

CHOICE HOTELS INTERNATIONAL INC /DE

Form 10-Q

August 09, 2010

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2010**

**OR**

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

**COMMISSION FILE NO. 001-13393**

**CHOICE HOTELS INTERNATIONAL, INC.**

(Exact name of registrant as specified in its charter)

**DELAWARE**  
 (State or other jurisdiction of  
 incorporation or organization)

**52-1209792**  
 (I.R.S. Employer  
 Identification No.)

**10750 COLUMBIA PIKE**  
**SILVER SPRING, MD. 20901**  
 (Address of principal executive offices)

(Zip Code)  
**(301) 592-5000**  
 (Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months. Yes  No

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

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

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

**CLASS**  
 Common Stock, Par Value \$0.01 per share

**SHARES OUTSTANDING AT JUNE 30, 2010**  
 59,603,015

**Table of Contents**

**CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES**

**INDEX**

	<b>PAGE NO.</b>
<b>PART I. FINANCIAL INFORMATION:</b>	
<u>Item 1. Financial Statements (Unaudited)</u>	3
<u>Consolidated Statements of Income For the three and six months ended June 30, 2010 and June 30, 2009</u>	3
<u>Consolidated Balance Sheets As of June 30, 2010 and December 31, 2009</u>	4
<u>Consolidated Statements of Cash Flows For the six months ended June 30, 2010 and June 30, 2009</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	42
<u>Item 4. Controls and Procedures</u>	42
<b>PART II. OTHER INFORMATION:</b>	
<u>Item 1. Legal Proceedings</u>	42
<u>Item 1A. Risk Factors</u>	42
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	43
<u>Item 3. Defaults Upon Senior Securities</u>	43
<u>Item 4. (Removed and Reserved)</u>	43
<u>Item 5. Other Information</u>	43
<u>Item 6. Exhibits</u>	43
<b><u>SIGNATURE</u></b>	45

Table of Contents

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED, IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<b>REVENUES:</b>				
Royalty fees	\$ 57,443	\$ 54,929	\$ 98,464	\$ 98,370
Initial franchise and relicensing fees	2,655	3,993	4,567	6,642
Procurement services	6,611	6,772	9,856	10,162
Marketing and reservation	80,389	75,296	139,229	137,338
Hotel operations	1,109	1,179	1,976	2,297
Other	1,641	1,174	3,177	2,692
<b>Total revenues</b>	<b>149,848</b>	<b>143,343</b>	<b>257,269</b>	<b>257,501</b>
<b>OPERATING EXPENSES:</b>				
Selling, general and administrative	22,824	27,076	44,640	48,537
Depreciation and amortization	2,220	2,032	4,392	4,147
Marketing and reservation	80,389	75,296	139,229	137,338
Hotel operations	808	829	1,564	1,614
<b>Total operating expenses</b>	<b>106,241</b>	<b>105,233</b>	<b>189,825</b>	<b>191,636</b>
<b>Operating income</b>	<b>43,607</b>	<b>38,110</b>	<b>67,444</b>	<b>65,865</b>
<b>OTHER INCOME AND EXPENSES, NET:</b>				
Interest expense	675	1,265	1,296	2,805
Interest and other investment (income) loss	1,103	(3,173)	26	(2,341)
Equity in net income of affiliates	(195)	(225)	(548)	(443)
<b>Total other income and expenses, net</b>	<b>1,583</b>	<b>(2,133)</b>	<b>774</b>	<b>21</b>
<b>Income before income taxes</b>	<b>42,024</b>	<b>40,243</b>	<b>66,670</b>	<b>65,844</b>
<b>Income taxes</b>	<b>15,013</b>	<b>14,740</b>	<b>23,866</b>	<b>24,033</b>
<b>Net income</b>	<b>\$ 27,011</b>	<b>\$ 25,503</b>	<b>\$ 42,804</b>	<b>\$ 41,811</b>
<b>Weighted average shares outstanding basic</b>	<b>59,592</b>	<b>60,467</b>	<b>59,553</b>	<b>60,499</b>
<b>Weighted average shares outstanding diluted</b>	<b>59,676</b>	<b>60,598</b>	<b>59,639</b>	<b>60,708</b>
<b>Basic earnings per share</b>	<b>\$ 0.45</b>	<b>\$ 0.42</b>	<b>\$ 0.72</b>	<b>\$ 0.69</b>

Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

<b>Diluted earnings per share</b>	<b>\$ 0.45</b>	\$ 0.42	<b>\$ 0.72</b>	\$ 0.69
<b>Cash dividends declared per share</b>	<b>\$ 0.185</b>	\$ 0.185	<b>\$ 0.37</b>	\$ 0.37

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

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(UNAUDITED, IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)**

	June 30, 2010	December 31, 2009
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 70,926	\$ 67,870
Receivables (net of allowance for doubtful accounts of \$7,779 and \$6,886, respectively)	50,342	41,898
Deferred income taxes	7,980	7,980
Other current assets	20,982	10,114
<b>Total current assets</b>	<b>150,230</b>	<b>127,862</b>
Property and equipment, at cost, net	48,422	43,627
Goodwill	66,033	65,813
Franchise rights and other identifiable intangibles, net	22,308	24,559
Receivable marketing and reservation fees	58,508	33,872
Investments, employee benefit plans, at fair value	20,868	20,931
Deferred income taxes	14,192	14,143
Other assets	9,647	9,230
<b>Total assets</b>	<b>\$ 390,208</b>	<b>\$ 340,037</b>
<b>LIABILITIES AND SHAREHOLDERS DEFICIT</b>		
<b>Current liabilities</b>		
Revolving credit facility	\$ 291,100	\$ 0
Accounts payable	42,735	33,859
Accrued expenses	30,442	37,074
Deferred revenue	57,226	51,765
Income taxes payable	17,648	6,310
Deferred compensation and retirement plan obligations	2,461	2,798
<b>Total current liabilities</b>	<b>441,612</b>	<b>131,806</b>
Long-term debt	0	277,700
Deferred compensation and retirement plan obligations	33,348	34,956
Other liabilities	12,283	9,787
<b>Total liabilities</b>	<b>487,243</b>	<b>454,249</b>
<b>Commitments and Contingencies</b>		
<b>SHAREHOLDERS DEFICIT</b>		
Common stock, \$0.01 par value, 160,000,000 shares authorized; 95,345,362 shares issued at June 30, 2010 and December 31, 2009 and 59,603,015 and 59,541,106 shares outstanding at June 30, 2010 and December 31, 2009, respectively	596	595
Additional paid-in capital	89,130	90,731
Accumulated other comprehensive income (loss)	(850)	333
	<b>(871,211)</b>	<b>(870,302)</b>

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

Treasury stock (35,742,347 and 35,804,256 shares at June 30, 2010 and December 31, 2009, respectively), at cost

Retained earnings	<b>685,300</b>	664,431
<b>Total shareholders deficit</b>	<b>(97,035)</b>	(114,212)
<b>Total liabilities and shareholders deficit</b>	<b>\$ 390,208</b>	\$ 340,037

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

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED, IN THOUSANDS)**

	<b>Six Months Ended June 30</b>	
	<b>2010</b>	<b>2009</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 42,804	\$ 41,811
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,392	4,147
Provision for bad debts	1,637	743
Non-cash stock compensation and other charges	5,297	6,601
Non-cash interest and other (income) loss	307	(2,107)
Dividends received from equity method investments	148	488
Equity in net income of affiliates	(548)	(443)
Changes in assets and liabilities, net of acquisitions:		
Receivables	(10,061)	(1,774)
Receivable - marketing and reservation fees, net	(17,996)	(19,513)
Accounts payable	9,043	1,523
Accrued expenses	(6,601)	(7,167)
Income taxes payable/receivable	11,492	20,093
Deferred income taxes	(55)	0
Deferred revenue	5,475	6,083
Other assets	(4,307)	1,574
Other liabilities	577	(3,685)
<b>Net cash provided by operating activities</b>	<b>41,604</b>	<b>48,374</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Investment in property and equipment	(12,249)	(4,989)
Acquisitions, net of cash acquired	(466)	0
Issuance of notes receivable	(8,008)	(1,329)
Collections of notes receivable	37	125
Purchases of investments, employee benefit plans	(1,204)	(2,464)
Proceeds from sale of investments, employee benefit plans	836	1,171
Other items, net	(361)	(246)
<b>Net cash used in investing activities</b>	<b>(21,415)</b>	<b>(7,732)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net borrowings pursuant to revolving credit facility	13,400	19,700
Purchase of treasury stock	(9,242)	(36,350)
Excess tax benefits from stock-based compensation	12	2,033
Dividends paid	(21,924)	(22,321)
Proceeds from exercise of stock options	1,315	4,603
<b>Net cash used in financing activities</b>	<b>(16,439)</b>	<b>(32,335)</b>
<b>Net change in cash and cash equivalents</b>	<b>3,750</b>	<b>8,307</b>
<b>Effect of foreign exchange rate changes on cash and cash equivalents</b>	<b>(694)</b>	<b>823</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>67,870</b>	<b>52,680</b>



<b>Cash and cash equivalents at end of period</b>	<b>\$ 70,926</b>	\$ 61,810
---	------------------	-----------

**Supplemental disclosure of cash flow information:****Cash payments during the period for:**

Income taxes, net of refunds	<b>\$ 11,921</b>	\$ 1,485
------------------------------	------------------	----------

Interest	<b>\$ 1,341</b>	\$ 3,258
----------	-----------------	----------

**Non-cash financing activities:**

Declaration of dividends	<b>\$ 21,934</b>	\$ 22,207
--------------------------	------------------	-----------

Issuance of restricted shares of common stock	<b>\$ 9,083</b>	\$ 6,931
---	-----------------	----------

Issuance of performance vested restricted stock units	<b>\$ 256</b>	\$ 461
---	---------------	--------

Issuance of treasury stock to employee stock purchase plan	<b>\$ 314</b>	\$ 301
--	---------------	--------

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

---

**Table of Contents**

**CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. Company Information and Significant Accounting Policies**

The accompanying unaudited consolidated financial statements of Choice Hotels International, Inc. and subsidiaries (together the Company) have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). In the opinion of management, all adjustments (which include any normal recurring adjustments) considered necessary for a fair presentation have been included. Certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States of America (GAAP) have been omitted. The year end balance sheet information was derived from audited financial statements, but does not include all disclosures required by GAAP. The Company believes the disclosures made are adequate to make the information presented not misleading. The consolidated financial statements should be read in conjunction with the consolidated financial statements for the year ended December 31, 2009 and notes thereto included in the Company's Form 10-K, filed with the SEC on March 1, 2010 (the 10-K). Interim results are not necessarily indicative of the entire year results because of seasonal variations. All intercompany transactions and balances between Choice Hotels International, Inc. and its subsidiaries have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Cash and Cash Equivalents***

The Company considers all highly liquid investments purchased with a maturity of three months or less at the date of purchase to be cash equivalents. As of June 30, 2010 and December 31, 2009, \$5.7 million and \$6.4 million, respectively, of book overdrafts representing outstanding checks in excess of funds on deposit are included in accounts payable in the accompanying consolidated balance sheets.

The Company maintains cash balances in domestic banks, which at times, may exceed the limits of amounts insured by the Federal Deposit Insurance Corporation. In addition, the Company also maintains cash balances in international banks which do not provide deposit insurance.

***Recently Adopted Accounting Guidance***

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-06, Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements, (ASU 2010-06) to require new disclosures and clarify existing disclosures relating to fair value measurements. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of this standard did not have and is not expected to have an effect on the Company's consolidated balance sheets, results of operations, or cash flows.

