitled to receive a

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Table of Contents

Description of the Class E preferred stock

dividend with respect to any dividend record date equal to the dividend paid with respect to each other share of Class E preferred stock that is outstanding on such date.

The first dividend, which will be payable on July 15, 2004 (or, if such day is not a Business Day, on the next succeeding Business Day), will be for less than a full quarterly dividend period. Dividends payable on the Class E preferred stock, including dividends payable for partial dividend periods, will be computed on the basis of a 360-day year consisting of twelve 30-day months.

Dividends will be payable to holders of record as they appear in our stock transfer books at the close of business on the applicable dividend record date, which will be the 1st day of the calendar month in which the applicable dividend payment date falls or such other date designated by our board of directors that is not more than 30 nor less than ten days prior to such dividend payment date.

If any dividend payment date or redemption date for the Class E preferred stock falls on a day which is not a Business Day, the payment which would otherwise be due on such dividend payment date or redemption date, as the case may be, may be made on the next succeeding Business Day with the same force and effect as if made on such dividend payment date or redemption date, as the case may be, and no interest or additional dividends or other sum will accrue on the amount so payable for the period from and after such dividend payment date or redemption date, as the case may be, to such next succeeding Business Day.

If any shares of Class E preferred stock are outstanding, no full dividends will be declared or paid or set apart for payment on any shares of our capital stock of any other class or series ranking, as to dividends, on a parity with, or junior to, the Class E preferred stock for any period unless full cumulative dividends have been or contemporaneously are declared and paid or declared and a sum sufficient for the payment thereof set apart for such payment on the Class E preferred stock for all past dividend periods (including, without limitation, any dividend period that terminates on any date upon which dividends on such other class or series of our capital stock are declared or paid or set apart for payment, as the case may be). When such cumulative dividends are not paid in full, or a sum sufficient for such full payment is not so set apart, upon the Class E preferred stock and the shares of any other class or series of our capital stock ranking on a parity as to dividends with the Class E preferred stock, all dividends declared upon the Class E preferred stock and any other class or series of our capital stock ranking on a parity as to dividends with the Class E preferred stock shall be declared pro rata so that the amount of dividends declared per share of Class E preferred stock and such other class or series of our capital stock shall in all cases bear to each other the same ratio that accrued and unpaid dividends per share on the Class E preferred stock and such other class or series of capital stock, which will not include any accrual in respect of unpaid dividends for prior dividend periods if the other class or series of capital stock does not provide for cumulative dividends, bear to each other.

Except as provided in the immediately preceding paragraph, unless full cumulative dividends on the Class E preferred stock have been or contemporaneously are declared and paid or declared and a sum sufficient for the payment thereof set apart for payment for all past dividend periods (including, without limitation, any dividend period that terminates on a date that also is a Subject Date (as defined below)), then

- no dividends, other than in common stock or shares of any other class or series of our capital stock ranking junior to the Class E preferred stock as to dividends and as to the distribution of assets upon our liquidation, dissolution or winding up, shall be declared or paid or set aside for payment and no other distribution shall be declared or made upon our common stock or any other class or series of our capital stock ranking junior to or on a parity with the Class E preferred stock as to dividends or as to the distribution of assets upon our liquidation, dissolution or winding up, and

- no common stock, or shares of any other class or series of our capital stock ranking junior to or on parity with the Class E preferred stock as to dividends or as to the distribution of assets upon our

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Description of the Class E preferred stock

liquidation, dissolution or winding up, shall be redeemed, purchased or otherwise acquired for any consideration or any money paid to or made available for a sinking fund for the redemption of any such shares by us, (1) except by conversion into or exchange for shares of any other class or series of our capital stock ranking junior to the shares of Class E preferred stock as to dividends and as to the distributions of assets upon our liquidation, dissolution or winding up and (2) except for the redemption, purchase or acquisition by us of our capital stock of any class or series in order to preserve our status as a REIT for Federal income tax purposes or the Operating Partnership s status as a partnership for Federal income tax purposes.

As used in this paragraph, the term Subject Date means (1) any date on which any dividends are declared or paid or set apart for payment or other distribution declared or made upon our common stock or any other class or series of our capital stock ranking junior to or on a parity with the Class E preferred stock as to dividends or as to the distribution of assets upon our liquidation, dissolution or winding up, and (2) any date on which any shares of our common stock or any other class or series of our capital stock ranking junior to or on a parity with the Class E preferred stock as to dividends or as to the distribution of assets upon our liquidation, dissolution or winding up are redeemed, purchased or otherwise acquired for any consideration or any money paid to or made available for a sinking fund for the redemption of any such shares by us.

Our charter provides that our ability to pay dividends on any class or series of our capital stock is not limited by the amount that would be needed, if we were to be dissolved at the time of the dividend, to satisfy the preferential rights upon our liquidation, dissolution or winding up of classes or series of capital stock ranking senior to the capital stock receiving the dividends, unless otherwise specifically provided for in the terms of any class or series of capital stock. The terms of the Class E preferred stock do not provide otherwise and, accordingly, the Class E preferred stock will be subject to the foregoing provisions.

No dividends on any shares of Class E preferred stock will be declared or paid or set apart for payment at such time as any agreement, including any agreement relating to our indebtedness, prohibits such declaration, payment or setting apart for payment or provides that such declaration, payment or setting apart for payment would constitute a breach thereof or a default thereunder, or if such declaration, payment or setting apart for payment will be restricted or prohibited by applicable law.

Notwithstanding the foregoing, dividends on the Class E preferred stock will accrue regardless of whether or not we have earnings, regardless of whether or not there are funds legally available for the payment of such dividends, and regardless of whether or not such dividends are declared. No interest, or sum of money in lieu of interest, will be payable in respect of any dividend payment or payments on the Class E preferred stock that may be in arrears, and holders of the Class E preferred stock will not be entitled to any dividends, whether payable in cash, securities or other property, in excess of the full cumulative dividends described above. Any dividend payment made on the Class E preferred stock will first be credited against the earliest accrued but unpaid dividend due with respect to the Class E preferred stock.

If for any taxable year, we elect to designate as capital gain dividends, as defined in the Internal Revenue Code, any portion of the dividends paid or made available for the year to holders of all classes and series of our capital stock, then the portion of the dividends designated as capital gain dividends that will be allocable to the holders of the Class E preferred stock will be an amount equal to the total capital gain dividends multiplied by a fraction, the numerator of which will be the total dividends, within the meaning of the Internal Revenue Code, paid or made available to the holders of the Class E preferred

Description of the Class E preferred stock

stock for the year, and the denominator of which will be the total dividends paid or made available to holders of all classes and series of our capital stock for that year.

Information contained under this caption Dividends supersedes and replaces, insofar as it concerns the Class E preferred stock, the discussion set forth in the accompanying prospectus under Description of Capital Stock Preferred Stock Distributions.

LIQUIDATION PREFERENCE

Upon any voluntary or involuntary liquidation, dissolution or winding up of the company, then, before any distribution or payment will be made to the holders of any common stock or any other class or series of our capital stock ranking junior to the Class E preferred stock as to the distribution of assets upon the liquidation, dissolution or winding up of the company, but subject to the preferential rights of the holders of any other class or series of our capital stock ranking senior to the Class E preferred stock as to such distribution of assets, the holders of Class E preferred stock will be entitled to receive and to be paid out of our assets legally available for distribution to stockholders liquidating distributions in the amount of $25.00 per share, plus an amount equal to all accrued and unpaid dividends to, but not including, the date of payment. After payment of the full amount of the liquidating distributions to which they are entitled, the holders of shares of Class E preferred stock, as such, will have no right or claim to any of our remaining assets. If, upon any such voluntary or involuntary liquidation, dissolution or winding up, our assets legally available for distribution to stockholders are insufficient to pay the full amount of the liquidating distributions on all outstanding shares of Class E preferred stock and the full amount of the liquidating distributions payable on all shares of any other classes or series of our capital stock ranking on a parity with the Class E preferred stock as to the distribution of assets upon our liquidation, dissolution or winding up, then the holders of the Class E preferred stock and all other such classes and series of capital stock will share ratably in any such distribution of assets in proportion to the full liquidating distributions to which they would otherwise be respectively entitled.

If liquidating distributions shall have been made in full to all holders of Class E preferred stock and any other classes or series of our capital stock ranking on a parity with the Class E preferred stock as to the distribution of assets upon our liquidation, dissolution or winding up, then our remaining assets will be distributed among the holders of any other classes or series of our capital stock ranking junior to the Class E preferred stock as to the distribution of assets upon our liquidation, dissolution or winding up, according to their respective rights and preferences.

For purposes of the two preceding paragraphs, neither the consolidation or merger of the company with or into any other corporation, trust or entity, nor the sale, lease or conveyance of all or substantially all of our property or business, will be deemed to constitute a liquidation, dissolution or winding up of the company.

The information contained under this caption Liquidation Preference supersedes and replaces, insofar as it concerns the Class E preferred stock, the discussion set forth in the accompanying prospectus under Description of Capital Stock Preferred Stock Liquidation Preference.

OPTIONAL REDEMPTION

The Class E preferred stock is not redeemable prior to June 2, 2009, except that we will be entitled, pursuant to provisions of our charter, to redeem, repurchase or acquire shares of Class E preferred stock

Description of the Class E preferred stock

in order to preserve our status as a REIT for Federal income tax purposes or the status of the Operating Partnership as a partnership for Federal income tax purposes. For a description of these provisions, see Other below and Description of Capital Stock Restrictions on Ownership and Transfer in the accompanying prospectus.

On and after June 2, 2009, we may, at our option upon not less than 30 nor more than 60 days prior written notice to the holders of the Class E preferred stock, redeem the Class E preferred stock, in whole or from time to time in part, for a cash redemption price equal to $25.00 per share plus, except as described below with respect to redemption after a dividend record date and on or prior to the corresponding dividend payment date, accrued and unpaid dividends to, but not including, the date fixed for redemption.

Notwithstanding anything to the contrary in this prospectus supplement or in the accompanying prospectus, unless full cumulative dividends on the Class E preferred stock have been or contemporaneously are declared and paid or declared and a sum sufficient for the payment thereof set apart for payment for all past dividend periods (including, without limitation, any dividend period that terminates on the date of any redemption of shares of Class E preferred stock referred to below or on the date of any direct or indirect purchase or other acquisition of shares of Class E preferred stock referred to below, as the case may be), then

- no shares of Class E preferred stock will be redeemed unless all outstanding shares of Class E preferred stock are simultaneously redeemed; provided, however, that the foregoing will not prevent our redemption, repurchase or acquisition of shares of Class E preferred stock (a) to preserve our status as a REIT for Federal income tax purposes or the status of the Operating Partnership as a partnership for Federal income tax purposes or (b) pursuant to a purchase or exchange offer made on the same terms to holders of all outstanding shares of Class E preferred stock, and

- we will not purchase or otherwise acquire directly or indirectly any shares of Class E preferred stock, except by conversion into or exchange for other capital stock ranking junior to the Class E preferred stock as to dividends and with respect to the distribution of assets upon our liquidation dissolution and winding up; provided, however, that the foregoing will not prevent our redemption, repurchase or acquisition of shares of Class E preferred stock (a) to preserve our status as a REIT for Federal income tax purposes or the status of the Operating Partnership as a partnership for Federal income tax purposes or (b) pursuant to a purchase or exchange offer made on the same terms to holders of all outstanding shares of Class E preferred stock.

If fewer than all of the outstanding shares of Class E preferred stock are to be redeemed, the number of shares to be redeemed will be determined by us and the shares to be so redeemed will be selected by us pro rata from the holders of record of the Class E preferred stock in proportion to the number of shares held of record by the holders, as nearly as may be practicable without creating fractional shares, or by lot or by any other equitable method determined by us that will not result in the transfer of any shares of Class E preferred stock to a trust for the benefit of a charitable beneficiary as described in the accompanying prospectus under Description of Capital Stock Restrictions on Ownership and Transfer. If fewer than all of the shares of Class E preferred stock represented by a stock certificate are to be redeemed, we will issue one or more new certificates for the unredeemed shares.

We will give notice of redemption by publication in The Wall Street Journal, or if such newspaper is not then published, a newspaper of general circulation in The City of New York, such publication to be made once a week for two successive weeks commencing not less than 30 nor more than 60 days prior to the redemption date. Notice of redemption also will be mailed, not less than 30 nor more than 60 days

S-24

Table of Contents

Description of the Class E preferred stock

prior to the applicable redemption date, to each holder of record of shares of Class E preferred stock at the holder s address in our share transfer records. Each such notice shall state:

- Ø the redemption price and the redemption date;
- Ø the number of shares of Class E preferred stock to be redeemed;
- Ø the place or places, which will include a place in the Borough of Manhattan, The City of New York, where the Class E preferred stock is to be surrendered for payment of the redemption price; and
- Ø that dividends on the shares of Class E preferred stock to be redeemed will cease to accrue on the applicable redemption date.

If fewer than all of the outstanding shares of Class E preferred stock are to be redeemed, the notice mailed to each holder will also specify the number of shares to be redeemed from that holder. No failure to mail or defect in any mailed notice or in the mailing thereof will affect the validity of the proceedings for the redemption of any shares of Class E preferred stock except as to the holder to whom notice was defective or not given.