In June 2009, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 167, Amendments to FASB Interpretation No. 46(R), or ASU No. 2009-17, now included in FASB Accounting Standards Codification (ASC) 810-10, Consolidation, which amends FASB Interpretation No. 46 (revised December 2003) to address the elimination of the concept of a qualifying special purpose entity. This guidance replaces the quantitative-based risks and rewards calculation for determining which enterprise has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity and the obligation to absorb losses of the entity or the right to receive benefits from the entity. Additionally, this guidance provides more timely and useful information about an enterprise's involvement with a variable interest entity. The Company adopted this guidance on January 1, 2010. The adoption of these provisions did not have an impact on our consolidated financial statements.

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)****2. Other Current Assets**

Other current assets consist of the following:

	June 30, 2010	December 31, 2009
(In thousands)		
Prepaid expenses	\$ 8,145	\$ 7,014
Notes receivable (See Note 3)	8,874	2,378
Land held for sale	2,991	
Other	972	722
<b>Total</b>	<b>\$ 20,982</b>	<b>\$ 10,114</b>

**3. Notes Receivable**

	June 30, 2010	December 31, 2009
(In thousands)		
Forgivable notes receivable	\$ 7,080	\$ 7,432
Mezzanine and other notes receivables	19,766	12,345
	26,846	19,777
Loan reserves	(9,733)	(9,531)
<b>Total</b>	<b>\$ 17,113</b>	<b>\$ 10,246</b>
Current portion, net	\$ 8,874	\$ 2,378
Long-term portion, net	8,239	7,868
<b>Total</b>	<b>\$ 17,113</b>	<b>\$ 10,246</b>

The Company classifies notes receivable due within one year as current assets and notes receivable with a maturity greater than one year as other assets in the Company's consolidated balance sheets.

***Forgivable Notes Receivable***

From time to time, the Company provides financing to franchisees for property improvements and other purposes in the form of forgivable promissory notes. The terms of the notes typically range from 3 to 10 years, bearing market interest rates, and are forgiven and amortized over that time period if the franchisee remains in the system in good standing. As of June 30, 2010 and December 31, 2009, the unamortized balance of these notes totaled \$7.1 million and \$7.4 million, respectively. The Company recorded an allowance for credit losses on these forgivable notes receivable of \$0.7 million at both June 30, 2010 and December 31, 2009. Amortization expense included in the accompanying consolidated statements of income related to the notes was \$0.5 million and \$1.0 million for the three and six months ended June 30, 2010, respectively. Amortization expense for the three and six months ended June 30, 2009 relating to the notes was \$0.5 million and \$1.0 million, respectively. At

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

June 30, 2010, the Company had commitments to extend an additional \$4.8 million in forgivable notes receivable provided certain commitments are met by its franchisees.

### *Mezzanine and Other Notes Receivable*

The Company has provided financing to franchisees in support of the development of properties in key markets. These notes include non-interest bearing receivables as well as notes bearing market interest and are due upon maturity. Interest income associated with these notes receivable is reflected in the accompanying consolidated statements of income under the caption interest and other investment (income) loss. The Company does not accrue interest on notes receivable that are impaired. At June 30, 2010, notes receivable advanced totaled \$19.8 million of which \$10.8 million was determined to be impaired at June 30, 2010. The Company has recorded an \$8.6 million allowance for credit losses on these impaired loans at both June 30, 2010 and December 31, 2009. In addition, at June 30, 2010 and December 31, 2009, the Company had provided loan reserves on non-impaired loans totaling \$0.4 million and \$0.2 million, respectively. The Company records bad debt expense in SG&A expenses in the accompanying consolidated statements of income. At June 30, 2010, the Company had a commitment to extend an additional \$2.1 million in mezzanine and other notes receivables provided certain conditions are met.

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)****4. Receivable Marketing and Reservation Fees**

As of June 30, 2010 and December 31, 2009, the Company's balance sheet includes a receivable of \$32.3 million and \$19.2 million, respectively from cumulative marketing expenses incurred in excess of cumulative marketing fee revenues earned. The reservation fees receivable related to cumulative reservation expenses incurred in excess of cumulative reservation fee revenues earned was \$26.2 million and \$14.7 million at June 30, 2010 and December 31, 2009, respectively. Depreciation and amortization expense attributable to marketing and reservation activities was \$3.4 million and \$2.5 million for the three months ended June 30, 2010 and 2009, respectively. Depreciation and amortization expense attributable to marketing and reservation activities was \$6.1 million and \$4.9 million for the six months ended June 30, 2010 and 2009, respectively. Interest expense attributable to reservation activities was approximately \$0.1 million for both the three months ended June 30, 2010 and 2009, while interest expense attributable to reservation activities was approximately \$0.2 million for both the six months ended June 30, 2010 and 2009.

**5. Deferred Revenue**

Deferred revenue consists of the following:

	June 30, 2010	December 31, 2009
	(In thousands)	
Loyalty programs	\$ 53,211	\$ 47,832
Initial, relicensing and franchise fees	2,489	2,160
Procurement service fees	947	884
Other	579	889
<b>Total</b>	<b>\$ 57,226</b>	<b>\$ 51,765</b>

**6. Debt**

On June 16, 2006, the Company entered into a \$350 million senior unsecured revolving credit agreement (the "Revolver"), with a syndicate of lenders. The Revolver allows the Company to borrow, repay and reborrow revolving loans up to \$350 million (which includes swingline loans for up to \$20 million and standby letters of credit of up to \$30 million) until the scheduled maturity date of June 16, 2011. The Company has the ability to request an increase in available borrowings under the Revolver by an additional amount of up to \$150 million by obtaining the agreement of the existing lenders to increase their lending commitments or by adding additional lenders. The rate of interest generally applicable for revolving loans under the Revolver is, at the Company's option, equal to either (i) the greater of the prime rate or the federal funds effective rate plus 50 basis points, or (ii) an adjusted LIBOR rate plus a margin between 22 and 70 basis points based on the Company's credit rating. The Revolver requires the Company to pay a quarterly facility fee, based upon the credit rating of the Company, at a rate between 8 and 17<sup>1/2</sup> basis points, on the full amount of the commitment (regardless of usage). The Revolver also requires the payment of a quarterly usage fee, based upon the credit rating of the Company, at a rate between 10 and 12<sup>1/2</sup> basis points, on the amount outstanding under the commitment, excluding swingline loans, at all times when the amount borrowed under the Revolver exceeds 50% of the total commitment. The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. The Revolver also restricts the Company's ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions. As of June 30, 2010, the Company had \$291.1 million of revolving loans outstanding pursuant to the Revolver and the Company was in compliance with all covenants.

The Company has a line of credit with a bank through August 31, 2010 providing up to an aggregate of \$5 million of borrowings, which is due upon demand. Borrowings under the line of credit bear interest at the lender's sole option at either of the following rates (i) prime rate or (ii) LIBOR rate plus 0.80% per annum; due monthly and upon demand for final payment. As of June 30, 2010, no amounts were outstanding

pursuant to this line of credit.

As of June 30, 2010, total debt outstanding for the Company was \$291.1 million and has been classified as a current liability due to the scheduled maturity of the Company's Revolver on June 16, 2011.

**7. Acquisition of Choice Hospitality (India) Ltd.**

In the first quarter of 2010, the Company acquired the remaining 60% ownership interest in one of the Company's master franchisees, Choice Hospitality (India) Ltd. ( CHN ), which conducts franchising operations in the Republics of India, Sri Lanka, Maldives and

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

the Kingdom of Nepal for \$0.6 million and began including the results of its operations in the Company's financial statements on January 8, 2010. Prior to the acquisition, the Company owned 40% of the outstanding common stock of CHN with the remaining 60% of the outstanding stock owned by unrelated parties. The Company allocated the purchase price based on management's assessment of the fair value of assets acquired and liabilities assumed as of January 8, 2010. The Company allocated \$0.3 million of the excess of the total purchase price over net tangible assets to franchise rights and the remaining \$0.2 million to goodwill. The franchise rights are being amortized over their estimated useful life of 8 years. The pro forma results of operations as if this entity had been combined at the beginning of 2010 and 2009 would not be materially different from the Company's reported results for those periods.

**8. Pension Plan**

The Company sponsors an unfunded non-qualified defined benefit plan (SERP) for certain senior executives. No assets are held with respect to the plan; therefore benefits are funded as paid to participants. For the three months ended June 30, 2010 and June 30, 2009, the Company recorded \$0.1 million and \$0.3 million, respectively, for the expenses related to the SERP which are included in SG&A expense in the accompanying consolidated statements of income. The expenses related to the SERP for the six month periods ended June 30, 2010 and 2009 are \$0.3 million and \$0.6 million, respectively. Benefit payments totaling \$0.4 million are currently scheduled to be remitted within the next twelve months.

The following table presents the components of net periodic benefit costs for the three and six months ended June 30, 2010 and 2009:

(In thousands)	Three Months Ended		Six Months Ended	
	June 30, 2010	2009	June 30, 2010	2009
Components of net periodic pension cost:				
Service cost	\$	\$ 101	\$	\$ 202
Interest cost	134	148	269	296
Amortization:				
Prior service cost		58		115
Net periodic pension cost	\$ 134	\$ 307	\$ 269	\$ 613

The net periodic pension costs for the year ended December 31, 2010 are projected to decline from the prior year due to the amendment of the SERP, effective December 31, 2009, which froze participant benefits. As a result of freezing the benefits future service costs and unrecognized prior service cost amortizations have been eliminated. The 2010 monthly net periodic pension costs are approximately \$45,000. The components of projected pension costs for the year ended December 31, 2010 are as follows:

(in thousands)	
Components of net periodic pension cost:	
Service cost	\$
Interest cost	538
Amortizations:	
(Gain)/Loss	
Prior service cost	
Net periodic pension cost	\$ 538

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

The following is a reconciliation of the changes in the projected benefit obligation for the six months ended June 30, 2010:

<b>(in thousands)</b>	
Projected benefit obligation, December 31, 2009	<b>\$ 9,176</b>
Service cost	
Interest cost	<b>269</b>
Benefit payments	<b>(198)</b>
Projected benefit obligation, June 30, 2010	<b>\$ 9,247</b>



**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

The amounts in accumulated other comprehensive income (loss) that have not yet been recognized as components of net periodic benefit costs at June 30, 2010 are as follows:

<b>(in thousands)</b>	
Transition asset (obligation)	<b>\$</b>
Prior service cost	
Accumulated gain	<b>93</b>
 Total	 <b>\$ 93</b>

**9. Non-Qualified Retirement, Savings and Investment Plans**

The Company sponsors two non-qualified retirement savings and investment plans for certain employees and senior executives. Employee and Company contributions are maintained in separate irrevocable trusts. Legally, the assets of the trusts remain those of the Company; however, access to the trusts' assets is severely restricted. The trusts cannot be revoked by the Company or an acquirer, but the assets are subject to the claims of the Company's general creditors. The participants do not have the right to assign or transfer contractual rights in the trusts.

In 2002, the Company adopted the Choice Hotels International, Inc. Executive Deferred Compensation Plan ( EDCP ) which became effective January 1, 2003. Under the EDCP, certain executive officers may defer a portion of their salary into an irrevocable trust. Prior to January 1, 2010, participants could elect an investment return of either the annual yield of the Moody's Average Corporate Bond Yield Index plus 300 basis points or a return based on a selection of available diversified investment options. Effective January 1, 2010, the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points is no longer an investment option for salary deferrals made on compensation earned after December 31, 2009. As of June 30, 2010 and December 31, 2009, the Company recorded a deferred compensation liability of \$16.6 million and \$17.6 million, respectively related to these deferrals and credited investment returns. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. Compensation expense recorded in SG&A for the three months ended June 30, 2010 and 2009 were \$0.1 million and \$0.3 million, respectively. Compensation expense recorded in SG&A for the six months ended June 30, 2010 and 2009 was \$0.3 million and \$0.5 million, respectively.

The Company has invested the employee salary deferrals in diversified long-term investments which are intended to provide investment returns that partially offset the earnings credited to the participants. The diversified investments held in the trusts totaled \$11.6 million and \$10.9 million as of June 30, 2010 and December 31, 2009, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore, the changes in the fair value of the diversified assets is included in other income and expenses, net in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended June 30, 2010 and 2009 totaling (\$0.7 million) and \$2.2 million, respectively. The Company recorded investment gains (losses) during the six months ended June 30, 2010 and 2009 totaling (\$0.2 million) and \$1.4 million, respectively.

In 1997, the Company adopted the Choice Hotels International, Inc. Nonqualified Retirement Savings and Investment Plan ( Non-Qualified Plan ). The Non-Qualified Plan allows certain employees who do not participate in the EDCP to defer a portion of their salary and invest these amounts in a selection of available diversified investment options. As of June 30, 2010 and December 31, 2009, the Company had recorded a deferred compensation liability of \$10.0 million and \$11.0 million, respectively related to these deferrals. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. The net increase (decrease) in compensation expense recorded in SG&A for the three months ended June 30, 2010 and 2009 was (\$0.7 million) and \$1.0 million, respectively. The net increase (decrease) in compensation expense recorded in SG&A for the six months ended June 30, 2010 and 2009 was (\$0.3 million) and \$0.7 million, respectively.

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

The diversified investments held in the trusts were \$9.2 million and \$10.1 million as of June 30, 2010 and December 31, 2009, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other income and expenses, net in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended June 30, 2010 and 2009 of (\$0.6 million) and \$1.0 million, respectively. The Company recorded investment gains (losses) during the six months ended June 30, 2010 and 2009 of (\$0.2 million) and \$0.8 million, respectively. In addition, the Non-Qualified Plan held shares of the Company's common stock with a market value of \$0.8 million and \$0.9 million at June 30, 2010 and December 31, 2009, respectively.

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)****10. Fair Value Measurements**

The Company estimates the fair value of our financial instruments utilizing a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. There have been no significant transfers into or out of Level 1 or Level 2 inputs. The following summarizes the three levels of inputs, as well as the assets that the Company values using those levels of inputs:

**Level 1:** Quoted prices in active markets for identical assets and liabilities. The Company's Level 1 assets consist of marketable securities (primarily mutual funds) held in the Company's EDCP and Non-Qualified Plan deferred compensation plans.

**Level 2:** Observable inputs, other than quoted prices in active markets for identical assets and liabilities, such as quoted prices for similar assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable. The Company's Level 2 assets consist of money market funds held in the Company's EDCP and Non-Qualified Plan deferred compensation plans.

**Level 3:** Unobservable inputs, supported by little or no market data available, where the reporting entity is required to develop its own assumptions to determine the fair value of the instrument. The Company does not currently have any assets whose fair value was determined using Level 3 inputs.

Assets (in thousands)	Fair Value Measurements at Reporting Date Using			
	June 30, 2010	Level 1	Level 2	Level 3
<b>As of June 30, 2010</b>				
Investments, employee benefits plans, at fair value	\$ 20,868	\$ 18,610	\$ 2,258	\$
<b>As of December 31, 2009</b>				
Investments, employee benefit plans, at fair value	\$ 20,931	\$ 18,505	\$ 2,426	\$

None of the Company's financial assets currently covered by the disclosure provisions are measured at fair value using significant unobservable inputs. There were no significant transfers in and out of Level 1 and 2 fair value measurements during the three and six months ended June 30, 2010.

**11. Income Taxes**

The effective income tax rate was 35.7% and 36.6% for the three months ended June 30, 2010 and June 30, 2009, respectively. The effective income tax rate was 35.8% and 36.5% for the six months ended June 30, 2010 and June 30, 2009, respectively. These rates differ from the U.S. federal statutory rate of 35% primarily due to state income taxes, partially offset by the effect of foreign operations.

As of both June 30, 2010 and December 31, 2009, the Company had \$4.2 million of total unrecognized tax benefits of which approximately \$2.5 million would affect the effective tax rate if recognized. These unrecognized tax benefits relate principally to state tax positions and stock-based compensation deductions. Estimated interest and penalties related to the underpayment of income taxes are classified as a component of income tax expense in the consolidated statement of income. Accrued interest and penalties included in other liabilities on the Company's consolidated balance sheet were \$1.0 million and \$0.8 million at June 30, 2010 and December 31, 2009, respectively. The Company believes it is reasonably possible it will recognize tax benefits of up to \$2.1 million within the next twelve months related to the anticipated lapse of applicable statutes of limitations regarding state tax positions and stock-based compensation deductions.

The Company's uncertain tax positions are related to tax years that remain subject to examination by the relevant tax authorities. The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of multiple state and foreign jurisdictions. The Company has

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

substantially concluded all U.S. federal income tax matters for years through and including 2005. Substantially all material state and local and foreign income tax matters have been concluded for years through and including 2005. U.S. federal income tax returns for 2006 through 2008 are currently open for examination.

The Company has estimated and accrued for certain tax assessments and the expected resolution of tax contingencies which arise in the course of our business. The ultimate outcome of these tax-related contingencies impact the determination of income tax expense and may not be resolved until several years after the related tax returns have been filed. Predicting the outcome of such tax assessments involves uncertainty and accordingly, actual results could differ from those estimates.

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)****12. Share-Based Compensation and Capital Stock****Stock Options**

The Company granted 12,649 and 10,310 options to certain employees of the Company at a fair value of \$0.2 million and \$0.1 million for the three month periods ended June 30, 2010 and 2009, respectively. The Company granted 0.3 million and 0.5 million options to certain employees of the Company at a fair value of \$2.6 million and \$3.8 million during the six months ended June 30, 2010 and 2009, respectively. The stock options granted by the Company had an exercise price equal to the market price of the Company's common stock on the date of grant. The fair value of the options granted was estimated on the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2010 Grants	2009 Grants
Risk-free interest rate	2.19%	1.81%
Expected volatility	41.92%	39.63%
Expected life of stock option	4.4 years	4.4 years
Dividend yield	2.26%	2.75%
Requisite service period	4 years	4 years
Contractual life	7 years	7 years
Weighted average fair value of options granted	\$ 10.07	\$ 7.36

The expected life of the options and volatility are based on historical data and are not necessarily indicative of exercise patterns or actual volatility that may occur. Historical volatility is calculated based on a period that corresponds to the expected life of the stock option. The dividend yield and the risk-free rate of return are calculated on the grant date based on the then current dividend rate and the risk-free rate of return for the period corresponding to the expected life of the stock option. Compensation expense related to the fair value of these awards is recognized straight-line over the requisite service period based on those awards that ultimately vest.

The aggregate intrinsic value of the stock options outstanding and exercisable at June 30, 2010 was \$4.8 million and \$3.5 million, respectively. The total intrinsic value of options exercised during the three months ended June 30, 2010 and 2009 was \$0.2 million and \$3.8 million, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2010 and 2009 was \$0.9 million and \$8.6 million, respectively.

The Company received \$0.7 million and \$1.9 million in proceeds from the exercise of approximately 23,992 and 0.2 million employee stock options during the three month periods ended June 30, 2010 and 2009, respectively. The Company received \$1.3 million and \$4.6 million in proceeds from the exercise of approximately 0.1 million and 0.5 million employee stock options during the six month periods ended June 30, 2010 and 2009, respectively.

**Restricted Stock**

The following table is a summary of activity related to restricted stock grants:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Restricted share grants	24,564	32,120	274,954	254,729
Weighted average grant date fair value per share	\$ 37.46	\$ 29.50	\$ 33.03	\$ 27.21
Aggregate grant date fair value (\$000)	\$ 920	\$ 948	\$ 9,083	\$ 6,931

Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

Restricted shares forfeited	<b>635</b>	1,582	<b>8,829</b>	11,137
Vesting service period of shares granted	<b>3-4 years</b>	3-4 years	<b>3-4 years</b>	3-4 years
Grant date fair value of shares vested (\$000)	<b>\$ 1,574</b>	\$ 1,428	<b>\$ 5,748</b>	\$ 5,257

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

Compensation expense related to the fair value of these awards is recognized straight-line over the requisite service period based on those restricted stock grants that ultimately vest. The fair value of grants is measured by the market price of the Company's stock on the date of grant. Restricted stock awards generally vest ratably over the service period beginning with the first anniversary of the grant date.

***Performance Vested Restricted Stock Units***

The Company has granted performance vested restricted stock units ( PVRSU ) to certain employees. The vesting of these stock awards is contingent upon the Company achieving performance targets at the end of specified performance periods and the employees' continued employment. The performance conditions affect the number of shares that will ultimately vest. The range of possible stock-based award vesting is between 0% and 200% of the initial target. If a minimum of 50% of the performance target is not attained then no awards will vest under the terms of the PVRSU agreements. Compensation expense related to these awards will be recognized over the requisite service period regardless of whether the performance targets have been met based on the Company's estimate of the achievement of the various performance targets. The Company has currently estimated that between 0% and 100% of the various award targets will be achieved. The fair value is measured by the market price of the Company's common stock on the date of grant. Compensation expense is recognized ratably over the requisite service period based on those PVRSU that ultimately vest.

The following table is a summary of activity related to PVRSU grants:

	Three Months Ended		Six Months Ended	
	June 30, 2010	2009	June 30, 2010	2009
Performance vested restricted stock units granted at target			33,517	9,588
Weighted average grant date fair value per share	\$	\$	\$ 32.60	\$ 26.88
Aggregate grant date fair value (\$000)	\$	\$	\$ 1,093	\$ 258
Stock units forfeited			9,650	4,011
Requisite service period			3 years	2 years

During the six months ended June 30, 2010, PVRSU grants totaling 10,880 vested at a fair value of \$0.3 million. These PVRSU grants were initially granted at a target of 15,541 units, however, since the Company achieved only 70% of the targeted performance conditions contained in the stock awards granted in prior periods, 4,661 shares out of the initial grant were forfeited. In addition, during the six months ended June 30, 2010, 4,989 units were forfeited since the performance targets of the applicable PVRSU grant were not achieved. During the six months ended June 30, 2009, PVRSU grants totaling 19,761 vested at a fair value of \$0.5 million. These PVRSU grants were initially granted at a target of 14,638 units, however, since the Company exceeded targeted performance conditions contained in the stock awards granted in prior periods by 35%, an additional 5,123 shares were earned and issued. No PVRSU grants vested during the three month periods ended June 30, 2010 and 2009.

A summary of stock-based award activity as of June 30, 2010 and changes during the six months ended are presented below:

	Six Months Ended June 30, 2010				Performance Vested Restricted Stock Units		
	Shares	Stock Options Weighted Average Exercise Price	Weighted Average Contractual Term	Restricted Stock Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	
Outstanding at January 1, 2010	1,658,844	\$ 30.05		539,341	\$ 31.68	118,385	\$ 34.58

Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

Granted	261,137	32.84		274,954	33.03	33,517	32.60
Exercised/Vested	(65,545)	20.06		(175,954)	33.65	(10,880)	40.65
Forfeited/Expired	(19,661)	8.57		(8,829)	30.73	(9,650)	36.74
Outstanding at June 30, 2010	1,834,775	\$ 31.03	4.8 years	629,512	\$ 31.75	131,372	\$ 33.42
Options exercisable at June 30, 2010	834,880	\$ 30.87	4.0 years				



**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

The components of the Company's pretax stock-based compensation expense and associated income tax benefits are as follows for the three and six months ended June 30, 2010 and 2009:

(in millions)	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Stock options	\$ 0.6	\$ 0.6	\$ 1.2	\$ 1.1
Restricted stock	1.8	1.7	3.5	3.3
Performance vested restricted stock units	0.2	0.2	0.3	0.4
Total	\$ 2.6	\$ 2.5	\$ 5.0	\$ 4.8
Income tax benefits	\$ 1.0	\$ 0.9	\$ 1.9	\$ 1.8

**Dividends**

On April 29, 2010, the Company's board of directors declared a quarterly cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on July 16, 2010 to shareholders of record as of July 2, 2010. On February 16, 2010, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on April 16, 2010 to shareholders of record on April 5, 2010.