If notice of redemption has been given and if funds necessary for such redemption have been irrevocably set aside in trust for the benefit of the holders of the shares of Class E preferred stock called for redemption, then from and after the date fixed for redemption, dividends will cease to accrue on the shares of Class E preferred stock so called for redemption, such shares of Class E preferred stock will no longer be deemed outstanding, and all rights of the holders of such shares of Class E preferred stock will terminate, except the right to receive the redemption price, including, if applicable, any accrued and unpaid dividends to, but not including, the redemption date.

If any redemption date is not a Business Day, then payment of the redemption price may be made on the next Business Day with the same force and effect as if made on the redemption date, and no interest, additional dividends or other sums will accrue on the amount payable from the redemption date to the next Business Day.

The holders of record of shares of Class E preferred stock at the close of business on a dividend record date will be entitled to receive the dividend payable with respect to those shares on the corresponding dividend payment date notwithstanding the redemption of those shares after that dividend record date and on or prior to the dividend payment date or our default in the payment of the dividend due on that payment date. If a redemption date falls after a dividend record date and on or prior to the corresponding dividend payment date, the amount payable upon redemption will not include the dividend payable on that dividend payment date and the full amount of that dividend will instead be paid on the applicable dividend payment date to the holders of record on the corresponding dividend record date. Except as provided in this paragraph and except to the extent that accrued and unpaid dividends are payable as part of the redemption price, we will make no payment or allowance for unpaid dividends, regardless of whether or not in arrears, on shares of Class E preferred stock called for redemption.

The Class E preferred stock has no stated maturity and is not subject to any sinking fund or mandatory redemption.

The information under this caption Optional Redemption supersedes and replaces, insofar as it concerns the Class E preferred stock, the discussion in the accompanying prospectus under Description of Capital Stock Preferred Stock Redemption.

Table of Contents

Description of the Class E preferred stock

VOTING RIGHTS

Holders of Class E preferred stock will not have any voting rights, except as set forth in the articles supplementary creating the Class E preferred stock which terms are described below or as otherwise from time to time required by law.

Whenever dividends on any shares of Class E preferred stock are in arrears for six or more quarterly dividend periods, whether or not consecutive:

- Ø The number of directors on the board of the company will automatically be increased by two, if not already increased by two by reason of the election of directors by the holders of any other class or series of our capital stock upon which like voting rights have been conferred and are exercisable and with which the Class E preferred stock is entitled to vote as a class with respect to the election of those two directors, and
- Ø the holders of Class E preferred stock, voting together as single class with all other classes or series of our capital stock upon which like voting rights have been conferred and are exercisable and which are entitled to vote as a class with the Class E preferred stock in the election of those two directors, will be entitled to vote for the election of a total of two additional directors at a special meeting called by an officer of the company at the request of holders of record of at least 10% of the outstanding Class E preferred stock or by the holders of any such other class or series of our capital stock, unless such request is received less than 90 days before the date fixed for the next annual or special meeting of our stockholders, in which case the vote will be held at the earlier of the next annual or special meeting of our stockholders, and at each subsequent annual meeting, until all dividends accumulated on the Class E preferred stock and on any other class or series of our capital stock upon which like voting rights have been conferred for all prior dividend periods and the then current dividend period have been fully paid or declared and a sum sufficient for the payment thereof set aside for payment in full.

If and when full cumulative dividends on the Class E preferred stock for all prior dividend periods and the then current dividend period have been paid in full or declared and a sum sufficient for the payment thereof set aside for payment in full, the right of holders of Class E preferred stock to elect those two directors will cease and, unless there are other classes and series of our capital stock upon which like voting rights have been conferred and are exercisable, the term of office of each of the two directors so elected will immediately and automatically terminate.

If a special meeting for the election of the additional directors is not called by one of our officers within 30 days after request, then the holders of record of at least 10% of the outstanding shares of Class E preferred stock may designate a holder of Class E preferred stock to call that meeting at our expense. At all times that the voting rights described above are exercisable, the holders of Class E preferred stock will have access to our stock transfer records. We will pay all costs and expenses of calling and holding any meeting and of electing directors as described above.

So long as any shares of Class E preferred stock remain outstanding, we will not, without the affirmative vote or consent of the holders of at least two-thirds of the Class E preferred stock outstanding at the time, given in person or by proxy either in writing or at a meeting, with the Class E preferred stock voting separately as a class,

- Ø authorize, create or issue, or increase the authorized or issued amount of, any class or series of our capital stock ranking senior to the Class E preferred stock as to the payment of dividends or the distribution of assets upon our liquidation, dissolution or winding up, or reclassify any authorized

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Table of Contents

Description of the Class E preferred stock

capital stock into such shares, or create, authorize or issue any obligation or security convertible into, exchangeable or exercisable for, or evidencing the right to purchase, any such shares; or

- amend, alter or repeal the provisions of our charter, including, without limitation, the articles supplementary creating the Class E preferred stock, whether by merger, consolidation or otherwise (an Event), so as to materially and adversely affect any right, preference, privilege or voting power of the Class E preferred stock; provided, however, with respect to the occurrence of any Event, so long as shares of Class E preferred stock remain outstanding or are converted into like securities of the surviving entity, in each case with the preferences, rights, privileges, voting powers and other terms thereof materially unchanged, taking into account that upon the occurrence of an Event we may not be the surviving entity and that the surviving entity may be a non-corporate entity, such as a limited liability company, limited partnership or business trust, in which case the Class E preferred stock would be converted into an equity interest, other than capital stock, having preferences, rights, privileges, voting powers and other terms which are materially unchanged from those of the Class E preferred stock, the occurrence of such Event will not be deemed to materially and adversely affect such rights, preferences, privileges or voting powers of the Class E preferred stock; and provided further that any increase in the amount of authorized preferred stock or common stock or increase in the amount of authorized shares of Class E preferred stock or the creation, issuance or increase in the amount of authorized shares of any other class or series of capital stock, in each case ranking on a parity with or junior to the Class E preferred stock as to dividends and the distribution of assets upon our liquidation, dissolution or winding up, will not be deemed to materially and adversely affect such rights, preferences, privileges or voting powers.

The foregoing voting provisions will not apply if, at or prior to the time when the act with respect to which such vote would otherwise be required will be effected, all outstanding shares of Class E preferred stock have been redeemed or called for redemption and sufficient funds will have been deposited in trust to effect such redemption.

In any matter in which the Class E preferred stock is entitled to vote, including any action by written consent, each share of Class E preferred will be entitled to one vote, except that when shares of any other class or series of our preferred stock have the right to vote with the Class E preferred stock as a single class on any matter, the Class E preferred stock and the shares of each such other class or series will have one vote for each $25.00 of liquidation preference (excluding accrued dividends).

The description of the voting rights set forth above supersedes and replaces, insofar as it concerns the Class E preferred stock, the discussion set forth in the accompanying prospectus under Description of Capital Stock Preferred Stock Voting Rights.

OTHER

The Class E preferred stock will not be exchangeable for or convertible into any other property or securities. The Class E preferred stock will not be entitled to any preemptive rights.

Except as expressly stated in the articles supplementary classifying the Class E preferred stock, the holders of the Class E preferred stock will not have any relative, participating, optional or other special voting rights or powers, and the consent of such holders shall not be required for the taking of any corporate actions.

Table of Contents

Description of the Class E preferred stock

RESTRICTIONS ON OWNERSHIP AND TRANSFER

Our charter contains certain provisions intended, among other purposes, to help preserve our status as a REIT for Federal income tax purposes and the status of the Operating Partnership as a partnership for Federal income tax purposes. Our board of directors may grant an exemption from the restrictions on ownership of Class E preferred stock to one or more purchasers in the offering if it is satisfied, based, in part, on representations by such purchaser(s), that such exemption would not jeopardize Host Marriott s status as a REIT. Our board of directors, or a committee thereof, is authorized to take such actions as it deems advisable to refuse to give effect to or to prevent transfers of capital stock which would endanger our status as a REIT or the status of the Operating Partnership as a partnership. Such actions could include, among other things, causing us to redeem shares of our capital stock, including Class E preferred stock, refusing to give effect to transfers of our capital stock, including Class E preferred stock, on our books or instituting proceedings to enjoin such transfers. In the event of any such redemption of Class E preferred stock, the redemption price will be $25.00 per share plus accrued and unpaid dividends unless the redemption date falls after a dividend record date and on or prior to the corresponding dividend payment date, in which case the amount payable upon redemption will not include the dividend payable on that dividend payment date and the full amount of that dividend will instead be paid on the applicable dividend payment date to the holder of record on the corresponding dividend record date.

In addition to the above powers of our board of directors, or a committee thereof, other provisions of our charter which are described in the accompanying prospectus under Description of Capital Stock Restrictions on Ownership and Transfer apply irrespective of any action or inaction by the board of directors or a committee thereof. The Class E preferred stock will be subject to such provisions. All certificates representing shares of Class E preferred stock will bear a legend referring to these restrictions.

BOOK-ENTRY, DELIVERY AND FORM

The Depository Trust Company, or DTC, will act as securities depositary for the Class E preferred stock. The shares of Class E preferred stock will be issued only as fully-registered securities registered in the name of Cede & Co., the depositary s nominee. One or more fully-registered global security certificates, representing the total aggregate number of shares of Class E preferred stock, will be issued and deposited with the depositary and a notice regarding the restrictions on exchanges and registration of transfer referred to below will be attached to the global security certificates.

The laws of some jurisdictions require that some purchasers of securities take physical delivery of securities in definitive form. Those laws may impair the ability to transfer beneficial interests in shares of Class E preferred stock so long as shares of Class E preferred stock are represented by global security certificates.

The depositary is a limited-purpose trust company organized under the New York Banking Law, a banking organization within the meaning of the New York Banking Law, a member of the Federal Reserve System, a clearing corporation within the meaning of the New York Uniform Commercial Code and a clearing agency registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934.

The depositary holds securities that its participants deposit with the depositary. The depositary also facilitates the settlement among participants of securities transactions, including transfers and pledges, in deposited securities through electronic computerized book-entry changes in participants accounts, thus

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eliminating the need for physical movement of securities certificates. Direct participants include securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. The depositary is owned by a number of its direct participants and by the New York Stock Exchange, the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc., collectively referred to as participants. Access to the depositary system is also available to others, including securities brokers and dealers, bank and trust companies that clear transactions through or maintain a direct or indirect custodial relationship with a direct participant, collectively referred to as indirect participants. The rules applicable to the depositary and its participants are on file with the SEC.

Except as otherwise required by applicable law, no shares of Class E preferred stock represented by global security certificates may be exchanged in whole or in part for shares of Class E preferred stock registered, and no transfer of global security certificates will be made in whole or in part for shares of Class E preferred stock registered, and no transfer of global security certificates in whole or in part may be registered, in the name of any person other than the depositary or any nominee of the depositary, unless, however, the depositary has notified us that it is unwilling or unable to continue as depositary for the global security certificates, has ceased to be qualified to act or we decide to discontinue the use of book-entry transfer through the depositary. All of the shares of Class E preferred stock represented by one or more global security certificates or any portion of them will be registered in those names as the depositary may direct.

As long as the depositary or its nominee is the registered owner of the global security certificates, the depositary or that nominee will be considered the sole owner and holder of the global security certificates and all of the shares of Class E preferred stock represented by those certificates for all purposes under the Class E preferred stock. Except in the limited circumstances referred to above or as otherwise required by applicable law, owners of beneficial interests in global security certificates will not be entitled to have the global security certificates or the shares of Class E preferred stock represented by those certificates registered in their names, will not receive or be entitled to receive physical delivery of certificates representing the shares of Class E preferred stock in exchange and will not be considered to be owners or holders of the global security certificates or any of the shares of Class E preferred stock represented by those certificates for any purpose under the Class E preferred stock. All payments on the shares of Class E preferred stock represented by the global security certificates will be made to the depositary or its nominee as their holder.

Ownership of beneficial interests in the global security certificates will be limited to participants or persons that may hold beneficial interests through institutions that have accounts with the depositary or its nominee. Ownership of beneficial interests in global security certificates will be shown only on, and the transfer of those ownership interests will be effected only through, records maintained by the depositary or its nominee with respect to participants interests or by the participant with respect to interests of persons held by the participants on their behalf.

Neither we nor any of our agents will have any responsibility or liability for any aspect of the depositary s or any participant s records relating to, or for payments made on account of, beneficial interests in global security certificates, or for maintaining, supervising or reviewing any of the depositary s records or any participant s records relating to those beneficial ownership interests.

The information in this section concerning the depositary and its book-entry system has been obtained from sources that we believe to be reliable, but we do not take responsibility for its accuracy.

(27,449
)

Effect of exchange rate changes on cash
(4,328
)

(18,349
)
Net decrease in cash and cash equivalents
(61,112
)

(45,600
)
Cash and cash equivalents at beginning of year
155,505

204,213

Cash and cash equivalents at end of period
$
94,393

$
158,613

Income taxes paid
$
16,055

$
27,910

Interest paid
57,919

57,757

See notes to condensed consolidated financial statements.

THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
Periods ended March 31, 2019 and 2018

NOTE 1—BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

There have been no significant changes in critical accounting policies since December 31, 2018, except as described in Note 2. Accounting estimates were revised as necessary during the first three months of 2019 based on new information and changes in facts and circumstances. Certain amounts in the 2018 condensed consolidated financial statements have been reclassified to conform to the 2019 presentation.

The Company primarily uses the last-in, first-out (LIFO) method of valuing inventory. An actual valuation of inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management’s estimates of expected year-end inventory levels and costs are subject to the final year-end LIFO inventory valuation. In addition, interim inventory levels include management’s estimates of annual inventory losses due to shrinkage and other factors. For further information on inventory valuations and other matters, refer to the consolidated financial statements and footnotes thereto included in the Company’s Form 10-K for the year ended December 31, 2018.

The consolidated results for the three months ended March 31, 2019 are not necessarily indicative of the results to be expected for the year ending December 31, 2019.

NOTE 2—RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Adopted in 2019

Effective January 1, 2019, the Company adopted Accounting Standards Update (ASU) No. 2016-02, "Leases" (ASC 842). ASC 842 consists of a comprehensive lease accounting standard requiring most leases to be recognized on the balance sheet and significant new disclosures. The Company adopted ASC 842 using the modified retrospective optional transition method. Therefore, the standard was applied starting January 1, 2019 and prior periods were not restated. The adoption of ASC 842 did not result in a material cumulative-effect adjustment to the opening balance of retained earnings.

The Company applied the package of practical expedients permitted under the ASC 842 transition guidance. As a result, the Company did not reassess the identification, classification and initial direct costs of leases commencing before the effective date. The Company also applied the practical expedient to not separate lease and non-lease components to all new leases as well as leases commencing before the effective date.

The adoption of ASC 842 resulted in the recognition of right-of-use assets, current liabilities and non-current liabilities related to operating leases of $1.7 billion, $.4 billion and $1.4 billion, respectively, at March 31, 2019. In addition, the adoption of ASC 842 resulted in a transition adjustment reducing the opening balance of retained earnings by $8.4 million. The adoption of ASC 842 did not have a material impact on the Company's results of operations, cash flows or debt covenants. See Note 16 for additional information.

Effective January 1, 2019, the Company adopted ASU No. 2018-02, "Reclassification of Certain Income Tax Effects from Accumulated Other Comprehensive Income." This standard allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. As a result of this standard, the Company recorded an $8.3 million reclassification from cumulative other comprehensive loss to retained earnings. See Note 4. The adoption of this standard did not have a significant impact on the Company's results of operations, financial condition or liquidity.

Not Yet Adopted

In June 2016, the FASB issued ASU No. 2016-13, "Measurement of Credit Losses on Financial Instruments." This ASU replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. In

6

addition, new disclosures are required. The ASU is effective for fiscal years beginning after December 15, 2019. The Company is evaluating the potential impact of the standard.

NOTE 3—REVENUE

The Company manufactures and sells paint, stains, supplies, equipment and floor covering through Company-operated stores, branded and private label products through retailers, and a broad range of industrial coatings directly to global manufacturing customers through company-operated branches. A large portion of the Company’s revenue is recognized at a point in time and made to customers who are not engaged in a long-term supply agreement or any form of contract with the Company. These sales are paid for at the time of sale in cash, credit card, or may be on account with the vast majority of customers having terms between 30 and 60 days, not to exceed one year. Many customers who purchase on account take advantage of early payment discounts offered by paying within 30 days of being invoiced. The Company estimates variable consideration for these sales on the basis of both historical information and current trends to estimate the expected amount of discounts to which customers are likely to be entitled.

The remaining revenue is governed by long-term supply agreements and related purchase orders (“contracts”) that specify shipping terms and aspects of the transaction price including rebates, discounts and other sales incentives, such as advertising support. Contracts are at standalone pricing. The performance obligation in these contracts is determined by each of the individual purchase orders and the respective stated quantities, with revenue being recognized at a point in time when obligations under the terms of the agreement are satisfied. This generally occurs with the transfer of control of our products to the customer. Sales, value add, and other taxes we collect concurrent with revenue-producing activities are excluded from revenue.

Refer to Note 13 for the Company's disaggregation of Net sales by reportable segment. As the reportable segments are aligned by similar economic factors, trends and customers, this disaggregation best depicts how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

The Company has made payments or credits for rebates or incentives at the beginning of a long-term contract where future revenue is expected and before satisfaction of performance obligations. Under these circumstances, the Company recognizes a contract asset and amortizes these prepayments over the expected benefit life of the long-term contract typically on a straight-line basis. Management judgment is required when estimating sales-based variable consideration, determining whether it is constrained, measuring obligations for returns, refunds, and determining amortization periods for prepayments.

The majority of variable consideration in the Company’s contracts include a form of volume rebate, discounts, and other incentives, where the customer receives a retrospective percentage rebate based on the amount of their purchases. In these situations, the rebates are accrued as a fixed percentage of sales and recorded as a reduction of net sales until paid to the customer per the terms of the supply agreement. Forms of variable consideration such as tiered rebates, whereby a customer receives a retrospective price decrease dependent on the volume of their purchases, are calculated using a forecasted percentage to determine the most likely amount to accrue. Management creates a baseline calculation using historical sales and then utilizing forecast information, estimates the anticipated sales volume each quarter to calculate the expected reduction to sales. The remainder of the transaction price is fixed as agreed upon with the customer, limiting estimation of revenues including constraints.

The Company’s Accounts receivable and current and long-term contract assets and liabilities are summarized in the following table.

(Thousands of dollars)

	Accounts Receivable, Less Allowance	Contract Assets (Current)	Contract Assets (Long-Term)	Contract Liabilities (Current)	Contract Liabilities (Long-Term)
Balance at January 1, 2019	$2,018,768	$56,598	$ 213,954	$272,857	$ 8,745
Balance at March 31, 2019	2,339,551	64,657	205,070	203,848	8,745

The difference between the opening and closing balances of the Company’s contract assets and contract liabilities primarily results from the timing difference between the Company’s performance and the customer’s payment.

Provisions for estimated returns are established and the expected costs continue to be recognized as contra-revenue per ASC 606 when the products are sold. The Company only offers an assurance type warranty on products sold, and there is no material service to the customer beyond fixing defects that existed at the time of sale and no warranties are sold separately. Warranty liabilities are excluded from the table above and discussed in Note 5. Amounts recognized during the quarter from deferred liabilities to revenue were not material. The Company records a right of return liability within each of its operations to accrue for expected customer returns. Historical actual returns are used to estimate future returns as a percentage of current sales. Obligations for returns and refunds were not material individually or in the aggregate.

NOTE 4—SHAREHOLDERS' EQUITY

Dividends paid on common stock during the first quarter of 2019 and 2018 were $1.13 per share and $.86 per share, respectively.

The following tables summarize the changes in the components of shareholders' equity for the three months ended March 31, 2019 and 2018.

(Thousands of dollars except per share data)	Common Stock	Other Capital	Retained Earnings	Treasury Stock	Cumulative Other Comprehensive Loss	Total
Balance at December 31, 2018	$118,373	$2,896,448	$6,246,548	$(4,900,690)	$ (629,934)	$3,730,745
Net income			245,237			245,237
Other comprehensive income					6,081	6,081
Adjustment to initially apply ASU 2016-02			(8,415)			(8,415)
Adjustment to initially apply ASU 2018-02			8,340		(8,340)	—
Treasury stock purchased				(305,146)		(305,146)
Treasury stock transferred from defined benefit pension plan				(131,781)		(131,781)
Stock-based compensation activity	299	47,561		(21,270)		26,590
Other adjustments		1,512				1,512
Cash dividends			(104,762)			(104,762)
Balance at March 31, 2019	$118,672	$2,945,521	$6,386,948	$(5,358,887)	$ (632,193)	$3,460,061

(Thousands of dollars except per share data)	Common Stock	Other Capital	Retained Earnings	Treasury Stock	Cumulative Other Comprehensive Loss	Total
Balance at December 31, 2017	$117,561	$2,723,183	$5,458,416	$(4,266,416)	$ (384,870)	$3,647,874
Net income			250,127			250,127
Other comprehensive income					51,535	51,535
Adjustment to initially apply ASU 2016-01			2,320		(2,320)	—
Treasury stock purchased				(241,148)		(241,148)
Stock-based compensation activity	314	35,821		(20,454)		15,681
Other adjustments		2,202	488			2,690
Cash dividends			(81,028)			(81,028)
Balance at March 31, 2018	$117,875	$2,761,206	$5,630,323	$(4,528,018)	$ (335,655)	$3,645,731

The treasury stock transferred from defined benefit pension plan relates to the termination of the Company's domestic defined benefit pension plan as described in Note 7. See Note 2 for information on ASU 2018-02.

NOTE 5—PRODUCT WARRANTIES

Changes in the Company’s accrual for product warranty claims during the first three months of 2019 and 2018, including customer satisfaction settlements, were as follows:

(Thousands of dollars)

	2019	2018
Balance at January 1	$57,067	$151,425
Charges to expense	6,460	6,437
Settlements	(6,667)	(4,488)
Balance at March 31	$56,860	$153,374

For further details on the Company’s accrual for product warranty claims, see Note 1 to the Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018. The furniture protection plan business divestiture in the third quarter of 2018 caused the large decrease in the product warranty claims accrual.

NOTE 6—EXIT OR DISPOSAL ACTIVITIES

Liabilities associated with exit or disposal activities are recognized as incurred in accordance with the Exit or Disposal Cost Obligations Topic of the ASC. Qualified exit costs primarily include post-closure rent expenses, incremental post-closure costs and costs of employee terminations. Adjustments may be made to liabilities accrued for qualified exit costs if information becomes available upon which more accurate amounts can be reasonably estimated. Concurrently, property, plant and equipment is tested for impairment in accordance with the Property, Plant and Equipment Topic of the ASC, and if impairment exists, the carrying value of the related assets is reduced to estimated fair value. Additional impairment may be recorded for subsequent revisions in estimated fair value.

In the three months ended March 31, 2019, two stores in The Americas Group and two branches in the Performance Coatings Group were closed due to lower demand or redundancy. The Company continues to evaluate all legacy operations in response to the Valspar acquisition in order to optimize restructured operations. These acquisition-related restructuring charges to date are recorded in the Administrative segment. The following table summarizes the activity and remaining liabilities associated with qualified exit costs at March 31, 2019 and 2018. The provisions and expenditures relate primarily to acquisition-related restructuring.

(Thousands of dollars)

	2019	2018
Balance at January 1	$7,052	$13,385
Provisions in Cost of goods sold or SG&A	949	3,799
Actual expenditures charged to accrual	(437)	(8,084)
Balance at March 31	$7,564	$9,100

For further details on the Company’s exit or disposal activities, see Note 6 to the Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018.

NOTE 7—HEALTH CARE, PENSION AND OTHER BENEFITS

Shown below are the components of the Company's net periodic benefit cost (credit) for domestic defined benefit pension plans, foreign defined benefit pension plans and postretirement benefits other than pensions:

(Thousands of dollars)	Domestic Defined Benefit Pension Plans		Foreign Defined Benefit Pension Plans		Postretirement Benefits Other than Pensions	
	2019	2018	2019	2018	2019	2018
Three Months Ended March 31:						
Net periodic benefit cost (credit):						
Service cost	$933	$4,357	$1,490	$2,016	$361	$498
Interest cost	1,198	8,152	2,356	2,352	2,800	2,545
Expected return on assets	(1,332)	(14,434)	(2,440)	(2,685)		
Recognition of:						
Unrecognized prior service cost (credit)	349	379			(1,249)	(1,642)
Unrecognized actuarial loss			258	383	134	581
Ongoing pension cost (credit)	1,148	(1,546)	1,664	2,066	2,046	1,982
Curtailment expense		825				
Settlement expense	32,410					
Net periodic benefit cost (credit)	$33,558	$(721)	$1,664	$2,066	$2,046	$1,982

Service cost is recorded in Cost of goods sold and Selling, general and administrative expenses. All other components are recorded in Other expense (income) - net.

During the first quarter of 2019, the Company purchased annuity contracts to settle the remaining liabilities of the domestic defined benefit pension plan that was terminated in 2018 (Terminated Plan). The annuity contract purchase resulted in a settlement charge of $32.4 million in the first quarter of 2019. The remaining surplus of the Terminated Plan will be used, as prescribed in the applicable regulations, to fund future Company contributions to a qualified replacement pension plan, which is the current domestic defined contribution plan (Qualified Replacement Plan). During the first quarter of 2019, the Company transferred $201.8 million of the surplus to a suspense account held within a trust for the Qualified Replacement Plan. This amount included $131.8 million of Company stock (300,000 shares). The shares are treated as treasury stock in accordance with ASC 715. The remainder of the surplus related to the Terminated Plan will be transferred to the Qualified Replacement Plan suspense account after the final expenses associated with the wind-up of the Terminated Plan have been settled.

For further details on the Company's health care, pension and other benefits, see Note 7 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

NOTE 8—OTHER LONG-TERM LIABILITIES

The Company initially provides for estimated costs of environmental-related activities relating to its past operations and third-party sites for which commitments or clean-up plans have been developed and when such costs can be reasonably estimated based on industry standards and professional judgment. These estimated costs are determined based on currently available facts regarding each site. If the best estimate of costs can only be identified as a range and no specific amount within that range can be determined more likely than any other amount within the range, the minimum of the range is provided. At March 31, 2019, the unaccrued maximum of the estimated range of possible outcomes is $116.4 million higher than the minimum.

The Company continuously assesses its potential liability for investigation and remediation-related activities and adjusts its environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated and as additional accounting guidelines are issued. Actual costs incurred may vary from the accrued estimates due to the inherent uncertainties involved including, among others, the number and financial condition of parties involved with respect to any given site, the volumetric contribution which may be attributed to the Company relative to that attributed to other parties, the nature and magnitude of the wastes involved, the various technologies that can be used for remediation and the determination of acceptable remediation with respect to a particular site.

Included in other long-term liabilities at March 31, 2019 and 2018 were accruals for extended environmental-related activities of $319.0 million and $177.8 million, respectively. Estimated costs of current investigation and remediation activities of $51.0 million and $27.0 million are included in other accruals at March 31, 2019 and 2018, respectively.

Four of the Company’s currently and formerly owned manufacturing sites account for the majority of the accrual for environmental-related activities and the unaccrued maximum of the estimated range of possible outcomes at March 31, 2019. At March 31, 2019, $323.4 million, or 87.4% of the total accrual, related directly to these four sites. In the aggregate unaccrued maximum of $116.4 million at March 31, 2019, $92.8 million, or 79.7%, related to the four manufacturing sites. While environmental investigations and remedial actions are in different stages at these sites, additional investigations, remedial actions and monitoring will likely be required at each site.

Management cannot presently estimate the ultimate potential loss contingencies related to these sites or other less significant sites until such time as a substantial portion of the investigation at the sites is completed and remedial action plans are developed. In the event any future loss contingency significantly exceeds the current amount accrued, the recording of the ultimate liability may result in a material impact on net income for the annual or interim period during which the additional costs are accrued. Management does not believe that any potential liability ultimately attributed to the Company for its environmental-related matters will have a material adverse effect on the Company’s financial condition, liquidity, or cash flow due to the extended period of time during which environmental investigation and remediation takes place. An estimate of the potential impact on the Company’s operations cannot be made due to the aforementioned uncertainties.

Management expects these contingent environmental-related liabilities to be resolved over an extended period of time. Management is unable to provide a more specific time frame due to the indefinite amount of time to conduct investigation activities at any site, the indefinite amount of time to obtain environmental agency approval, as necessary, with respect to investigation and remediation activities, and the indefinite amount of time necessary to conduct remediation activities.

For further details on the Company’s Other long-term liabilities, see Note 9 to the Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018.

NOTE 9 – LITIGATION

In the course of its business, the Company is subject to a variety of claims and lawsuits, including, but not limited to, litigation relating to product liability and warranty, personal injury, environmental, intellectual property, commercial, contractual and antitrust claims that are inherently subject to many uncertainties regarding the possibility of a loss to the Company. These uncertainties will ultimately be resolved when one or more future events occur or fail to occur confirming the incurrence of a liability or the reduction of a liability. In accordance with the Contingencies Topic of the ASC, the Company accrues for these contingencies by a charge to income when it is both probable that one or more future events will occur confirming the fact of a loss and the amount of the loss can be reasonably estimated. In the event that the Company’s loss contingency is ultimately determined to be significantly higher than currently accrued, the recording of the additional liability may result in a material impact on the Company’s results of operations, liquidity or financial condition for the annual or interim period during which such additional liability is accrued. In those cases where no accrual is recorded because it is not probable that a liability has been incurred and the amount of any such loss cannot be reasonably estimated, any potential liability ultimately determined to be attributable to the Company may result in a material impact on the Company’s results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued. In those cases where no accrual is recorded or exposure to loss exists in excess of the amount accrued, the Contingencies Topic of the ASC requires disclosure of the contingency when there is a reasonable possibility that a loss or additional loss may have been incurred.

Lead pigment and lead-based paint litigation. The Company’s past operations included the manufacture and sale of lead pigments and lead-based paints. The Company, along with other companies, is and has been a defendant in a number of legal proceedings, including individual personal injury actions, purported class actions, and actions brought by various counties, cities, school districts and other government-related entities, arising from the manufacture and sale of lead pigments and lead-based paints. The plaintiffs’ claims have been based upon various legal theories, including negligence, strict liability, breach of warranty, negligent misrepresentations and omissions, fraudulent misrepresentations and omissions, concert of action, civil conspiracy, violations of unfair trade practice and consumer protection laws, enterprise liability, market share liability, public nuisance, unjust enrichment and other theories. The plaintiffs seek various damages and relief, including personal injury and property damage, costs relating to the detection and abatement of lead-based paint from buildings, costs associated with a public education campaign, medical monitoring costs and others. The Company has also been a defendant in legal proceedings arising from the manufacture and sale of non-lead-based paints that seek recovery based upon various legal theories, including the failure to adequately warn of potential exposure to lead during surface preparation when using non-lead-based paint on surfaces previously painted with lead-based paint. The Company believes that the litigation brought to date is without merit or subject to meritorious defenses and is vigorously defending such litigation. The Company has not settled any material lead pigment or lead-based paint litigation. The Company expects that additional lead pigment and lead-based paint litigation may be filed against the Company in the future asserting similar or different legal theories and seeking similar or different types of damages and relief.

Notwithstanding the Company's views on the merits, litigation is inherently subject to many uncertainties, and the Company ultimately may not prevail. Adverse court rulings or determinations of liability, among other factors, could affect the lead pigment and lead-based paint litigation against the Company and encourage an increase in the number and nature of future claims and proceedings. In addition, from time to time, various legislation and administrative regulations have been enacted, promulgated or proposed to impose obligations on present and former manufacturers of lead pigments and lead-based paints respecting asserted health concerns associated with such products or to overturn the effect of court decisions in which the Company and other manufacturers have been successful.

Due to the uncertainties involved, management is unable to predict the outcome of the lead pigment and lead-based paint litigation, the number or nature of possible future claims and proceedings or the effect that any legislation and/or administrative regulations may have on the litigation or against the Company. In addition, management cannot reasonably determine the scope or amount of the potential costs and liabilities related to such litigation, or resulting from any such legislation and regulations. Except with respect to the litigation in California discussed below, the Company has not accrued any amounts for such litigation because the Company does not believe it is probable that a loss has occurred, and the Company believes it is not possible to estimate the range of potential losses as there is no substantive information upon which an estimate could be based. In addition, any potential liability that may result from any changes to legislation and regulations cannot reasonably be estimated. In the event any significant liability is determined to be attributable to the Company relating to such litigation or any such liability is higher than any amount currently accrued for such litigation, the recording of the liability may result in a material impact on net income for the annual or interim period during which such liability is accrued. Additionally, due to the uncertainties associated with the amount of any such liability and/or the nature of any other remedy which may be imposed in such litigation, any potential liability determined to be attributable to the Company arising out of such litigation may have a material adverse effect on the Company's results of operations, liquidity or financial condition. An estimate of the potential impact on the Company's results of operations, liquidity or financial condition cannot be made due to the aforementioned uncertainties.

Public nuisance claim litigation. The Company and other companies are or were defendants in legal proceedings seeking recovery based on public nuisance liability theories, among other theories, brought by the State of Rhode Island; the City of St. Louis, Missouri; various cities and counties in the State of New Jersey; various cities in the State of Ohio and the State of Ohio; the City of Chicago, Illinois; the City of Milwaukee, Wisconsin; the County of Santa Clara, California, and other public entities in the State of California; and Lehigh and Montgomery Counties in Pennsylvania. Except for the Santa Clara County, California proceeding and the pending Pennsylvania proceedings, all of these legal proceedings have been concluded in favor of the Company and other defendants at various stages in the proceedings.

Santa Clara County, California Proceeding. The Santa Clara County, California proceeding was initiated in March 2000 in the Superior Court of the State of California, County of Santa Clara. In the original complaint, the plaintiffs asserted various claims including fraud and concealment, strict product liability/failure to warn, strict product liability/design defect, negligence, negligent breach of a special duty, public nuisance, private nuisance, and violations of California's Business and Professions Code. A number of the asserted claims were resolved in favor of the defendants through pre-trial proceedings. The named plaintiffs in the Fourth Amended Complaint, filed on March 16, 2011, are the Counties of Santa Clara, Alameda, Los Angeles, Monterey, San Mateo, Solano and Ventura, as well as the Cities of Oakland and San Diego and the City and County of San Francisco. The Fourth Amended Complaint asserted a sole claim for public nuisance, alleging that the presence of lead pigments for use in paint and coatings in, on and around residences in the plaintiffs' jurisdictions constitutes a public nuisance. The plaintiffs sought the abatement of the alleged public nuisance that exists within the plaintiffs' jurisdictions. A trial commenced on July 15, 2013 and ended on August 22, 2013. The court entered final judgment on January 27, 2014, finding in favor of the plaintiffs and against the Company and two other defendants (ConAgra Grocery Products Company and NL Industries, Inc.). The final judgment held the Company jointly and severally liable with the other two defendants to pay $1.15 billion into a fund to abate the public nuisance. The Company strongly disagrees with the judgment.

On February 18, 2014, the Company filed a motion for new trial and a motion to vacate the judgment. The court denied these motions on March 24, 2014. On March 28, 2014, the Company filed a notice of appeal to the Sixth

District Court of Appeal for the State of California. Oral argument before the Sixth District Court of Appeal was held on August 24, 2017. On November 14, 2017, the Sixth District Court of Appeal entered its decision, which affirmed the trial court's judgment of liability with respect to residences built before 1951 and reversed and vacated the trial court's judgment with respect to residences built after 1950. The Sixth District Court of Appeal directed the trial court to: (i) recalculate the amount of the abatement fund to limit the fund to the amount necessary to cover the cost of inspecting and remediating pre-1951 residences; and (ii) hold an evidentiary hearing to appoint a suitable receiver. On November 29, 2017, the Company and the two other defendants filed separate Petitions for Rehearing, which the Sixth District Court of Appeal denied on December 6, 2017. The Sixth District Court of Appeal's decision became final on December 14, 2017. On December 22, 2017, the Company and the two other defendants submitted separate Petitions for Review to the California Supreme Court. On February 14, 2018, the California Supreme Court issued an order denying the Petitions for Review.

On April 17, 2018, the parties filed their briefs with the trial court regarding the recalculation of the amount of the abatement fund. The plaintiffs proposed $730.0 million as the amount of the abatement fund, and the Company and the other two defendants jointly proposed a maximum amount of no more than $409.1 million. On August 17, 2018, the trial court held a hearing regarding the recalculation of the amount of the abatement fund. On September 4, 2018, the trial court ruled that the amount of the abatement fund is $409.1 million. On March 8, 2019, the trial court approved a setoff of $8.0 million to the abatement fund reducing the abatement fund to $401.1 million. On May 17, 2018, NL Industries filed a Motion for Good Faith Settlement, which the Company and ConAgra opposed. The trial court held a hearing on NL Industries’ Motion for Good Faith Settlement on July 12, 2018 and subsequently denied NL Industries' Motion. NL Industries has filed a petition for writ of mandate with the Sixth District Court of Appeal seeking to obtain immediate appellate review and reversal of the denial of its motion. On July 16, 2018, the Company filed a Petition for Writ of Certiorari with the Supreme Court of the United States seeking discretionary review. On October 15, 2018, the Supreme Court of the United States denied the Company's Petition for Writ of Certiorari.

The trial court has selected a receiver for the abatement fund, but the terms of an order appointing the receiver have not been determined. The trial court has stayed the entry of judgment pending the decision of the Sixth District Court of Appeal on NL Industries' petition for writ of mandate, but otherwise has ruled that, within sixty days of entry of judgment, the Company, ConAgra and NL Industries shall pay into the abatement fund all amounts due.

Although the Company believes it is probable that a loss has occurred, the ultimate amount of such loss and the timing of any payments remains uncertain and could change in the future due to the numerous possible outcomes and uncertainties, including, but not limited to, (i) the final amount of the abatement fund that will be paid, particularly because participation in the abatement program by eligible homeowners is voluntary and it is uncertain what percentage of eligible homeowners will participate or how claims will be administered, and (ii) the portion of the abatement fund for which the Company, the two other defendants and others are determined to be responsible. However, the Company accrued $136.3 million for this litigation in 2018, which is approximately one-third of the amount of the abatement fund. It is possible that the Company may change the amount accrued for this litigation based on the facts and circumstances. Because of joint and several liability, it is possible the Company could ultimately be liable for the total amount of the abatement fund. In the event any liability is higher than any amount currently accrued for such litigation, the recording of any liability may result in a material impact on the Company’s results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued.