On May 4, 2009, the Company's board of directors declared a quarterly cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on July 17, 2009 to shareholders of record on July 2, 2009. On February 9, 2009, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.1 million in the aggregate), which was paid on April 17, 2009 to shareholders of record on April 3, 2009.

**Stock Repurchase Program**

During the three months ended June 30, 2010, the Company did not purchase any shares of common stock under the share repurchase program. During the six months ended June 30, 2010, the Company purchased 0.2 million shares of common stock under the share repurchase program at a total cost of \$6.9 million. During the three and six months ended June 30, 2009, the Company purchased 0.6 million and 1.3 million shares of common stock under the share repurchase program at a total cost of \$16.8 million and \$34.9 million, respectively.

During the three and six months ended June 30, 2010, the Company redeemed 8,563 and 73,696 shares of common stock at a total cost of \$0.3 million and \$2.4 million, respectively, from employees to satisfy statutory minimum tax requirements from the vesting of restricted stock and PVRSU grants.

During the three and six months ended June 30, 2009, the Company redeemed 6,904 and 55,872 shares of common stock at a total cost of \$0.2 million and \$1.5 million, respectively, from employees to satisfy statutory minimum tax requirements from the vesting of restricted stock and PVRSU grants.

These redemptions were outside the share repurchase program initiated in June 1998.

**13. Comprehensive Income**

The differences between net income and comprehensive income are described in the following table:

(In thousands)	Three Months Ended		Six Months Ended	
	2010	2009	2010	2009
Net income	\$ 27,011	\$ 25,503	\$ 42,804	\$ 41,811
Other comprehensive income (loss), net of tax:				
Amortization of pension related costs, net of tax				
Prior service costs		36		72
Foreign currency translation adjustment, net	(1,189)	1,586	(1,183)	1,327
Other comprehensive income (loss), net of tax	(1,189)	1,622	(1,183)	1,399
Comprehensive income	\$ 25,822	\$ 27,125	\$ 41,621	\$ 43,210

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)****14. Earnings Per Share**

The computation of basic and diluted earnings per common share is as follows:

(In thousands, except per share amounts)	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<b>Computation of Basic Earnings Per Share:</b>				
Net income	\$ 27,011	\$ 25,503	\$ 42,804	\$ 41,811
Income allocated to participating securities	(289)	(243)	(442)	(385)
Net income available to common shareholders	\$ 26,722	\$ 25,260	\$ 42,362	\$ 41,426
Weighted average common shares outstanding basic	58,954	59,891	58,939	59,942
Basic earnings per share	\$ 0.45	\$ 0.42	\$ 0.72	\$ 0.69
<b>Computation of Diluted Earnings Per Share:</b>				
Net income	\$ 27,011	\$ 25,503	\$ 42,804	\$ 41,811
Income allocated to participating securities	(289)	(243)	(441)	(385)
Net income available to common shareholders	\$ 26,722	\$ 25,260	\$ 42,363	\$ 41,426
Weighted average common shares outstanding basic	58,954	59,891	58,939	59,942
Diluted effect of stock options and PVRsUs	84	131	86	209
Weighted average shares outstanding-diluted	59,038	60,022	59,025	60,151
Diluted earnings per share	\$ 0.45	\$ 0.42	\$ 0.72	\$ 0.69

The Company's unvested restricted shares contain rights to receive non-forfeitable dividends, and thus are participating securities requiring the two-class method of computing earnings per share (EPS). The calculation of EPS for common stock shown above excludes the income attributable to the unvested restricted share awards from the numerator and excludes the dilutive impact of those awards from the denominator.

At June 30, 2010 and 2009, the Company had 1.8 million and 1.9 million outstanding stock options, respectively. Stock options are included in the diluted earnings per share calculation using the treasury stock method and average market prices during the period, unless the stock options would be anti-dilutive. For both the three and six months ended June 30, 2010, the Company excluded 0.6 million of anti-dilutive stock options from the diluted earnings per share calculation. For both the three and six months ended June 30, 2009, the Company excluded 1.0 million of anti-dilutive stock options from the diluted earnings per share calculation.

PVRsUs are also included in the diluted earnings per share calculation assuming the performance conditions have been met at the reporting date. However, at June 30, 2010 and 2009, PVRsUs totaling 131,372 and 120,420, respectively were excluded from the computation since the performance conditions had not been met.



**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

The following table reconciles the number of shares used in the basic and diluted earnings per share disclosures contained in the consolidated statements of income:

(in thousands)	Three Months Ended		Six Months	
	June 30,		Ended	
	2010	2009	2010	2009
Weighted average common shares outstanding	58,954	59,891	58,939	59,942
Weighted average participating shares outstanding	638	576	614	557
<b>Weighted average shares outstanding basic</b>	<b>59,592</b>	60,467	<b>59,553</b>	60,499
Effect of dilutive securities:				
Employee stock options and PVRsUs	84	131	86	209
<b>Weighted average shares outstanding dilutive</b>	<b>59,676</b>	60,598	<b>59,639</b>	60,708

**15. Reportable Segment Information**

The Company has a single reportable segment encompassing its franchising business. Revenues from the franchising business include royalty fees, initial franchise and relicensing fees, marketing and reservation fees, procurement services revenue and other revenue. The Company is obligated under its franchise agreements to provide marketing and reservation services appropriate for the operation of its systems. These services do not represent separate reportable segments as their operations are directly related to the Company's franchising business. The revenues received from franchisees that are used to pay for part of the Company's ongoing operations are included in franchising revenues and are offset by the related expenses paid for marketing and reservation activities to calculate franchising operating income. Corporate and other revenue consists of hotel operations. Except as described in Note 4, the Company does not allocate interest income, interest expense or income taxes to its franchising segment.

The following table presents the financial information for the Company's franchising segment:

(In thousands)	Three Months Ended June 30, 2010			Three Months Ended June 30, 2009		
	Corporate &			Corporate &		
	Franchising	Other	Consolidated	Franchising	Other	Consolidated
<b>Revenues</b>	<b>\$ 148,739</b>	<b>\$ 1,109</b>	<b>\$ 149,848</b>	\$ 142,164	\$ 1,179	\$ 143,343
<b>Operating income (loss)</b>	<b>\$ 52,564</b>	<b>\$ (8,957)</b>	<b>\$ 43,607</b>	\$ 50,863	\$ (12,753)	\$ 38,110

(In thousands)	Six Months Ended June 30, 2010			Six Months Ended June 30, 2009		
	Corporate &			Corporate &		
	Franchising	Other	Consolidated	Franchising	Other	Consolidated
<b>Revenues</b>	<b>\$ 255,293</b>	<b>\$ 1,976</b>	<b>\$ 257,269</b>	\$ 255,204	\$ 2,297	\$ 257,501
<b>Operating income (loss)</b>	<b>\$ 85,632</b>	<b>\$ (18,188)</b>	<b>\$ 67,444</b>	\$ 87,360	\$ (21,495)	\$ 65,865

**16. Commitments and Contingencies**

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

The Company is a defendant in a number of lawsuits arising in the ordinary course of business. In the opinion of management and the Company's legal counsel, the ultimate outcome of any such lawsuit individually will not have a material adverse effect on the Company's business, financial position, results of operations or cash flows.

In June 2010, the Company's guaranty of a \$1 million bank loan to fund a franchisee's construction of a Cambria Suites in Green Bay, Wisconsin expired.

In June 2008, the Company guaranteed \$1 million of a bank loan funding a franchisee's construction of a Cambria Suites in Columbus, Ohio. The guaranty will terminate on the earlier of (i) the repayment of all outstanding obligations under the bank loan that it supports (the current initial loan term runs through June 2013), or (ii) when the franchisee achieves certain debt service coverage

**Table of Contents**

**CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

ratios outlined in the underlying bank loan agreement. The Company has received a pledge of an equity interest in the entity constructing the property as well as personal guarantees from several of the franchisee's principal owners related to the repayment of any amounts the Company may be required to pay under this guaranty.

In July 2008, the Company guaranteed \$1 million of a bank loan funding a franchisee's construction of a Cambria Suites in Noblesville, Indiana. The guaranty will terminate on the earlier of (i) the repayment of all outstanding obligations under the bank loan that it supports (the current initial loan term runs through September 2011), or (ii) when the franchisee achieves certain debt service coverage ratios outlined in the underlying bank loan agreement. The Company has received a pledge of an equity interest in the entity constructing the property as well as personal guarantees from several of the franchisee's principal owners related to the repayment of any amounts the Company may be required to pay under this guaranty.

The Company has made commitments to purchase various parcels of real estate to support the development of its brands. Providing certain conditions are met by the seller, the Company expects to acquire these parcels of land for a total price of approximately \$9.0 million during the year ended December 31, 2010. Subsequent to June 30, 2010, the Company completed the purchase of one of these parcels of real estate at a total cost of \$5.5 million.

In the ordinary course of business, the Company enters into numerous agreements that contain standard indemnities whereby the Company indemnifies another party for breaches of representations and warranties. Such indemnifications are granted under various agreements, including those governing (i) purchases or sales of assets or businesses, (ii) leases of real estate, (iii) licensing of trademarks, (iv) access to credit facilities, (v) issuances of debt or equity securities, and (vi) certain operating agreements. The indemnifications issued are for the benefit of the (i) buyers in sale agreements and sellers in purchase agreements, (ii) landlords in lease contracts, (iii) franchisees in licensing agreements, (iv) financial institutions in credit facility arrangements, (v) underwriters in debt or equity security issuances and (vi) parties under certain operating agreements. In addition, these parties are also generally indemnified against any third party claim resulting from the transaction that is contemplated in the underlying agreement. While some of these indemnities extend only for the duration of the underlying agreement, many survive the expiration of the term of the agreement or extend into perpetuity (unless subject to a legal statute of limitations). There are no specific limitations on the maximum potential amount of future payments that the Company could be required to make under these indemnities, nor is the Company able to develop an estimate of the maximum potential amount of future payments to be made under these indemnifications as the triggering events are not subject to predictability. With respect to certain of the aforementioned indemnities, such as indemnifications of landlords against third party claims for the use of real estate property leased by the Company, the Company maintains insurance coverage that mitigates potential liability.

**17. Termination Charges**

During six months ended June 30, 2010, the Company recorded one-time employee termination charges totaling \$0.7 million in SG&A and marketing and reservation expenses. These charges related to salary and benefits continuation payments for employees separating from service with the Company. At June 30, 2010, the Company had approximately \$0.2 million of these salary and benefits continuation payments remaining to be remitted. The Company recorded a \$1.2 million charge in SG&A and marketing and reservations expenses related to salary and benefits continuation for terminated employees during the six months ended June 30, 2009. At June 30, 2010 the Company had approximately \$2.9 million of benefits remaining to be paid on these termination benefits as well as those incurred prior to January 1, 2009.

At June 30, 2010 and December 31, 2009, approximately \$3.2 million and \$5.5 million, respectively, of benefits remained unpaid and are included as current and non-current liabilities in the Company's consolidated financial statements. At June 30, 2010, the Company expects \$2.4 million of these benefits to be paid within the next twelve months.

**18. Future Adoption of Accounting Standards**

In October 2009, the FASB issued ASU 2009-13, "Revenue Recognition: Multiple-Deliverable Arrangements" now included in ASC 605-25, "Revenue Recognition". This guidance modifies the fair value requirements of revenue recognition on multiple element arrangements by allowing the use of the "best estimate of selling price" in addition to vendor specific objective evidence and third-party evidence for determining the selling price of a deliverable. ASU 2009-13 also establishes a selling price hierarchy for determining the selling price of a deliverable. In addition, this

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

guidance eliminates the residual method allocation and expands the disclosure requirements for such arrangements. This guidance is effective for contracts entered into during fiscal periods beginning on or after June 15, 2010. The Company does not expect this guidance to have a significant impact on our consolidated financial statements.