Pennsylvania Proceedings. Two proceedings in Pennsylvania were initiated in October 2018. The County of Montgomery, Pennsylvania filed a Complaint against the Company and several other former lead-based paint and lead pigment manufacturers in the Court of Common Pleas of Montgomery County, Pennsylvania. The County of Lehigh, Pennsylvania also filed a Complaint against the Company and several other former lead-based paint and lead pigment manufacturers in the Court of Common Pleas of Lehigh County, Pennsylvania. The Company removed both actions to the United States District Court for the Eastern District of Pennsylvania on November 28, 2018. The plaintiffs filed a motion for remand in each action on January 7, 2019, which the defendants have opposed. In both actions, the counties request declaratory relief establishing the existence of a public nuisance and the defendants' contribution to it, the abatement of an ongoing public nuisance arising from the presence of lead-based paint in housing throughout the applicable county, an injunction against future illicit conduct, and the costs of litigation and attorneys' fees.

In October 2018, the Company filed a Complaint in the United States District Court for the Eastern District of Pennsylvania against the Pennsylvania Counties of Delaware, Erie and York seeking injunctive and declaratory relief to prevent the violation of the Company's rights under the First Amendment and Due Process Clause of the U.S. Constitution. The Company voluntarily dismissed defendant Erie County on November 9, 2018 and defendant York County on November 21, 2018. Defendant Delaware County has filed a motion to dismiss the Complaint, which is pending.

Litigation seeking damages from alleged personal injury. The Company and other companies are defendants in a number of legal proceedings seeking monetary damages and other relief from alleged personal injuries. These proceedings include claims by children allegedly injured from ingestion of lead pigment or lead-containing paint and claims for damages allegedly incurred by the children’s parents or guardians. These proceedings generally seek compensatory and punitive damages, and seek other relief including medical monitoring costs. These proceedings include purported claims by individuals, groups of individuals and class actions.

The plaintiff in Thomas v. Lead Industries Association, et al., initiated an action in Wisconsin state court against the Company, other alleged former lead pigment manufacturers and the Lead Industries Association in September 1999. The claims against the Company and the other defendants included strict liability, negligence, negligent misrepresentation and omissions, fraudulent misrepresentation and omissions, concert of action, civil conspiracy and enterprise liability. Implicit within these claims is the theory of “risk contribution” liability (Wisconsin’s theory which is similar to market share liability, except that liability can be joint and several) due to the plaintiff’s inability to identify the manufacturer of any product that allegedly

13

injured the plaintiff. The case ultimately proceeded to trial and, on November 5, 2007, the jury returned a defense verdict, finding that the plaintiff had ingested white lead carbonate, but was not brain damaged or injured as a result. The plaintiff appealed and, on December 16, 2010, the Wisconsin Court of Appeals affirmed the final judgment in favor of the Company and other defendants.

Wisconsin is the only jurisdiction to date to apply a theory of liability with respect to alleged personal injury (i.e., risk contribution/market share liability) that does not require the plaintiff to identify the manufacturer of the product that allegedly injured the plaintiff in the lead pigment and lead-based paint litigation. Although the risk contribution liability theory was applied during the Thomas trial, the constitutionality of this theory as applied to the lead pigment cases has not been judicially determined by the Wisconsin state courts. However, in an unrelated action filed in the United States District Court for the Eastern District of Wisconsin, Gibson v. American Cyanamid, et al., on November 15, 2010, the District Court held that Wisconsin's risk contribution theory as applied in that case violated the defendants' right to substantive due process and is unconstitutionally retroactive. The District Court's decision in Gibson v. American Cyanamid, et al., was appealed by the plaintiff to the United States Court of Appeals for the Seventh Circuit. On July 24, 2014, the United States Court of Appeals for the Seventh Circuit reversed the judgment and remanded the case back to the District Court for further proceedings. On January 16, 2015, the defendants filed a petition for certiorari in the United States Supreme Court seeking that Court's review of the Seventh Circuit's decision, and on May 18, 2015, the United States Supreme Court denied the defendants' petition. The case is currently pending in the District Court.

The United States District Court for the Eastern District of Wisconsin has consolidated three cases (Ravon Owens v. American Cyanamid, et al., Cesar Sifuentes v. American Cyanamid, et al., and Glenn Burton, Jr. v. American Cyanamid, et al.) for purposes of trial and set a trial date for May 6, 2019. The parties are preparing for trial.

In Maniya Allen, et al. v. American Cyanamid, et al., also pending in the United States District Court for the Eastern District of Wisconsin, cases involving six of the 146 plaintiffs were selected for discovery. In Dijonae Trammell, et al. v. American Cyanamid, et al., also pending in the United States District Court for the Eastern District of Wisconsin, discovery for one of the three plaintiffs was consolidated with the six Allen cases referenced above. The parties have selected four of the cases to proceed to expert discovery and to prepare for trial. No dates for expert discovery, pretrial dispositive motions or trial have been set by the District Court in the Allen and Trammell cases.

Other lead-based paint and lead pigment litigation. In Mary Lewis v. Lead Industries Association, et al. pending in the Circuit Court of Cook County, Illinois, parents seek to recover the cost of their children's blood lead testing against the Company and three other defendants that made (or whose alleged corporate predecessors made) white lead pigments. The Circuit Court has certified a statewide class and a Chicago subclass of parents or legal guardians of children who lived in high-risk zip codes identified by the Illinois Department of Health and who were screened for lead toxicity between August 1995 and February 2008. Excluded from the class are those parents or guardians who have incurred no expense, liability or obligation to pay for the cost of their children's blood lead testing. In 2017, the Company and other defendants moved for summary judgment on the grounds that the three named plaintiffs have not paid and have no obligation or liability to pay for their children's blood lead testing because Medicaid paid for the children of two plaintiffs and private insurance paid for the third plaintiff without any evidence of a co-pay or deductible. The Circuit Court granted the motion, but on September 7, 2018, the Appellate Court reversed with respect to the two plaintiffs for whom Medicaid paid for their children's testing. Defendants filed a petition with the Supreme Court of Illinois for discretionary review. By order entered January 31, 2019, that court has allowed defendants' petition for leave to appeal.

Insurance coverage litigation. The Company and its liability insurers, including certain underwriters at Lloyd's of London, initiated legal proceedings against each other to determine, among other things, whether the costs and liabilities associated with the abatement of lead pigment are covered under certain insurance policies issued to the Company. The Company's action, filed on March 3, 2006 in the Common Pleas Court, Cuyahoga County, Ohio, previously was stayed and inactive. On January 9, 2019, the Company filed an unopposed motion to lift the stay with the trial court, which was granted, allowing the case to proceed. The liability insurers' action, which was filed on February 23, 2006 in the Supreme Court of the State of New York, County of New York, has been dismissed. An ultimate loss in the insurance coverage litigation would mean that insurance proceeds could be unavailable under the policies at issue to mitigate any ultimate abatement related costs and liabilities. The Company has not recorded any assets related to these insurance policies or otherwise assumed that proceeds from these insurance policies would be received in estimating any contingent liability accrual. Therefore, an ultimate loss in the insurance coverage litigation without a determination of liability against the Company in the lead pigment or lead-based paint litigation will have no impact on the Company's results of operation, liquidity or financial condition. As previously stated, however, except with respect to the litigation in California discussed above, the Company has not accrued any amounts for the lead pigment or lead-based paint litigation and any significant liability ultimately determined to be attributable to the Company relating to such litigation may result in a material impact on the Company's results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued.

NOTE 10—OTHER

Other general (income) expense - net

Included in Other general (income) expense - net were the following:

(Thousands of dollars)	Three Months Ended March 31, 2019	2018
Provisions for environmental matters - net	$592	$765
(Gain) loss on sale or disposition of assets	(1,050)	2,225
Total	$(458)	$2,990

Provisions for environmental matters - net represent site-specific increases or decreases to environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated and as additional accounting guidelines are issued. Environmental-related accruals are not recorded net of insurance proceeds in accordance with the Offsetting Subtopic of the Balance Sheet Topic of the ASC. See Note 8 for further details on the Company's environmental-related activities.

The (gain) loss on sale or disposition of assets represents net realized (gains) losses associated with the sale or disposal of fixed assets previously used in the conduct of the primary business of the Company.

Other expense (income) - net

Included in Other expense (income) - net were the following:

(Thousands of dollars)	Three Months Ended March 31, 2019	2018
Dividend and royalty income	$(4,766)	$(1,451)
Net expense from banking activities	2,668	2,236
Foreign currency transaction related gains	(2,106)	(2,462)
Domestic pension plan settlement expense	32,410	
Miscellaneous pension expense (income)	2,074	(3,544)
Other income	(8,958)	(7,109)
Other expense	1,987	3,058
Total	$23,309	$(9,272)

Foreign currency transaction related gains represent net realized gains on U.S. dollar-denominated liabilities of foreign subsidiaries and net realized and unrealized gains from foreign currency option and forward contracts. There were no material foreign currency option and forward contracts outstanding at March 31, 2019 and 2018.

Miscellaneous pension expense (income) consists of the non-service components of net pension costs (credits). See Note 7 for information on Miscellaneous pension income and the Domestic pension plan settlement expense.

Other income and Other expense included items of revenue, gains, expenses and losses that were unrelated to the primary business purpose of the Company. There were no other items within the other income or other expense caption that were individually significant.

NOTE 11—INCOME TAXES

The effective tax rate was 17.9% for the first quarter of 2019 compared to 17.6% for the first quarter of 2018. The increase in the effective tax rate for the first quarter of 2019 compared to 2018 was primarily due to tax benefits related to research and development credit refund requests that were claimed in the first quarter of 2018 that were not available in the first quarter of 2019.

At December 31, 2018, the Company had $89.5 million in unrecognized tax benefits, the recognition of which would have an effect of $83.0 million on the effective tax rate. Included in the balance of unrecognized tax benefits at December 31, 2018 was $14.5 million related to tax positions for which it is reasonably possible that the total amounts could significantly change

15

during the next twelve months. This amount represents a decrease in unrecognized tax benefits comprised primarily of items related to federal audits of partnership investments and expiring statutes in federal, foreign and state jurisdictions. There were no significant changes to any of the balances of unrecognized tax benefits at December 31, 2018 during the first three months of 2019.

The Company classifies all income tax related interest and penalties as income tax expense. At December 31, 2018, the Company had accrued $24.8 million for the potential payment of income tax interest and penalties.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The IRS is currently auditing the Company's 2013, 2014 and 2015 income tax returns. No significant adjustments have been proposed by the IRS. The IRS and the Joint Committee of Taxation have approved refund claims for the 2010, 2011 and 2012 tax years. The Company will receive approximately $5.0 million of tax and interest related to the refund claims. In addition, the IRS is reviewing the refund claim audit for the 2014 tax year of Valspar. Once the review is complete, the IRS will submit the refund request of $5.4 million to the Joint Committee of Taxation for approval. A refund claim for $1.5 million has been filed on behalf of Valspar for the 2015 tax year. As of March 31, 2019, the federal statute of limitations had not expired for the 2013 through 2018 tax years.

As of March 31, 2019, the Company is subject to non-U.S. income tax examinations for the tax years of 2010 through 2018. In addition, the Company is subject to state and local income tax examinations for the tax years 1998 through 2018.

NOTE 12—NET INCOME PER SHARE

Basic and diluted earnings per share are calculated using the treasury stock method.

(Thousands of dollars except per share data)	Three Months Ended March 31,	
	2019	2018
Basic		
Average shares outstanding	91,952,828	93,339,564
Net income	$245,237	$250,127
Basic net income per share	$2.67	$2.68
Diluted		
Average shares outstanding	91,952,828	93,339,564
Stock options and other contingently issuable shares [1]	1,662,297	2,138,874
Non-vested restricted stock grants	53,603	67,714
Average shares outstanding assuming dilution	93,668,728	95,546,152
Net income	$245,237	$250,127
Diluted net income per share	$2.62	$2.62

(1) Stock options and other contingently issuable shares excluded 49,501 shares due to their anti-dilutive effect for the three months ended March 31, 2019. There were no options excluded due to their anti-dilutive effect for the three months ended March 31, 2018.

16

NOTE 13—REPORTABLE SEGMENT INFORMATION

The Company reports its segment information in the same way that management internally organizes its business for assessing performance and making decisions regarding allocation of resources in accordance with the Segment Reporting Topic of the ASC. The Company has determined that it has three reportable operating segments: The Americas Group, Consumer Brands Group and Performance Coatings Group (individually, a Reportable Segment and collectively, the Reportable Segments).

(Thousands of dollars)	Three Months Ended March 31, 2019				
	The Americas Group	Consumer Brands Group	Performance Coatings Group	Administrative	Consolidated Totals
Net external sales	$2,154,853	$654,502	$1,230,798	$708	$4,040,861
Intersegment transfers	6	792,786	28,486	(821,278)	
Total net sales and intersegment transfers	$2,154,859	$1,447,288	$1,259,284	$(820,570)	$4,040,861
Segment profit	$331,088	$87,937	$98,693		$517,718
Interest expense				$(90,994)	(90,994)
Administrative expenses and other				(127,870)	(127,870)
Income before income taxes	$331,088	$87,937	$98,693	$(218,864)	$298,854

	Three Months Ended March 31, 2018				
	The Americas Group	Consumer Brands Group	Performance Coatings Group	Administrative	Consolidated Totals
Net external sales	$2,080,415	$656,379	$1,227,775	$437	$3,965,006
Intersegment transfers	53	766,063	5,844	(771,960)	
Total net sales and intersegment transfers	$2,080,468	$1,422,442	$1,233,619	$(771,523)	$3,965,006
Segment profit	$337,392	$74,228	$90,766		$502,386
Interest expense				$(91,547)	(91,547)
Administrative expenses and other				(107,253)	(107,253)
Income before income taxes	$337,392	$74,228	$90,766	$(198,800)	$303,586

In the reportable segment financial information, Segment profit was total net sales and intersegment transfers less operating costs and expenses. Domestic intersegment transfers were accounted for at the approximate fully absorbed manufactured cost, based on normal capacity volumes, plus customary distribution costs. International intersegment transfers were accounted for at values comparable to normal unaffiliated customer sales. The Administrative segment includes the administrative expenses of the Company's corporate headquarters site. Also included in the Administrative segment was interest expense, interest and investment income, certain expenses related to closed facilities and environmental-related matters, and other expenses that were not directly associated with the reportable segments. The Administrative segment did not include any significant foreign operations. Also included in the Administrative segment was a real estate management unit that is responsible for the ownership, management and leasing of non-retail properties held primarily for use by the Company, including the Company's headquarters site, and disposal of idle facilities. Sales of this segment represented external leasing revenue of excess headquarters space or leasing of facilities no longer used by the Company in its primary businesses. Gains and losses from the sale of property were not a significant operating factor in determining the performance of the Administrative segment.

Net external sales of all consolidated foreign subsidiaries were $886.0 million and $919.7 million for the first quarter of 2019 and 2018, respectively. Long-lived assets of these subsidiaries totaled $3.268 billion and $3.722 billion at March 31, 2019 and March 31, 2018, respectively. Domestic operations accounted for the remaining net external sales, segment profits and long-lived assets. No single geographic area outside the United States was significant relative to consolidated net external sales, income before taxes or consolidated long-lived assets.

Export sales and sales to any individual customer were each less than 10% of consolidated sales during all periods presented.

For further details on the Company's Reportable Segments, see Note 19 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

NOTE 14—FAIR VALUE MEASUREMENTS

The Fair Value Measurements and Disclosures Topic of the ASC applies to the Company’s financial and non-financial assets and liabilities. The guidance applies when other standards require or permit the fair value measurement of assets and liabilities. The Company did not have any fair value measurements for its non-financial assets and liabilities during the first quarter. The following table presents the Company’s financial assets and liabilities that are measured at fair value on a recurring basis, categorized using the fair value hierarchy:

(Thousands of dollars)

	Fair Value at March 31, 2019	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Deferred compensation plan assets [1]	$57,606	$29,313	$ 28,293	
Liabilities:				
Deferred compensation plan liabilities [2]	$67,189	$67,189		

[1] The deferred compensation plan assets consist of the investment funds maintained for the future payments under the Company’s executive deferred compensation plans, which are structured as rabbi trusts. The investments are marketable securities accounted for under the Debt and Equity Securities Topic of the ASC. The level 1 investments are valued using quoted market prices multiplied by the number of shares. The level 2 investments are valued based on vendor or broker models. The cost basis of the investment funds is $54,369.

[2] The deferred compensation plan liabilities are the Company’s liabilities under its deferred compensation plans. The liabilities represent the fair value of the participant shadow accounts, and the value is based on quoted market prices in active markets for identical assets.

NOTE 15—DEBT

The table below summarizes the carrying amount and fair value of the Company’s publicly traded debt and non-publicly traded debt in accordance with the Fair Value Measurements and Disclosures Topic of the ASC. The fair values of the Company’s publicly traded debt are based on quoted market prices. The fair values of the Company’s non-publicly traded debt are estimated using discounted cash flow analyses, based on the Company’s current incremental borrowing rates for similar types of borrowing arrangements. The Company’s publicly traded debt and non-publicly traded debt are classified as level 1 and level 2, respectively, in the fair value hierarchy.

(Thousands of dollars)

	March 31, 2019		March 31, 2018	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Publicly traded debt	$8,729,040	$8,683,686	$8,739,950	$8,670,864
Non-publicly traded debt	277,486	268,747	1,152,246	1,082,658

18

NOTE 16—LEASES

The Company leases retail stores, manufacturing and distribution facilities, office space and equipment under operating lease agreements. Operating lease right-of-use (ROU) assets and lease liabilities are recognized based on the present value of lease payments over the lease term. The majority of the ROU asset and lease liability balances relate to the retail operations of The Americas Group.

Most leases include one or more options to renew. The exercise of lease renewal options is at the Company's discretion and is not reasonably certain at lease commencement. Some leases have variable payments, however, because they are not based on an index or rate, they are not included in the ROU assets and liabilities. Variable payments for real estate leases relate primarily to common area maintenance, insurance, taxes and utilities associated with the properties. Variable payments for equipment leases relate primarily to hours, miles, or other quantifiable usage factors which are not determinable at the time the lease agreement is entered into by the Company. The Company has made an accounting policy election by class of underlying asset to not apply the recognition requirements of ASC 842 to short-term leases. As a result, certain leases with a term of 12 months or less are not recorded on the balance sheet and expense is recognized on a straight-line basis over the lease term. Most leases do not contain an implicit discount rate. Therefore, the Company’s estimated incremental borrowing rate based on information available at the time of lease inception is used to discount lease payments to present value.

Additional lease information is summarized below:

(Thousands of dollars)

	Three Months Ended March 31, 2019	
Operating lease cost	$112,105	
Short-term lease cost	10,103	
Variable lease cost	17,334	
Operating cash outflows from operating leases	106,692	
Weighted average remaining lease term for operating leases	6.1 years	
Weighted average discount rate for operating leases	4.0	%

The following table reconciles the undiscounted cash flows for each of the first five years and thereafter to the operating lease liabilities recognized on the balance sheet. The reconciliation excludes short-term leases that are not recorded on the balance sheet.

(Thousands of dollars)

	Operating Leases
Year Ending December 31,	
2019 (excluding the three months ended March 31, 2019)	$320,062
2020	393,077
2021	328,670

2022	265,871
2023	199,120
Thereafter	449,256
Total lease payments	1,956,056
Amount representing interest	(228,162)
Present value of operating lease liabilities	$ 1,727,894

19

NOTE 17—NON-TRADED INVESTMENTS

The Company has invested in the U.S. affordable housing and historic renovation real estate markets. These non-traded investments have been identified as variable interest entities. However, because the Company does not have the power to direct the day-to-day operations of the investments and the risk of loss is limited to the amount of contributed capital, the Company is not considered the primary beneficiary. In accordance with the Consolidation Topic of the ASC, the investments are not consolidated. For affordable housing investments entered into prior to the January 1, 2015 adoption of ASU No. 2014-01, the Company uses the effective yield method to determine the carrying value of the investments. Under the effective yield method, the initial cost of the investments is amortized to income tax expense over the period that the tax credits are recognized. For affordable housing investments entered into on or after the January 1, 2015 adoption of ASU No. 2014-01, the Company uses the proportional amortization method. Under the proportional amortization method, the initial cost of the investments is amortized to income tax expense in proportion to the tax credits and other tax benefits received. The carrying amount of the affordable housing and historic renovation investments, included in other assets, was $197.4 million and $189.5 million at March 31, 2019 and 2018, respectively. The liability for estimated future capital contributions to the investments was $174.3 million and $167.0 million at March 31, 2019 and 2018, respectively.

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

SUMMARY

The Sherwin-Williams Company, founded in 1866, and its consolidated wholly owned subsidiaries (collectively, the "Company") are engaged in the development, manufacture, distribution and sale of paints, coatings and related products to professional, industrial, commercial and retail customers primarily in North and South America with additional operations in the Caribbean region, Europe, Asia and Australia. The Company is structured into three reportable segments—The Americas Group, Consumer Brands Group and Performance Coatings Group (collectively, the "Reportable Segments")—and an Administrative segment in the same way it is internally organized for assessing performance and making decisions regarding allocation of resources. See Note 13 for more information.

The Company's financial condition, liquidity and cash flow continued to be strong through the first three months of 2019. A decrease in net working capital of $686.3 million at March 31, 2019 compared to the end of the first quarter of 2018 was due to a significant increase in current liabilities. Current portion of long-term debt increased $302.7 million while current portion of operating lease liabilities increased $356.5 million as a result of recording operating leases on the balance sheet as required by ASC 842 (See Note 2 and Note 16). The Company has been able to arrange sufficient short-term borrowing capacity at reasonable rates, and the Company continues to have sufficient total available borrowing capacity to fund its current operating needs. Net operating cash for the three months ended March 31, 2019 was a cash usage of $36.0 million compared to a cash source of $40.7 million for the same period in 2018.

Consolidated net sales increased 1.9% in the first quarter of 2019 to $4.041 billion from $3.965 billion in the first quarter of 2018. The increase was due primarily to a new customer program launched in 2018, higher paint sales volume in North America, and selling price increases partially offset by soft end market demand outside the U.S. and unfavorable currency translation rate changes. Currency translation rate changes decreased net sales by 2.3% in the quarter. Consolidated gross profit as a percent of consolidated net sales increased in the first quarter of 2019 to 42.9% compared to 42.5% in the first quarter of 2018. Consolidated gross profit dollars and percent improved as a result of selling price increases and reduced impacts of purchase accounting on cost of goods sold, partially offset by higher raw material costs and unfavorable currency translation rate changes. Selling, general and administrative expenses (SG&A) increased as a percent of consolidated net sales to 30.8% in the first quarter of 2019 from 30.6% in the first quarter of 2018. The increase was primarily due to net new store openings in The Americas Group. Amortization expense decreased $6.3 million in the first quarter of 2019 versus 2018, due to acquisition-related purchase accounting fair value adjustments. Interest expense decreased $0.6 million in the first quarter of 2019 versus 2018. The effective tax rate was 17.9% for the first quarter of 2019 compared to 17.6% for the first quarter of 2018. Diluted net income per share in the first quarter of 2019 and 2018 was flat at $2.62 per share. First quarter 2019 diluted net income per share included a $.71 per share charge for acquisition-related costs and a $.27 per share charge for pension plan settlement expense. Currency translation rate changes decreased diluted net income per share in the first quarter by $.08 per share. First quarter 2018 diluted net income per share included a $.95 per share charge from acquisition-related costs.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation and fair presentation of the consolidated unaudited interim financial statements and accompanying notes included in this report are the responsibility of management. The financial statements and footnotes have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements and contain certain amounts that were based upon management's best estimates, judgments and assumptions that were believed to be reasonable under the circumstances. Management considered the impact of the uncertain economic environment and utilized certain outside sources of economic information when developing the basis for their estimates and assumptions. The impact of the global economic conditions on the estimates and assumptions used by management was believed to be reasonable under the circumstances. Management used assumptions based on historical results, considering the current economic trends, and other assumptions to form the basis for determining appropriate carrying values of assets and liabilities that were not readily available from other sources. Actual results could differ from those estimates. Also, materially different amounts may result under materially different conditions, materially different economic trends or from using materially different assumptions. However, management believes that any materially different amounts resulting from materially different conditions or material changes in facts or circumstances are unlikely to significantly impact the current valuation of assets and liabilities that were not readily available from other sources.

A comprehensive discussion of the Company’s critical accounting policies, management estimates and significant accounting policies followed in the preparation of the financial statements is included in Management’s Discussion and Analysis of Financial Condition and Results of Operations and in Note 1, on pages 45 through 49, in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018. There have been no significant changes in critical accounting policies, management estimates or accounting policies followed since the year ended December 31, 2018, except in connection with the adoption of ASC 842, "Leases," as described in Notes 2 and 16.