In July 2010, the FASB issued ASU No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, ( ASU 2010-20 ), which is included in the codification under ASC 815, Derivatives and Hedging ( ASC 815 ). ASU 2010-20 sets forth requirements to improve financial reporting by companies with financial receivables (as defined in ASU 2010-20) and to provide more relevant and reliable information to the users of the financial statements. A significant change in ASU



---

**Table of Contents**

**CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

2010-20 is that companies will be required to provide information for both the financing receivable and the related allowance on credit losses at disaggregated levels. ASU 2010-20 will be effective for both interim and annual reporting periods ending after December 15, 2010. The Company is currently evaluating the impact of this guidance on its consolidated financial statements, if any.

**19. Subsequent Events**

Subsequent to June 30, 2010, the Company purchased various parcels of real estate for a total cost of \$7.6 million as part of its program to incent franchise development in top markets for certain brands. The Company has acquired this real estate with the intent to sell it to third-party developers for the construction of hotels operated under the Company's brands.

On July 20, 2010, the Company entered into an interest rate swap agreement for the purposes of minimizing the Company's exposure to the volatility of floating-rate loans. The interest rate swap qualifies as a cash-flow hedge and will be recorded in accordance with ASC 815.

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

The following Management's Discussion and Analysis (MD&A) is intended to help the reader understand Choice Hotels International, Inc. and subsidiaries (together the Company). MD&A is provided as a supplement to and should be read in conjunction with our consolidated financial statements and the accompanying notes.

**Overview**

We are a hotel franchisor with franchise agreements representing 6,074 hotels open and 683 hotels under construction, awaiting conversion or approved for development as of June 30, 2010, with 490,483 rooms and 55,782 rooms, respectively, in 49 states, the District of Columbia and over 40 countries and territories outside the United States. Our brand names include Comfort Inn®, Comfort Suites®, Quality®, Clarion®, Ascend Collection®, Sleep Inn®, Econo Lodge®, Rodeway Inn®, MainStay Suites®, Suburban Extended Stay Hotel®, and Cambria Suites® (collectively, the Choice brands).

The Company conducts its international franchise operations through a combination of direct franchising and master franchising relationships. Master franchising relationships allow the use of our brands by third parties in foreign countries. The Company has made equity investments in certain non-domestic lodging franchise companies that conduct franchise operations for the Choice brands under master franchising relationships. As a result of our use of master franchising relationships and international market conditions, total revenues from international franchising operations comprised only 7% and 8% of our total revenues for the three and six months ended June 30, 2010, respectively, while representing approximately 19% of hotels open at June 30, 2010.

The Company previously had a 40% equity interest in Choice Hospitality (India) Ltd. (CHN) which it accounted for under the equity method of accounting. On January 8, 2010, the Company purchased the remaining 60% of CHN at which time it became a wholly-owned subsidiary. The pro forma results of operations as if CHN had been combined at the beginning of 2010 and 2009, would not be materially different from the Company's reported results for those periods. This transaction enabled Choice to continue its strategy of more closely directing the growth of our international franchise operations.

Our Company generates revenues, income and cash flows primarily from initial, relicensing and continuing royalty fees attributable to our franchise agreements. Revenues are also generated from procurement services vendor arrangements, hotel operations and other sources. The hotel industry is seasonal in nature. For most hotels, demand is lower in December through March than during the remainder of the year. Our principal source of revenues is franchise fees based on the gross room revenues of our franchised properties. The Company's franchise fee revenues and operating income reflect the industry's seasonality and historically have been lower in the first quarter than in the second, third or fourth quarters.

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

With a focus on hotel franchising instead of ownership, we benefit from the economies of scale inherent in the franchising business. The fee and cost structure of our business provides opportunities to improve operating results by increasing the number of franchised hotel rooms and effective royalty rates of our franchise contracts resulting in increased initial fee revenue, ongoing royalty fees and procurement services revenues. In addition, our operating results can also be improved through our company-wide efforts related to improving property level performance. The Company currently estimates that based on its current domestic portfolio of hotels under franchise that a 1% change in revenue per available room ( RevPAR ) or rooms under franchise would increase or decrease annual domestic royalty revenues by approximately \$2.0 million and a 1 basis point change in the Company's effective royalty rate would increase or decrease annual domestic royalties by approximately \$0.5 million. In addition to these revenues, we also collect marketing and reservation system fees to support centralized marketing and reservation activities for the franchise system. As a lodging franchisor, the Company currently has relatively low capital expenditure requirements.

The principal factors that affect the Company's results are: the number and relative mix of franchised hotel rooms; growth in the number of hotel rooms under franchise; occupancy and room rates achieved by the hotels under franchise; the effective royalty rate

## **Table of Contents**

achieved; the level of franchise sales and relicensing activity; and our ability to manage costs. The number of rooms at franchised properties and occupancy and room rates at those properties significantly affect the Company's results because our fees are based upon room revenues at franchised hotels. The key industry standard for measuring hotel-operating performance is RevPAR, which is calculated by multiplying the percentage of occupied rooms by the average daily room rate realized. Our variable overhead costs associated with franchise system growth have historically been less than incremental royalty fees generated from new franchises. Accordingly, continued growth of our franchise business should enable us to realize benefits from the operating leverage in place and improve operating results.

We are contractually required by our franchise agreements to use the marketing and reservation system fees we collect for system-wide marketing and reservation activities. These expenditures, which include advertising costs and costs to maintain our central reservations system, help to enhance awareness and increase consumer preference for our brands. Greater awareness and preference promotes long-term growth in business delivery to our franchisees, which ultimately increases franchise fees earned by the Company.

Our Company articulates its mission as a commitment to our franchisees' profitability by providing them with hotel franchises that generate the highest return on investment of any hotel franchise. We have developed an operating system dedicated to our franchisees' success that focuses on delivering guests to our franchised hotels and reducing costs for our hotel owners.

We believe that executing our strategic priorities creates value. Our Company focuses on two key value drivers:

*Profitable Growth.* We believe our success is dependent on improving the performance of our hotels, increasing our system size by selling additional hotel franchises and effective royalty rate improvement. We attempt to improve our franchisees' revenues and overall profitability by providing a variety of products and services designed to increase business delivery to and/or reduce operating and development costs for our franchisees. These products and services include national marketing campaigns, a central reservation system, property and yield management systems, quality assurance standards and procurement services vendor relationships. We believe that healthy brands, which deliver a compelling return on investment for franchisees, will enable us to sell additional hotel franchises and raise royalty rates. We have established multiple brands that meet the needs of many types of guests, and can be developed at various price points and applied to both new and existing hotels. This ensures that we have brands suitable for creating growth in a variety of market conditions. Improving the performance of the hotels under franchise, growing the system through additional franchise sales and improving franchise agreement pricing while maintaining a disciplined cost structure are the keys to profitable growth.

*Maximizing Financial Returns and Creating Value for Shareholders.* Our capital allocation decisions, including capital structure and uses of capital, are intended to maximize our return on invested capital and create value for our shareholders. We believe our strong and predictable cash flows create a strong financial position that provides us a competitive advantage. Currently, our business does not require significant capital to operate and grow. Therefore, we can maintain a capital structure that generates high financial returns and use our excess cash flow to increase returns to our shareholders. Historically, we have returned value to our shareholders in two primary ways: share repurchases and dividends. In 1998, we instituted a share repurchase program which has generated substantial value for our shareholders. During the six months ended June 30, 2010, the Company repurchased 0.2 million shares of its common stock under the share repurchase program at a total cost of \$6.9 million. Since the program's inception through June 30, 2010, we have repurchased 43.1 million shares (including 33.0 million prior to the two-for-one stock split effected in October 2005) of common stock at a total cost of \$1.0 billion. Considering the effect of the two-for-one stock split, the Company has repurchased 76.1 million shares at an average price of \$13.33 per share. We currently believe that our cash flows from operations will support our ability to complete the current board of directors repurchase authorization of approximately 3.6 million shares remaining as of June 30, 2010. Upon completion of the current authorization, our board of directors will evaluate the advisability of additional share repurchases. During the six months ended June 30, 2010, we paid cash dividends totaling approximately \$21.9 million and we presently expect to continue to pay dividends in the future, subject to future business performance, economic conditions and changes in income tax regulations. Based on our present dividend rate and outstanding share count, aggregate annual dividends for 2010 would be approximately \$43.8 million.

Our Board previously authorized us to enter into programs which permit us to offer financing, investment and guaranty support to qualified franchisees as well as to acquire and resell real estate to incent franchise development for certain brands in top markets. Recent market conditions have resulted in an increase in opportunities to incentivize development under these programs. As a result, during the six months ended June 30, 2010, the Company has invested approximately \$10.2 million pursuant to these programs (of which \$5 million has been repaid to the Company subsequent to June 30, 2010). Subsequent to June 30, 2010 and through August 9, 2010, the Company invested an additional \$7.6 million under these programs.

Over the next several years, we expect to continue to deploy capital opportunistically pursuant to these programs to promote growth of our emerging brands. The amount and timing of the investment in these programs will be dependent on market and other conditions. Our current expectation is that our annual investment in these programs will range from \$20 million to \$40 million. Notwithstanding these programs, the company expects to continue to return value to its shareholders through a combination of share repurchases and dividends, subject to market and

other conditions.

## **Table of Contents**

We believe these value drivers, when properly implemented, will enhance our profitability, maximize our financial returns and continue to generate value for our shareholders. The ultimate measure of our success will be reflected in the items below.

*Results of Operation:* Royalty fees, operating income, net income and diluted earnings per share ( EPS ) represent key measurements of these value drivers. In the three months ended June 30, 2010, royalty fees revenue totaled \$57.4 million, a 5% increase from the same period in 2009. Operating income totaled \$43.6 million for the three months ended June 30, 2010, a \$5.5 million or 14% increase from the same period in 2009. Net income increased \$1.5 million or 6% from the same period of the prior year to \$27.0 million. Diluted earnings per share for the quarter ended June 30, 2010 were \$0.45 compared to \$0.42 for the three months ended June 30, 2009. These measurements will continue to be a key management focus in 2010 and beyond.

Refer to MD&A heading *Operations Review* for additional analysis of our results.

*Liquidity and Capital Resources:* Historically, the Company has generated significant cash flows from operations. In the six months ended June 30, 2010 and 2009, net cash provided by operating activities was \$41.6 million and \$48.4 million, respectively. Since our business does not currently require significant reinvestment of capital, we utilize cash in ways that management believes provide the greatest returns to our shareholders, which include share repurchases and dividends. We believe the Company's cash flow from operations and available financing capacity is sufficient to meet the expected future operating, investing, and financing needs of the business.

Refer to MD&A heading *Liquidity and Capital Resources* for additional analysis.

## **Operations Review**

### ***Comparison of Operating Results for the Three-Month Periods Ended June 30, 2010 and 2009***

The Company recorded net income of \$27.0 million for the three months ended June 30, 2010, a \$1.5 million, or 6% increase from the \$25.5 million for the quarter ended June 30, 2009. The increase in net income for the three months ended June 30, 2010, is primarily attributable to a \$5.5 million or 14% increase in operating income partially offset by investment losses resulting from a decline in the fair value of investments held in the Company's non-qualified employee benefit plans compared to an appreciation in the fair value of these investments in the prior year period.