FINANCIAL CONDITION, LIQUIDITY AND CASH FLOW

Overview

The Company continues to maintain sufficient short-term borrowing capacity at reasonable rates, and the Company has sufficient cash on hand and total available borrowing capacity to fund its current operating needs. Net working capital decreased $686.3 million at March 31, 2019 compared to the end of the first quarter of 2018 due to an increase in current liabilities. Current portion of long-term debt increased $302.7 million while current portion of operating lease liabilities increased $356.5 million, as a result of recording operating leases on the balance sheet as required by ASC 842 (See Note 2 and Note 16). The Company accrued $136.3 million for the California public nuisance litigation expense in the third quarter of 2018. Cash and cash equivalents decreased $64.2 million at March 31, 2019 compared to March 31, 2018 while accounts receivable increased $13.1 million and inventories increased $50.7 million when normal seasonal trends typically require significant growth in these categories. Other current assets decreased $12.5 million, accounts payable decreased $81.3 million, accrued taxes increased $15.9 million and other accruals increased $55.0 million due to timing of payments. Short-term borrowings decreased $95.2 million and current portion of long-term debt increased $302.7 million resulting from 7.25% senior notes becoming due in 2019. In the first three months of 2019, cash and cash equivalents decreased $61.1 million while accounts receivable increased $320.8 million, inventories increased $178.2 million, other current assets increased $32.8 million, and accounts payable increased $94.6 million when normal seasonal trends typically require significant growth in these categories. Accrued taxes increased $48.2 million, while other accruals decreased $185.8 million and compensation and taxes withheld decreased $103.8 million due to timing of payments. Short-term borrowings increased $496.4 million resulting from treasury stock purchases. Total debt at March 31, 2019 decreased $980.8 million to $9.831 billion from $10.812 billion at March 31, 2018 and decreased as a percentage of total capitalization to 74.0% from 74.8% at the end of the first quarter last year. Total debt increased $487.7 million from December 31, 2018 and increased as a percentage of total capitalization from 71.5% to 74.0%. At March 31, 2019, the Company had remaining short-term borrowing ability of $2.732 billion. Net operating cash decreased $76.7 million in the first three months of 2019 to a cash usage of $36.0 million from a cash source of $40.7 million in 2018. In the twelve month period from April 1, 2018 through March 31, 2019, the Company generated net operating cash of $1.867 billion.

Net Working Capital, Debt and Other Long-Term Assets and Liabilities

Cash and cash equivalents decreased $61.1 million during the first three months of 2019. Cash flow from increased short-term borrowings funded cash requirements for normal seasonal increases in working capital, treasury stock purchases of $305.1 million, payments of cash dividends of $104.8 million, and capital expenditures of $51.4 million. At March 31, 2019, the Company's current ratio was 0.96 compared to 1.01 at December 31, 2018 and 1.12 a year ago. Goodwill and intangible assets decreased $74.8 million from December 31, 2018 and decreased $692.8 million from March 31, 2018. The net decrease during the first three months of 2019 was primarily due to amortization of $78.8 million, partially offset by capitalized software additions and foreign currency translation of $4.0 million. The net decrease over the twelve month period from March 31, 2018 was primarily due to purchase accounting adjustments of $76.1 million, amortization of $311.8 million, and foreign currency translation and other of $309.1 million, partially offset by capitalized software additions of $4.2 million. Additionally, see Note 5, on pages 52 and 53, in the Company's Annual Report on Form 10-K for the year ended December 31, 2018 for more information concerning the Company's goodwill and intangible assets.

Deferred pension assets decreased $234.7 million during the first three months of 2019 and decreased $262.5 million from March 31, 2018. The decrease in both periods is due to settling the majority of the Company's domestic defined benefit pension plan liabilities. See Note 7, on pages 55 through 60, in the Company's Annual Report on Form 10-K for the year ended December 31, 2018 for more information concerning the Company's benefit plan assets. During the first quarter of 2019, the Company purchased annuity contracts to settle the remaining liabilities of the domestic defined benefit pension plan that was terminated in 2018 (Terminated Plan). The annuity contract purchase resulted in a settlement charge of $32.4 million in the first quarter of 2019. The remaining surplus of the Terminated Plan will be used, as prescribed in the applicable regulations, to fund future Company contributions to a qualified replacement pension plan, which is the current domestic defined contribution plan (Qualified Replacement Plan). During the first quarter of 2019, the Company transferred $201.8 million of the surplus to a suspense account held within a trust for the Qualified Replacement Plan. This amount included $131.8 million of Company stock (300,000 shares). The shares are treated as treasury stock in accordance with ASC 715. The remainder of the surplus related to the Terminated Plan will be transferred to the Qualified Replacement Plan suspense account after the final expenses associated with the wind-up of the Terminated Plan have been settled.

Other assets at March 31, 2019 increased $16.5 million in the first three months of 2019 and increased $34.5 million from a year ago primarily due to increases in deferred tax assets and other investments.

Net property, plant and equipment decreased $13.8 million in the first three months of 2019 and decreased $77.0 million in the twelve months since March 31, 2018. The decrease in the first three months was primarily due to depreciation expense of $64.7 million, partially offset by capital expenditures of $51.4 million. Since March 31, 2018, the decrease was primarily due to depreciation expense of $271.3 million and sale or disposition of fixed assets and changes in currency translation rates of $65.3 million, partially offset by capital expenditures of $259.9 million. Capital expenditures primarily represented expenditures associated with improvements and normal equipment replacement in manufacturing and distribution facilities in the Consumer Brands Group, normal equipment replacement in The Americas and Performance Coatings Groups, and information systems hardware in the Administrative Segment.

At March 31, 2019, the Company had outstanding borrowings of $768.5 million with a weighted average interest rate of 2.9% under its commercial paper program. The Company had unused capacity under the global credit agreement of $1.232 billion at March 31, 2019. Short-term borrowings under various other foreign programs were $56.3 million with a weighted average interest rate of 4.9%.

Long-term liabilities for postretirement benefits other than pensions did not change significantly from December 31, 2018 and March 31, 2018. See Note 7, on pages 55 through 60, in the Company's Annual Report on Form 10-K for the year ended December 31, 2018 for more information concerning the Company's benefit plan obligations.

Deferred income taxes at March 31, 2019 remained mostly unchanged in the first three months of 2019 and decreased $351.3 million from a year ago primarily due to the overall favorable impact of the Tax Cuts and Jobs Act.

Environmental-Related Liabilities

The operations of the Company, like those of other companies in the same industry, are subject to various federal, state and local environmental laws and regulations. These laws and regulations not only govern current operations and products, but also impose potential liability on the Company for past operations. Management expects environmental laws and regulations to impose increasingly stringent requirements upon the Company and the industry in the future. Management believes that the Company conducts its operations in compliance with applicable environmental laws and regulations and has implemented various programs designed to protect the environment and promote continued compliance.

Depreciation of capital expenditures and other expenses related to ongoing environmental compliance measures were included in the normal operating expenses of conducting business. The Company's capital expenditures, depreciation and other expenses related to ongoing environmental compliance measures were not material to the Company's financial condition, liquidity, cash flow or results of operations during the first three months of 2019. Management does not expect that such capital expenditures, depreciation and other expenses will be material to the Company's financial condition, liquidity, cash flow or results of operations in 2019. See Note 8 for further information on environmental-related long-term liabilities.

Contractual Obligations, Commercial Commitments and Warranties

Short-term borrowings increased $496.4 million to $824.8 million at March 31, 2019 from $328.4 million at December 31, 2018. Total long-term debt decreased $8.7 million to $9.007 billion at March 31, 2019 from $9.015 billion at December 31, 2018, and decreased $885.7 million from $9.892 billion at March 31, 2018. There have been no other significant changes to the Company's contractual obligations and commercial commitments in the first quarter of 2019 as summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

See Note 5 for changes to the Company's accrual for product warranty claims in the first three months of 2019.

Litigation

See Note 9 for information concerning litigation.

Shareholders' Equity

Shareholders' equity decreased $270.7 million to $3.460 billion at March 31, 2019 from $3.731 billion at December 31, 2018 and decreased $185.7 million from $3.646 billion at March 31, 2018. The decrease in Shareholders' equity for the first three months of 2019 resulted primarily from increased treasury stock of $458.2

million, cash dividends paid on common stock of $104.8 million and an increase in cumulative other comprehensive loss of $2.3 million primarily due to currency translation, partially offset by net income of $245.2 million and an increase in other capital of $49.1 million. The decrease in Shareholders'

equity since March 31, 2018 resulted primarily from increased treasury stock of $830.9 million, cash dividends paid on common stock of $346.7 million and an increase in cumulative other comprehensive loss of $296.5 million, partially offset by net income of $1.104 billion and an increase in other capital of $184.3 million.
During the first three months of 2019, the Company purchased 750,000 shares of its common stock for treasury purposes through open market purchases. The Company acquires its common stock for general corporate purposes, and depending on its cash position and market conditions, it may acquire additional shares in the future. The Company had remaining authorization at March 31, 2019 to purchase 9.38 million shares of its common stock. On April 17, 2019, the Company's Board of Directors approved a dividend of $1.13 per share, an increase of 31% over the May 2018 dividend, payable on May 31, 2019 to shareholders of record on May 17, 2019.

Cash Flow

Net operating cash for the three months ended March 31, 2019 was a cash usage of $36.0 million compared to a cash source of $40.7 million for the same period in 2018. The decrease in net operating cash was primarily due to an increase in cash requirements for working capital and other long-term items, partially offset by cash requirements for defined benefit pension plans. Net investing cash usage increased $31.7 million in the first three months of 2019 to a usage of $72.2 million from a usage of $40.6 million in 2018 due to an increase in other investments, capital expenditures and a decrease in proceeds from sale of assets. Net financing cash increased $78.8 million to a source of $51.4 million in the first three months of 2019 from a usage of $27.4 million in 2018 primarily due to proceeds from short-term debt partially offset by increases in treasury stock purchases, payments of cash dividends and payments of other accruals. In the twelve month period from April 1, 2018 through March 31, 2019, the Company generated net operating cash of $1.867 billion, used $283.3 million in investing activities and used $1.668 billion in financing activities.

Market Risk

The Company is exposed to market risk associated with interest rate, foreign currency and commodity fluctuations. The Company occasionally utilizes derivative instruments as part of its overall financial risk management policy, but does not use derivative instruments for speculative or trading purposes. The Company believes it may be exposed to continuing market risk from foreign currency exchange rate and commodity price fluctuations. However, the Company does not expect that foreign currency exchange rate and commodity price fluctuations or hedging contract losses will have a material adverse effect on the Company’s financial condition, results of operations or cash flows.

Financial Covenant

Certain borrowings contain a consolidated leverage covenant. The covenant states that the Company’s leverage ratio is not to exceed 4.75 to 1.00. The leverage ratio is defined as the ratio of total indebtedness (the sum of Short-term borrowings, Current portion of long-term debt and Long-term debt) at the reporting date to consolidated pro forma “Earnings Before Interest, Taxes, Depreciation, and Amortization” (EBITDA) for the twelve month period ended on the same date. Refer to the “Results of Operations” caption below for a reconciliation of EBITDA to Net income. At March 31, 2019, the Company was in compliance with the covenant. The Company’s notes, debentures and revolving credit agreements contain various default and cross-default provisions. In the event of default under any one of these arrangements, acceleration of the maturity of any one or more of these borrowings may result. See Note 8, on pages 61 and 62, in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018 for more information concerning the Company’s debt and related covenant.

RESULTS OF OPERATIONS

Shown below are net sales and income before taxes by segment for the three months ended March 31, 2019:

(Thousands of dollars)	Three Months Ended March 31,		
	2019	2018	Change
Net Sales:			
The Americas Group	$2,154,853	$2,080,415	3.6 %
Consumer Brands Group	654,502	656,379	-0.3 %
Performance Coatings Group	1,230,798	1,227,775	0.2 %
Administrative	708	437	62.0 %
Total	$4,040,861	$3,965,006	1.9 %

(Thousands of dollars)	Three Months Ended March 31,		
	2019	2018	Change
Income Before Income Taxes:			
The Americas Group	$331,088	$337,392	-1.9 %
Consumer Brands Group	87,937	74,228	18.5 %
Performance Coatings Group	98,693	90,766	8.7 %
Administrative	(218,864)	(198,800)	-10.1 %
Total	$298,854	$303,586	-1.6 %

Three Months Ended March 31, 2019

Consolidated net sales increased in the first quarter of 2019 due primarily to a new customer program launched in 2018, higher paint sales volume in North America, and selling price increases partially offset by soft end market demand outside the U.S. and unfavorable currency translation rate changes. Currency translation rate changes decreased net sales by 2.3% in the quarter. Net sales of all consolidated foreign subsidiaries were down 3.7% to $886.0 million in the first quarter compared to $919.7 million in the same period last year. The decrease in net sales for all consolidated foreign subsidiaries in the quarter was due primarily to unfavorable currency translation rate changes partially offset by selling price increases. Net sales of all operations other than consolidated foreign subsidiaries were up 3.6% to $3.155 billion in the quarter compared to $3.045 billion in the same period last year. Net sales in The Americas Group increased in the first quarter of 2019 due primarily to higher paint sales volume across most end markets in North American stores and selling price increases partially, offset by unfavorable currency translation rate changes. Currency translation rate changes decreased Group net sales by 1.5% in the quarter. Net sales from stores open for more than twelve calendar months in the U.S. and Canada increased 3.6% in the quarter compared to last year’s comparable period. Sales of non-paint products increased 4.1% over last year's first quarter. A discussion of changes in volume versus pricing for sales of products other than paint is not pertinent due to the wide assortment of general merchandise sold. Net sales of the Consumer Brands Group decreased in the first quarter primarily due to soft non-domestic market conditions, the divestiture of a furniture protection plan business in the third quarter of 2018, and unfavorable currency translation rate changes, partially offset by a new customer program launched in 2018 and selling price increases. The divestiture negatively impacted Group net sales by 2.6% in the quarter and currency translation rate changes decreased Group net sales by 1.6% in the quarter. Net sales in the Performance Coatings Group stated in U.S. dollars increased in the first quarter primarily due to selling price increases, partially offset by soft sales outside North America and unfavorable currency translation rate changes. Currency translation rate changes decreased Group net sales by 3.9% in the quarter. Net sales in the Administrative segment, which primarily consist of external leasing revenue of excess headquarters space and leasing of facilities no longer used by the Company in its primary business, were essentially flat in the first quarter.

Consolidated gross profit increased $48.2 million in the first quarter of 2019 compared to the same period in 2018. Consolidated gross profit as a percent of consolidated net sales increased in the first quarter of 2019 to 42.9%, compared to 42.5% during the same period in 2018. Consolidated gross profit dollars and percent improved as a result of selling price increases and reduced impacts of purchase accounting on cost of goods sold, partially offset by higher raw material costs and unfavorable currency translation rate changes.

The Americas Group's gross profit was higher than last year by $27.7 million in the first quarter of 2019 due to selling price increases, partially offset by increased raw material costs and unfavorable currency translation rate changes. The Americas Group's gross profit as a percent of sales decreased in the quarter due to increased raw material costs only partially offset by selling price increases. The Consumer Brands Group's gross profit increased by $6.3 million in the quarter compared to the same period last year due primarily to selling price increases and reduced impacts of purchase accounting on cost of goods sold, partially offset by higher raw material costs and unfavorable currency translation rate changes. The Consumer Brands Group's gross profit as a percent of sales was up in the quarter compared to the same period last year for these same reasons. The Performance Coatings Group's gross profit increased $7.2 million in the first quarter compared to the same period last year, when stated in U.S. dollars, primarily due to selling price increases and reduced impacts of purchase accounting on cost of goods sold, partially offset by higher raw material costs and unfavorable currency translation rate changes. The Performance Coatings Group's gross profit as a percent of sales was up in the quarter compared to the same period last year for these same reasons. The Administrative segment's gross profit increased by $7.1 million in the first quarter compared to the same period last year.

Selling, general and administrative expenses (SG&A) increased $29.5 million in the first quarter of 2019 versus the same period last year. As a percent of sales, consolidated SG&A increased to 30.8% in the first quarter of 2019, from 30.6% in the first quarter of 2018. These increases to SG&A dollars and percent were primarily due to net new store openings and general comparable store expenses to support higher sales levels partially offset by realized administrative and selling synergies.

The Americas Group's SG&A increased $31.0 million in the first quarter due primarily to net new store openings and general comparable store expenses to support higher sales levels. The Consumer Brands Group's SG&A decreased $4.3 million in the quarter compared to the same period last year primarily due to realized administrative and selling synergies. The Performance Coatings Group's SG&A decreased $1.1 million in the quarter primarily due to realized administrative and selling synergies. The Administrative segment's SG&A increased $3.8 million in the quarter.

Amortization expense decreased $6.3 million in the first quarter of 2019 versus the same period in 2018, primarily due to purchase accounting measurement period adjustments in second quarter 2018 which impacted amortization of acquired intangibles. In the first quarter of 2019, amortization of acquired intangibles was $50.9 million and $21.4 million for the Performance Coatings and Consumer Brands Groups, respectively. In the first quarter of 2018, amortization of acquired intangibles was $54.3 million and $23.2 million for the Performance Coatings and Consumer Brands Groups, respectively.

Interest expense decreased $0.6 million in the first quarter of 2019 compared to the same period in 2018.

Other general (income) expense - net decreased $3.4 million in the first quarter of 2019, compared to the same period in 2018, primarily due to increased gain on sale or disposition of assets in the Administrative segment.

Other expense (income) - net increased $32.6 million in the first quarter as compared to 2018 primarily due to a pension plan settlement expense recorded in the Administrative segment. The settlement expense resulted from the Company's purchase of annuity contracts to settle the remaining liabilities of its overfunded domestic defined benefit pension plan.

Consolidated income before income taxes decreased $4.7 million in the first quarter of 2019 versus the same period last year, primarily due to a pension plan settlement expense recorded in the Administrative segment and decreased segment profit in The Americas Group, partially offset by increased segment profit in the Consumer Brands and Performance Coatings Groups.

The effective tax rate was 17.9% for the first quarter of 2019 compared to 17.6% for the first quarter of 2018. The increase in the effective tax rate for the first quarter of 2019 compared to the first quarter of 2018 was primarily due to timing of discrete items.

Diluted net income per share in the first quarter of 2019 and 2018 was flat at $2.62 per share. First quarter 2019 diluted net income per share included a $.71 per share charge for acquisition-related costs and a $.27 per share charge for pension plan settlement expense. Currency translation rate changes decreased diluted net income per share in the first quarter by $.08 per share. First quarter 2018 diluted net income per share included a $.95 per share charge from acquisition-related costs.

Management considers a measurement that is not in accordance with U.S. generally accepted accounting principles a useful measurement of the operational profitability of the Company. Some investment professionals also utilize such a measurement as an indicator of the value of profits and cash that are generated strictly from operating activities, putting aside working capital and certain other balance sheet changes. For this measurement, management increases net income for significant non-operating and non-cash expense items to arrive at an amount known as "Earnings Before Interest, Taxes, Depreciation and Amortization" (EBITDA). The reader is cautioned that the following value for EBITDA should not be compared to other entities unknowingly. EBITDA should not be considered an alternative to net income or cash flows from operating activities as an indicator of operating performance or as a measure of liquidity. The reader should refer to the determination of net income and cash flows from operating activities in accordance with U.S. generally accepted accounting principles disclosed in the Statements of Consolidated Income and Comprehensive Income and Statements of Consolidated Cash Flows. EBITDA as used by management is calculated as follows:

(Thousands of dollars)	Three Months Ended March 31,	
	2019	2018
Net income	$245,237	$250,127
Interest expense	90,994	91,547
Income taxes	53,617	53,459
Depreciation	64,716	71,591
Amortization	78,771	85,049
EBITDA	$533,335	$551,773

27

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Certain statements contained in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this report constitute “forward-looking statements” within the meaning of the federal securities laws. These forward-looking statements are based upon management’s current expectations, estimates, assumptions and beliefs concerning future events and conditions and may discuss, among other things, anticipated future performance (including sales and earnings), expected growth, future business plans and the costs and potential liability for environmental-related matters and the lead pigment and lead-based paint litigation. Any statement that is not historical in nature is a forward-looking statement and may be identified by the use of words and phrases such as "believe," "expect," "may," "will," "should," "project," "could," "plan," "goal," "potential," "seek," "intend" or "anticipate" or the negative thereof or comparable terminology.

Readers are cautioned not to place undue reliance on any forward-looking statements. Forward-looking statements are necessarily subject to risks, uncertainties and other factors, many of which are outside our control, that could cause actual results to differ materially from such statements and from our historical results and experience. These risks, uncertainties and other factors include such things as:

- general business conditions, strengths of retail and manufacturing economies and growth in the coatings industry;
- changes in general domestic economic conditions such as inflation rates, interest rates, tax rates, unemployment rates, higher labor and healthcare costs, recessions, and changing government policies, laws and regulations;
- changes in raw material and energy supplies and pricing;
- changes in our relationships with customers and suppliers;
- our ability to successfully integrate past and future acquisitions into our existing operations, including Valspar, as well as the performance of the businesses acquired;
- risks inherent in the achievement of additional anticipated cost synergies resulting from the Valspar acquisition and the timing thereof;
- competitive factors, including pricing pressures and product innovation and quality;
- our ability to attain cost savings from productivity initiatives;
- risks and uncertainties associated with our expansion into and our operations in Asia, Europe, South America and other foreign markets, including general economic conditions, inflation rates, recessions, foreign currency exchange rates, foreign investment and repatriation restrictions, legal and regulatory constraints, civil unrest and other external economic and political factors;
- the achievement of growth in foreign markets, such as Asia, Europe and South America;
- increasingly stringent domestic and foreign governmental regulations, including those affecting health, safety and the environment;
- inherent uncertainties involved in assessing our potential liability for environmental-related activities;
- other changes in governmental policies, laws and regulations, including changes in tariff policies, as well as changes in accounting policies and standards and taxation requirements (such as new tax laws and new or revised tax law interpretations);
- the nature, cost, quantity and outcome of pending and future litigation and other claims, including the lead pigment and lead-based paint litigation, and the effect of any legislation and administrative regulations relating thereto; and
- adverse weather conditions and natural disasters.

Readers are cautioned that it is not possible to predict or identify all of the risks, uncertainties and other factors that may affect future results and that the above list should not be considered to be a complete list. Any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as otherwise required by law.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk associated with interest rate, foreign currency and commodity fluctuations. The Company occasionally utilizes derivative instruments as part of its overall financial risk management policy, but does not use derivative instruments for speculative or trading purposes. The Company enters into option and forward currency exchange contracts and commodity swaps to hedge against value changes in foreign currency and commodities. The Company believes it may experience continuing losses from foreign currency translation and commodity price fluctuations. However, the Company does not expect currency translation, transaction, commodity price fluctuations or hedging contract losses to have a material adverse effect on the Company’s financial condition, results of operations or cash flows. There were no material changes in the Company’s exposure to market risk since the disclosure included in Management’s Discussion and Analysis of Financial Condition and Results of Operations in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018.

Item 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chairman and Chief Executive Officer and our Senior Vice President—Finance and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 and Rule 15d-15 of the Securities Exchange Act of 1934, as amended ("Exchange Act"). Based upon that evaluation, our Chairman and Chief Executive Officer and our Senior Vice President—Finance and Chief Financial Officer concluded that as of the end of the period covered by this report our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and accumulated and communicated to our management including our Chairman and Chief Executive Officer and our Senior Vice President—Finance and Chief Financial Officer, to allow timely decisions regarding required disclosure.

The Company implemented technology, processes and controls related to the global recording of right-of-use assets and lease liabilities in connection with the adoption of ASC 842, "Leases," as described in Notes 2 and 16 of the financial statements. Otherwise, there were no changes in our internal control over financial reporting identified in connection with the evaluation that occurred during the period covered by this report 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.

For information with respect to certain environmental-related matters and legal proceedings, see the information included under the captions entitled “Environmental-Related Liabilities” and “Litigation” of “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and Notes 8 and 9 of the “Notes to Condensed Consolidated Financial Statements,” which is incorporated herein by reference.

Item 1A. Risk Factors

We face a number of risks that could materially and adversely affect our business, results of operations, cash flow, liquidity or financial condition. A discussion of our risk factors can be found in Item 1A, Risk Factors, in our Annual Report on Form 10-K for the fiscal year ended December 31, 2018. During the first quarter ended March 31, 2019, there were no material changes to our previously disclosed risk factors.

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

A summary of the repurchase activity for the Company's first quarter is as follows:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Number of Shares Purchased as Part of a Publicly Announced Plan	Number of Shares That May Yet Be Purchased Under the Plan
January 1 - January 31				
Share repurchase program [1]	450,000	$393.66	450,000	9,675,000
Employee transactions [2]	323	$389.90		N/A
February 1 - February 28				
Share repurchase program [1]	300,000	$426.67	300,000	9,375,000
Employee transactions [2]	48,427	$436.98		N/A
Shares transferred from defined benefit pension plan [3]	300,000	$439.27		N/A
March 1 - March 31				
Share repurchase program [1]				9,375,000
Employee transactions [2]	893	$432.38		N/A
Total				
Share repurchase program [1]	750,000	$406.86	750,000	9,375,000
Employee transactions [2]	49,643	$436.59		N/A
Shares transferred from defined benefit pension plan [3]	300,000	$439.27		N/A

(1) Shares were purchased through the Company's publicly announced share repurchase program. There is no expiration date specified for the program. The Company had remaining authorization at March 31, 2019 to purchase 9,375,000 shares.

(2) Shares were delivered to satisfy the exercise price and/or tax withholding obligations by employees who exercised stock options or had restricted stock units vest.

(3) Shares were transferred from the Company's terminated domestic defined benefit pension plan surplus assets to a suspense account held within a trust for the Qualified Replacement Plan. In accordance with ASC 715, the transferred shares are treated as treasury stock.

Item 5. Other Information.

During the three months ended March 31, 2019, the Audit Committee of the Board of Directors of the Company approved permitted non-audit services to be performed by Ernst & Young LLP, the Company's independent registered public accounting firm. These non-audit services were approved within categories related to domestic tax advisory, tax compliance and other advisory services.

Item 6. Exhibits.

10.1*	Schedule of Executive Officers who are Parties to the Amended and Restated Severance Agreements in the forms filed as Exhibit 10(e) to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010 (filed herewith).
31(a)	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer (filed herewith).
31(b)	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer (filed herewith).
32(a)	Section 1350 Certification of Chief Executive Officer (furnished herewith).
32(b)	Section 1350 Certification of Chief Financial Officer (furnished herewith).
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

* Management contract or compensatory plan or arrangement.

Signatures

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

THE SHERWIN-WILLIAMS COMPANY

April 25, 2019	By:	/s/ Jane M. Cronin Jane M. Cronin Senior Vice President - Corporate Controller
April 25, 2019	By:	/s/ Allen J. Mistysyn Allen J. Mistysyn Senior Vice President - Finance and Chief Financial Officer

36