**Table of Contents**

Summarized financial results for the three months ended June 30, 2010 and 2009 are as follows:

(in thousands, except per share amounts)	2010	2009
<b>REVENUES:</b>		
Royalty fees	\$ 57,443	\$ 54,929
Initial franchise and relicensing fees	2,655	3,993
Procurement services	6,611	6,772
Marketing and reservation	80,389	75,296
Hotel operations	1,109	1,179
Other	1,641	1,174
<b>Total revenues</b>	<b>149,848</b>	<b>143,343</b>
<b>OPERATING EXPENSES:</b>		
Selling, general and administrative	22,824	27,076
Depreciation and amortization	2,220	2,032
Marketing and reservation	80,389	75,296
Hotel operations	808	829
<b>Total operating expenses</b>	<b>106,241</b>	<b>105,233</b>
<b>Operating income</b>	<b>43,607</b>	<b>38,110</b>
<b>OTHER INCOME AND EXPENSES, NET:</b>		
Interest expense	675	1,265
Interest and other investment (income) loss	1,103	(3,173)
Equity in net income of affiliates	(195)	(225)
<b>Total other income and expenses, net</b>	<b>1,583</b>	<b>(2,133)</b>
<b>Income before income taxes</b>	<b>42,024</b>	<b>40,243</b>
<b>Income taxes</b>	<b>15,013</b>	<b>14,740</b>
<b>Net income</b>	<b>\$ 27,011</b>	<b>\$ 25,503</b>
<b>Weighted average shares outstanding diluted</b>	<b>59,676</b>	<b>60,598</b>
<b>Diluted earnings per share</b>	<b>\$ 0.45</b>	<b>\$ 0.42</b>

The Company utilizes certain measures such as adjusted net income, adjusted diluted EPS, adjusted SG&A, adjusted operating income and franchising revenues which do not conform to generally accepted accounting principles in the United States ( GAAP ) when analyzing and discussing its results with the investment community. This information should not be considered as an alternative to any measure of performance as promulgated under GAAP, such as net income, diluted EPS, SG&A, operating income and total revenues. The Company's calculation of these measurements may be different from the calculations used by other companies and therefore comparability may be limited. We have included below a reconciliation of these measures to the comparable GAAP measurement below as well as our reason for reporting these non-GAAP measures.

*Franchising Revenues:* The Company utilizes franchising revenues which exclude marketing and reservation revenues and hotel operations rather than total revenues when analyzing the performance of the business. Marketing and reservation activities are excluded from revenues since the Company is contractually required by its franchise agreements to use these fees collected for marketing and reservation activities; as such, no income or loss to the Company is generated. Cumulative reservation and marketing fees not expended are recorded as a payable on the Company's financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

Cumulative marketing and reservation expenditures in excess of fees collected for marketing and reservation activities are recorded as a receivable on the Company's financial statements. Hotel operations are excluded since they do not reflect the most accurate measure of the Company's core franchising business. This non-GAAP measure is a commonly used measure of performance in our industry and facilitates comparisons between the Company and its competitors.

**Table of Contents****Calculation of Franchising Revenues**

	<b>Three Months Ended June 30,</b> <b>(\$ amounts in thousands)</b>	
	<b>2010</b>	<b>2009</b>
<b>Franchising Revenues:</b>		
<b>Total Revenues</b>	<b>\$ 149,848</b>	<b>\$ 143,343</b>
Adjustments:		
Marketing and reservation revenues	<b>(80,389)</b>	<b>(75,296)</b>
Hotel operations	<b>(1,109)</b>	<b>(1,179)</b>
<b>Franchising Revenues</b>	<b>\$ 68,350</b>	<b>\$ 66,868</b>

*Adjusted Net Income, Adjusted Diluted EPS, Adjusted SG&A and Adjusted Operating Income:* We also use adjusted net income, adjusted diluted EPS, adjusted SG&A and adjusted operating income all of which exclude employee termination benefits for the three months ended June 30, 2010 and 2009 as well as a loss on sublease of office space for the three months ended June 30, 2009. The loss on the sublease of office space represents a \$1.0 million charge resulting from the fair value of the Company's operating lease rental payments exceeding the anticipated revenue from the operating sublease and a \$0.5 million impairment charge related to the office leasehold improvements. The Company utilizes these non-GAAP measures to enable investors to perform meaningful comparisons of past, present and future operating results and as a means to emphasize the results of on-going operations.

**Calculation of Adjusted Operating Income**

	<b>Three Months Ended June 30,</b> <b>(\$ amounts in thousands)</b>	
	<b>2010</b>	<b>2009</b>
<b>Operating Income</b>	<b>\$ 43,607</b>	<b>\$ 38,110</b>
Adjustments:		
Employee termination benefits	<b>(119)</b>	<b>399</b>
Loss on sublease of office space		<b>1,503</b>
<b>Adjusted Operating Income</b>	<b>\$ 43,488</b>	<b>\$ 40,012</b>



**Table of Contents****Calculation of Adjusted SG&A**

	Three Months Ended June 30, (\$ amounts in thousands)	
	2010	2009
<b>SG&amp;A</b>	<b>\$ 22,824</b>	<b>\$ 27,076</b>
Adjustments:		
Employee termination benefits	119	(399)
Loss on sublease of office space		(1,503)
<b>Adjusted SG&amp;A</b>	<b>\$ 22,943</b>	<b>\$ 25,174</b>

**Calculation of Adjusted Net Income and Adjusted Diluted EPS**

	Three Months Ended June 30, (In thousands, except per share amounts)	
	2010	2009
<b>Net Income</b>	<b>\$ 27,011</b>	<b>\$ 25,503</b>
Adjustments:		
Employee termination benefits	(74)	250
Loss on sublease of office space		941
<b>Adjusted Net Income</b>	<b>\$ 26,937</b>	<b>\$ 26,694</b>
Weighted average shares outstanding diluted	59,676	60,598
<b>Diluted EPS</b>	<b>\$ 0.45</b>	<b>\$ 0.42</b>
Adjustments:		
Employee termination benefits		
Loss on sublease of office space		\$ 0.02
<b>Adjusted Diluted EPS</b>	<b>\$ 0.45</b>	<b>\$ 0.44</b>

The Company recorded adjusted net income of \$26.9 million for the three months ended June 30, 2010 compared to an adjusted net income of \$26.7 million for the three months ended June 30, 2009. The increase in adjusted net income for the three months ended June 30, 2010 is primarily attributable to a \$3.5 million increase in adjusted operating income and lower interest expense, partially offset by declines in the fair value of investments held in the Company's non-qualified employee benefit plans compared to appreciation of these investments during the three months ended June 30, 2009. Adjusted operating income increased \$3.5 million as the Company's franchising revenues for the three months ended June 30, 2010 increased \$1.5 million or 2% from the same period of the prior year and adjusted SG&A expenses decreased \$2.2 million or 9%.

**Table of Contents**

*Franchising Revenues:* Franchising revenues were \$68.4 million for the three months ended June 30, 2010 compared to \$66.9 million for the three months ended June 30, 2009. The increase in franchising revenues is primarily due to a 5% increase in royalty revenues partially offset by a 34% decline in initial franchise and relicensing fees.

Domestic royalty fees for the three months ended June 30, 2010 increased \$1.7 million to \$51.7 million from \$50.0 million in the three months ended June 30, 2009, an increase of 3%. The increase in royalties is attributable to a combination of factors including a 0.3% increase in RevPAR, a 2.2% increase in the number of domestic franchised hotel rooms and an increase in the effective royalty rate of the domestic hotel system from 4.26% to 4.32%. System-wide RevPAR increased due to a 130 basis point increase in occupancy, partially offset by a 2.2% decline in average daily rates.

A summary of the Company's domestic franchised hotels operating information is as follows:

	For the Three Months Ended June 30, 2010*			For the Three Months Ended June 30, 2009*			Change		
	Average Daily Rate	Occupancy	RevPAR	Average Daily Rate	Occupancy	RevPAR	Average Daily Rate	Occupancy	RevPAR
<b>Comfort Inn</b>	\$ 75.22	55.9%	\$ 42.04	\$ 75.86	55.0%	\$ 41.72	(0.8%)	90 bps	0.8%
<b>Comfort Suites</b>	82.40	56.9%	46.88	85.67	55.0%	47.12	(3.8%)	190 bps	(0.5%)
<b>Sleep</b>	68.54	53.3%	36.51	70.10	54.1%	37.94	(2.2%)	(80) bps	(3.8%)
<b>Midscale without Food &amp; Beverage</b>	76.13	55.8%	42.44	77.38	54.9%	42.46	(1.6%)	90 bps	(0.0%)
<b>Quality</b>	65.93	48.0%	31.62	67.27	47.3%	31.83	(2.0%)	70 bps	(0.7%)
<b>Clarion</b>	74.37	44.2%	32.85	77.52	43.8%	33.96	(4.1%)	40 bps	(3.3%)
<b>Midscale with Food &amp; Beverage</b>	67.70	47.1%	31.89	69.29	46.6%	32.28	(2.3%)	50 bps	(1.2%)
<b>Econo Lodge</b>	52.44	45.7%	23.95	53.54	43.5%	23.30	(2.1%)	220 bps	2.8%
<b>Rodeway</b>	48.32	44.8%	21.63	51.07	42.8%	21.87	(5.4%)	200 bps	(1.1%)
<b>Economy</b>	51.20	45.4%	23.24	52.83	43.3%	22.89	(3.1%)	210 bps	1.5%
<b>MainStay</b>	65.04	66.3%	43.09	70.76	59.7%	42.25	(8.1%)	660 bps	2.0%
<b>Suburban</b>	39.51	65.8%	25.98	42.89	55.7%	23.90	(7.9%)	1,010 bps	8.7%
<b>Extended Stay</b>	46.65	65.9%	30.74	51.05	56.8%	29.02	(8.6%)	910 bps	5.9%
<b>Total</b>	\$ 69.01	51.7%	\$ 35.69	\$ 70.53	50.4%	\$ 35.58	(2.2%)	130 bps	0.3%

\* Operating statistics represent hotel operations from March through May

The number of domestic rooms on-line increased to 389,625 as of June 30, 2010 from 381,225 as of June 30, 2009, an increase of 2.2%. The total number of domestic hotels on-line grew 2.6% to 4,936 as of June 30, 2010 from 4,812 as of June 30, 2009.

**Table of Contents**

A summary of domestic hotels and rooms on-line at June 30, 2010 and 2009 by brand is as follows:

	June 30, 2010		June 30, 2009		Variance			
	Hotels	Rooms	Hotels	Rooms	Hotels	Rooms	%	%
<b>Comfort Inn</b>	<b>1,446</b>	<b>113,677</b>	1,461	114,531	(15)	(854)	(1.0%)	(0.7%)
<b>Comfort Suites</b>	<b>621</b>	<b>48,200</b>	576	45,056	45	3,144	7.8%	7.0%
<b>Sleep</b>	<b>392</b>	<b>28,586</b>	376	27,576	16	1,010	4.3%	3.7%
<b>Midscale without Food &amp; Beverage</b>	<b>2,459</b>	<b>190,463</b>	2,413	187,163	46	3,300	1.9%	1.8%
<b>Quality</b>	<b>984</b>	<b>88,453</b>	941	86,675	43	1,778	4.6%	2.1%
<b>Clarion</b>	<b>175</b>	<b>25,188</b>	163	23,444	12	1,744	7.4%	7.4%
<b>Midscale with Food &amp; Beverage</b>	<b>1,159</b>	<b>113,641</b>	1,104	110,119	55	3,522	5.0%	3.2%
<b>Econo Lodge</b>	<b>785</b>	<b>48,543</b>	796	49,596	(11)	(1,053)	(1.4%)	(2.1%)
<b>Rodeway</b>	<b>381</b>	<b>21,473</b>	362	20,840	19	633	5.2%	3.0%
<b>Economy</b>	<b>1,166</b>	<b>70,016</b>	1,158	70,436	8	(420)	0.7%	(0.6%)
<b>MainStay</b>	<b>36</b>	<b>2,798</b>	37	2,866	(1)	(68)	(2.7%)	(2.4%)
<b>Suburban</b>	<b>63</b>	<b>7,608</b>	64	7,657	(1)	(49)	(1.6%)	(0.6%)
<b>Extended Stay</b>	<b>99</b>	<b>10,406</b>	101	10,523	(2)	(117)	(2.0%)	(1.1%)
<b>Ascend Collection</b>	<b>32</b>	<b>2,646</b>	22	1,444	10	1,202	45.5%	83.2%
<b>Cambria Suites</b>	<b>21</b>	<b>2,453</b>	14	1,540	7	913	50.0%	59.3%
<b>Total Domestic Franchises</b>	<b>4,936</b>	<b>389,625</b>	4,812	381,225	124	8,400	2.6%	2.2%

International available rooms increased 2.3% to 100,858 as of June 30, 2010 from 98,603 as of June 30, 2009. The total number of international hotels increased 3.3% from 1,102 as of June 30, 2009 to 1,138 as of June 30, 2010.

As of June 30, 2010, the Company had 586 franchised hotels with 47,056 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 827 hotels and 64,384 rooms at June 30, 2009. The number of new construction franchised hotels in the Company's domestic pipeline decreased 30% to 431 at June 30, 2010 from 618 at June 30, 2009. The number of conversion franchised hotels in the Company's domestic pipeline declined by 54 units or 26% from June 30, 2009 to 155 hotels at June 30, 2010. The domestic system hotels under construction, awaiting conversion or approved for development declined 29% from the prior year primarily due to the decline in new executed franchise agreements over the trailing twelve months due to the current economic environment coupled with the opening of 366 franchised units over the twelve months ending June 30, 2010. The Company had an additional 97 franchised hotels with 8,726 rooms under construction, awaiting conversion or approved for development in its international system as of June 30, 2010 compared to 110 hotels and 8,737 rooms at June 30, 2009. While the Company's hotel pipeline provides a strong platform for growth, a hotel in the pipeline does not always result in an open and operating hotel due to various factors.

**Table of Contents**

A summary of the domestic franchised hotels under construction, awaiting conversion or approved for development at June 30, 2010 and 2009 by brand is as follows:

	June 30, 2010			June 30, 2009			Variance					
	Units			Units			Conversion		New Construction		Total	
	Conversion	New Construction	Total	Conversion	New Construction	Total	Units	%	Units	%	Units	%
<b>Comfort Inn</b>	33	69	102	37	110	147	(4)	(11%)	(41)	(37%)	(45)	(31%)
<b>Comfort Suites</b>	1	136	137	1	227	228		0%	(91)	(40%)	(91)	(40%)
<b>Sleep Inn</b>	1	101	102	3	139	142	(2)	(67%)	(38)	(27%)	(40)	(28%)
<b>Midscale without Food &amp; Beverage</b>	35	306	341	41	476	517	(6)	(15%)	(170)	(36%)	(176)	(34%)
<b>Quality</b>	41	11	52	57	15	72	(16)	(28%)	(4)	(27%)	(20)	(28%)
<b>Clarion</b>	15	5	20	25	5	30	(10)	(40%)		0%	(10)	(33%)
<b>Midscale with Food &amp; Beverage</b>	56	16	72	82	20	102	(26)	(32%)	(4)	(20%)	(30)	(29%)
<b>Econo Lodge</b>	35	2	37	36	4	40	(1)	(3%)	(2)	(50%)	(3)	(8%)
<b>Rodeway</b>	26	3	29	48	2	50	(22)	(46%)	1	50%	(21)	(42%)
<b>Economy</b>	61	5	66	84	6	90	(23)	(27%)	(1)	(17%)	(24)	(27%)
<b>MainStay Suburban</b>		39	39		35	35		NM	4	11%	4	11%
		26	26		32	32		NM	(6)	(19%)	(6)	(19%)
<b>Extended Stay</b>		65	65		67	67		NM	(2)	(3%)	(2)	(3%)
<b>Ascend Collection</b>	3	4	7	2	1	3	1	50%	3	300%	4	133%
<b>Cambria Suites</b>		35	35		48	48		NM	(13)	(27%)	(13)	(27%)
<b>Total</b>	155	431	586	209	618	827	(54)	(26%)	(187)	(30%)	(241)	(29%)

There were 31 net domestic franchise additions during the three months ended June 30, 2010, compared to 45 net domestic franchise additions during the three months ended June 30, 2009. Gross domestic franchise additions declined from 121 for the three months ended June 30, 2009 to 79 for the same period of 2010. New construction hotels represented 22 of the gross domestic additions during the three months ended June 30, 2010 compared to 38 hotels in the same period of the prior year. Gross domestic additions for conversion hotels during the three months ended June 30, 2010 declined by 26 to 57 hotels compared to the same period of the prior year. The decline in conversion hotel openings has resulted from a decline in new executed conversion franchise agreements due to the challenging economic and hotel financing environment which has had a negative effective on the level of hotel transactions.

Domestic franchise terminations declined from 76 in the three months ended June 30, 2009 to 48 for the three months ended June 30, 2010 primarily due to the timing of fewer terminations related to the non-payment of franchise fees and other terminating events compared to the prior year period. The Company has continued to execute its strategy to replace franchised hotels that do not meet our brand standards or are underperforming in their market. As the competition gets stronger and more focused on limited service franchising, the Company will continue to focus on improving its system of hotels and utilizing the domestic hotels under construction, awaiting conversion or approved for development as a strong platform for continued system growth.

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

International royalties increased by \$0.8 million or 16% from \$5.0 million in the second quarter of 2009 to \$5.8 million for the same period of 2010 primarily due to foreign currency fluctuations.

New domestic franchise agreements executed in the three months ended June 30, 2010 totaled 62 representing 5,478 rooms compared to 118 agreements representing 8,426 rooms executed in the second quarter of 2009. During the second quarter of 2010, 12 of the executed agreements were for new construction hotel franchises representing 1,109 rooms compared to 16 contracts representing

**Table of Contents**

1,249 rooms for the same period a year ago. Conversion hotel executed franchise agreements totaled 50 representing 4,369 rooms for the three months ended June 30, 2010 compared to 102 agreements representing 7,177 rooms for the same period a year ago. Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise agreements decreased 33% to \$1.6 million for the three months ended June 30, 2010 from \$2.4 million for the three months ended June 30, 2009. The decline in revenues primarily reflects a 47% decline in the number of executed agreements compared to the prior year, partially offset by an increase in the average initial fee per agreement.

Based on the uncertainty around the current economic and credit market conditions, we expect the number of franchise applications received and therefore the number of new franchise agreements executed to remain below levels achieved in the most recent pre-economic recessionary periods. We believe this trend is likely to continue while the lodging industry experiences negative operating conditions and the availability of hotel financing continues to be limited. During prior lodging industry downturns, we experienced an increase in the number of new domestic franchise agreements from conversion hotels. While we believe that a greater percentage of new contracts will result from conversion hotel agreements, the length and breadth of the current economic crisis and the disruption of the credit markets could result in a prolonged downturn in the number of both conversion and new construction hotel contracts executed. This trend could have a material adverse affect on our financial results.

A summary of executed domestic franchise agreements by brand for the three months ended June 30, 2010 and 2009 is as follows:

	For the Three Months Ended June 30, 2010			For the Three Months Ended June 30, 2009			% Change		
	New Construction	Conversion	Total	New Construction	Conversion	Total	New Construction	Conversion	Total
<b>Comfort Inn</b>	2	5	7	2	8	10	0%	(38%)	(30%)
<b>Comfort Suites</b>	6	1	7	4		4	50%	NM	75%
<b>Sleep</b>				5	2	7	(100%)	(100%)	(100%)
<b>Midscale without Food &amp; Beverage</b>	8	6	14	11	10	21	(27%)	(40%)	(33%)
<b>Quality</b>		20	20	1	41	42	(100%)	(51%)	(52%)
<b>Clarion</b>		3	3		8	8	NM	(63%)	(63%)
<b>Midscale with Food &amp; Beverage</b>		23	23	1	49	50	(100%)	(53%)	(54%)
<b>Econo Lodge</b>		12	12		20	20	NM	(40%)	(40%)
<b>Rodeway</b>		8	8		21	21	NM	(62%)	(62%)
<b>Economy</b>		20	20		41	41	NM	(51%)	(51%)
<b>MainStay</b>	1		1	1		1	0%	NM	0%
<b>Suburban</b>				2		2	(100%)	NM	(100%)
<b>Extended Stay</b>	1		1	3		3	(67%)	NM	(67%)
<b>Ascend Collection</b>		1	1		2	2	NM	(50%)	(50%)
<b>Cambria Suites</b>	3		3	1		1	200%	NM	200%
<b>Total Domestic System</b>	12	50	62	16	102	118	(25%)	(51%)	(47%)



**Table of Contents**

Relicensing fees include fees charged to the new owners of a franchised property whenever an ownership change occurs and the property remains in the franchise system as well as fees required to renew expiring franchise contracts. Relicensing and renewal contracts declined 28% from 43 in the second quarter of 2009 to 31 for the three months ended June 30, 2010. As a result of the decline in contracts, relicensing revenues declined \$0.6 million from \$1.6 million for the three months ended June 30, 2009 to \$1.0 million for the three months ended June 30, 2010. The Company's relicensing activity in 2010 and beyond is dependent on the availability and cost of capital as well as the presence of an active real estate market for hotel transactions.

*Selling, General and Administrative Expenses:* The cost to operate the franchising business is reflected in SG&A on the consolidated statements of income. SG&A expenses were \$22.8 million for the three months ended June 30, 2010, a \$4.3 million or 16% decline from the three months ended June 30, 2009. Adjusted SG&A costs, which exclude certain items described above, for the three months ended June 30, 2010 totaled \$22.9 million compared to adjusted SG&A of \$25.2 million for the same period of the prior year. The \$2.3 million decline in adjusted SG&A was primarily attributable to lower variable franchise sales compensation and lower compensation expense recognized on deferred compensation arrangements as described in more detail in *Other Income and Expenses, Net*.

*Marketing and Reservations:* The Company's franchise agreements require the payment of franchise fees, which include marketing and reservation system fees. The fees, which are primarily based on a percentage of the franchisees' gross room revenues, are used exclusively by the Company for expenses associated with providing franchise services such as central reservation systems, national marketing and media advertising. The Company is contractually obligated to expend the marketing and reservation system fees it collects from franchisees in accordance with the franchise agreements; as such, no income or loss to the Company is generated.

Combined marketing and reservation fees were \$80.4 million and \$75.3 million for the three months ended June 30, 2010 and 2009, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$3.4 million and \$2.5 million for the three months ended June 30, 2010 and 2009, respectively. Interest expense attributable to reservation activities was approximately \$0.1 million for both the three month periods ended June 30, 2010 and 2009. As of June 30, 2010 and December 31, 2009, the Company's balance sheet includes a receivable of \$32.3 million and \$19.2 million, respectively from cumulative marketing expenses incurred in excess of cumulative marketing fee revenues earned. As of June 30, 2010 and December 31, 2009, the Company's balance sheet includes a receivable from cumulative reservation expenses incurred in excess of cumulative reservation fee revenues earned totaling \$26.2 million and \$14.7 million, respectively. These receivables are recorded as an asset in the financial statements as the Company has the contractual authority to require that the franchisees in the system at any given point repay the Company for any deficits related to marketing and reservation activities. The Company's current franchisees are legally obligated to pay any assessment the Company imposes on its franchisees to obtain reimbursement of such deficit regardless of whether those constituents continue to generate gross room revenue. The Company has no present intention to accelerate repayment of the deficit from current franchisees. Conversely, cumulative reservation and marketing fees not expended are recorded as a payable in the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

Our ability to recover these receivables may be adversely impacted by certain factors, including, among others, declines in the ability of our franchisees to generate revenues at properties they franchise from us, lower than expected franchise system growth of certain brands and/or lower than expected international franchise system growth. An extended period of occupancy or room rate declines or a decline in the number of hotel rooms in our franchise system could result in the generation of insufficient funds to recover marketing and reservation advances as well as meet the ongoing marketing and reservation needs of the overall system.

*Other Income and Expenses, Net:* Other income and expenses, net, decreased \$3.7 million to an expense of \$1.6 million for the three months ended June 30, 2010 compared to income of \$2.1 million in the same period of the prior year. Interest expense decreased from \$1.3 million for the three months ended June 30, 2009 to \$0.7 million for the same period of 2010. Interest expense decreased due to a decline in the Company's weighted average interest rate from 1.1% as of June 30, 2009 to 0.8% as of June 30, 2010, as well as lower outstanding borrowings. The decline in the weighted average interest rate is due to lower variable borrowing costs on the Company's \$350 million senior unsecured revolving credit agreement.

Interest and other investment income decreased \$4.3 million primarily due to the decline in the fair value of investments held in the Company's non-qualified employee benefit plans compared to an increase in the fair value of these investments in the prior year. As discussed in the accompanying critical accounting policies, the Company sponsors two non-qualified retirement and savings plans: the Non-Qualified Plan and the EDCP plan. The fair value of the Non-Qualified Plan investments declined \$0.6 million during the three months ended June 30, 2010 compared to a \$1.0 million appreciation in fair value during the three months ended June 30, 2009. The fair value of the Company's investments held in the EDCP plan declined \$0.7 million during the three months ended June 30, 2010 compared to an increase in fair value of \$2.2 million during the same period of the prior year.





**Table of Contents**

The Company accounts for the Non-Qualified Plan in accordance with accounting for deferred compensation arrangements when investments are held in a rabbi trust and invested. As a result, the Company also recognizes compensation expense in SG&A related to changes in the fair value of investments held in the Non-Qualified Plan, excluding investments in the Company's stock. Therefore, during the three months ended June 30, 2010, the Company's SG&A expense was reduced by \$0.7 million due to the decline in the fair value of these investments. During the three months ended June 30, 2009, the Company recognized additional SG&A expense totaling \$1.0 million due to the appreciation in the fair value of these investments.

*Income Taxes:* The Company's effective income tax rate was 35.7% for the three months ended June 30, 2010, compared to an effective income tax rate of 36.6% for the three months ended June 30, 2009. The effective income tax rate for the three months ended June 30, 2010, declined from the same period of the prior year primarily due to a decrease in the effective state and foreign tax rates. Depending upon the outcome of certain income tax contingencies, up to an additional \$2.1 million of additional tax benefits may be reflected in our 2010 results of operations from the resolution of tax contingency reserves.

*Net income:* Net income for the three months ended June 30, 2010 increased by 6% to \$27.0 million from \$25.5 million in the same period of the prior year. Adjusted net income, as adjusted for certain items described above, increased by \$0.2 million to \$26.9 million for the three months ended June 30, 2010 from \$26.7 million for the same period of the prior year.

*Diluted EPS:* Diluted EPS increased \$0.03 per share from \$0.42 for the three months ended June 30, 2009 to \$0.45 for 2010. Adjusted diluted EPS, which excludes certain items described above, totaled \$0.45 for the three months ended June 30, 2010 compared to \$0.44 for the same period of the prior year.

***Comparison of Operating Results for the Six-Month Periods Ended June 30, 2010 and 2009***

The Company recorded net income of \$42.8 million for the six months ended June 30, 2010, a \$1.0 million, or 2% increase from the \$41.8 million for the six months ended June 30, 2009. The increase in net income for the six months ended June 30, 2010, is primarily attributable to a \$1.6 million or 2% increase in operating income and lower effective borrowing rates partially offset by investment losses resulting from a decline in the fair value of investments held in the Company's non-qualified employee benefit plans compared to an appreciation in the fair value of these investments in the prior year period.

**Table of Contents**

Summarized financial results for the six months ended June 30, 2010 and 2009 are as follows:

(in thousands, except per share amounts)	2010	2009
<b>REVENUES:</b>		
Royalty fees	\$ 98,464	\$ 98,370
Initial franchise and relicensing fees	4,567	6,642
Procurement services	9,856	10,162
Marketing and reservation	139,229	137,338
Hotel operations	1,976	2,297
Other	3,177	2,692
<b>Total revenues</b>	<b>257,269</b>	<b>257,501</b>
<b>OPERATING EXPENSES:</b>		
Selling, general and administrative	44,640	48,537
Depreciation and amortization	4,392	4,147
Marketing and reservation	139,229	137,338
Hotel operations	1,564	1,614
<b>Total operating expenses</b>	<b>189,825</b>	<b>191,636</b>
<b>Operating income</b>	<b>67,444</b>	<b>65,865</b>
<b>OTHER INCOME AND EXPENSES, NET:</b>		
Interest expense	1,296	2,805
Interest and other investment (income) loss	26	(2,341)
Equity in net income of affiliates	(548)	(443)
<b>Total other income and expenses, net</b>	<b>774</b>	<b>21</b>
<b>Income before income taxes</b>	<b>66,670</b>	<b>65,844</b>
<b>Income taxes</b>	<b>23,866</b>	<b>24,033</b>
<b>Net income</b>	<b>\$ 42,804</b>	<b>\$ 41,811</b>
<b>Weighted average shares outstanding diluted</b>	<b>59,639</b>	<b>60,708</b>
<b>Diluted earnings per share</b>	<b>\$ 0.72</b>	<b>\$ 0.69</b>

The Company utilizes certain measures such as adjusted net income, adjusted diluted EPS, adjusted SG&A, adjusted operating income and franchising revenues which do not conform to generally accepted accounting principles in the United States ( GAAP ) when analyzing and discussing its results with the investment community. This information should not be considered as an alternative to any measure of performance as promulgated under GAAP, such as net income, diluted EPS, SG&A, operating income and total revenues. The Company's calculation of these measurements may be different from the calculations used by other companies and therefore comparability may be limited. We have included below a reconciliation of these measures to the comparable GAAP measurement below as well as our reason for reporting these non-GAAP measures.

*Franchising Revenues:* The Company utilizes franchising revenues which exclude marketing and reservation revenues and hotel operations rather than total revenues when analyzing the performance of the business. Marketing and reservation activities are excluded from revenues since the Company is contractually required by its franchise agreements to use these fees collected for marketing and reservation activities; as such, no income or loss to the Company is generated. Cumulative reservation and marketing fees not expended are recorded as a payable on the Company's financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

Cumulative marketing and reservation expenditures in excess of fees collected for marketing and reservation activities are recorded as a receivable on the Company's financial statements. Hotel operations are excluded since they do not reflect the most accurate measure of the Company's core franchising business. This non-GAAP measure is a commonly used measure of performance in our industry and facilitates comparisons between the Company and its competitors.

**Table of Contents****Calculation of Franchising Revenues**

	Six Months Ended June 30, (\$ amounts in thousands)	
	2010	2009
<b>Franchising Revenues:</b>		
<b>Total Revenues</b>	<b>\$ 257,269</b>	\$ 257,501
Adjustments:		
Marketing and reservation revenues	(139,229)	(137,338)
Hotel operations	(1,976)	(2,297)
<b>Franchising Revenues</b>	<b>\$ 116,064</b>	\$ 117,866

*Adjusted Net Income, Adjusted Diluted EPS, Adjusted SG&A and Adjusted Operating Income:* We also use adjusted net income, adjusted diluted EPS, adjusted SG&A and adjusted operating income all of which exclude employee termination benefits for the six months ended June 30, 2010 and 2009 as well as a loss on sublease of office space for the six months ended June 30, 2009. The loss on the sublease of office space represents a \$1.0 million charge resulting from the fair value of the Company's operating lease rental payments exceeding the anticipated revenue from the operating sublease and a \$0.5 million impairment charge related to the office leasehold improvements. The Company utilizes these non-GAAP measures to enable investors to perform meaningful comparisons of past, present and future operating results and as a means to emphasize the results of on-going operations.

**Calculation of Adjusted Operating Income**

	Six Months Ended June 30, (\$ amounts in thousands)	
	2010	2009
<b>Operating Income</b>	<b>\$ 67,444</b>	\$ 65,865
Adjustments:		
Employee termination benefits	233	774
Loss on sublease of office space		1,503
<b>Adjusted Operating Income</b>	<b>\$ 67,677</b>	\$ 68,142

**Table of Contents****Calculation of Adjusted SG&A**

	Six Months Ended June 30, (\$ amounts in thousands)	
	2010	2009
<b>SG&amp;A</b>	<b>\$ 44,640</b>	\$ 48,537
Adjustments:		
Employee termination benefits	(233)	(774)
Loss on sublease of office space		(1,503)
<b>Adjusted SG&amp;A</b>	<b>\$ 44,407</b>	\$ 46,260

**Calculation of Adjusted Net Income and Adjusted Diluted EPS**

	Six Months Ended June 30, (In thousands, except per share amounts)	
	2010	2009
<b>Net Income</b>	<b>\$ 42,804</b>	\$ 41,811
Adjustments:		
Employee termination benefits	146	485
Loss on sublease of office space		941
<b>Adjusted Net Income</b>	<b>\$ 42,950</b>	\$ 43,237
Weighted average shares outstanding-diluted	59,639	60,708
<b>Diluted EPS</b>	<b>\$ 0.72</b>	\$ 0.69
Adjustments:		
Employee termination benefits		
Loss on sublease of office space		\$ 0.02
<b>Adjusted Diluted EPS</b>	<b>\$ 0.72</b>	\$ 0.71

The Company recorded adjusted net income of \$43.0 million for the six months ended June 30, 2010 compared to an adjusted net income of \$43.2 million for the six months ended June 30, 2009. The decline in adjusted net income for the six months ended June 30, 2010 is primarily attributable to a \$0.5 million decline in adjusted operating income and declines in the fair value of investments held in the Company's non-qualified employee benefit plans compared to appreciation of these investments during the six months ended June 30, 2009 partially offset by lower interest expense. Adjusted operating income declined \$0.5 million as the Company's franchising revenues for the six months ended June 30, 2010 declined \$1.8 million or 2% from the same period of the prior year offset by a decline in adjusted SG&A expenses of \$1.9 million or 9%.

**Table of Contents**

*Franchising Revenues:* Franchising revenues were \$116.1 million for the six months ended June 30, 2010 compared to \$117.9 million for the six months ended June 30, 2009. The decline in franchising revenues is primarily due to a 31% decrease in initial franchise and relicensing fees.

Domestic royalty fees for the six months ended June 30, 2010 declined \$1.5 million to \$87.7 million from \$89.2 million for the six months ended June 30, 2009, a decline of 1.7%. The decline in royalties is attributable to a combination of factors including a 4.3% decline in RevPAR, partially offset by a 2.2% increase in the number of domestic franchised hotel rooms and an increase in the effective royalty rate of the domestic hotel system from 4.26% to 4.33%. System-wide RevPAR declined due to a 50 basis point decline in occupancy as well as a 3.2% decline in average daily rates.

A summary of the Company's domestic franchised hotels operating information is as follows:

	For the Six Months Ended June 30, 2010*			For the Six Months Ended June 30, 2009*			Change		
	Average Daily Rate	Occupancy	RevPAR	Average Daily Rate	Occupancy	RevPAR	Average Daily Rate	Occupancy	RevPAR
<b>Comfort Inn</b>	<b>\$ 73.44</b>	<b>49.5%</b>	<b>\$ 36.33</b>	\$ 75.01	50.5%	\$ 37.90	(2.1%)	(100)bps	(4.1%)
<b>Comfort Suites</b>	<b>81.05</b>	<b>50.5%</b>	<b>40.92</b>	85.14	51.2%	43.56	(4.8%)	(70)bps	(6.1%)
<b>Sleep</b>	<b>66.93</b>	<b>47.3%</b>	<b>31.68</b>	68.94	49.6%	34.20	(2.9%)	(230)bps	(7.4%)
<b>Midscale without Food &amp; Beverage</b>	<b>74.48</b>	<b>49.4%</b>	<b>36.79</b>	76.57	50.5%	38.70	(2.7%)	(110)bps	(4.9%)
<b>Quality</b>	<b>64.10</b>	<b>42.6%</b>	<b>27.31</b>	66.15	43.3%	28.64	(3.1%)	(70)bps	(4.6%)
<b>Clarion</b>	<b>72.34</b>	<b>39.1%</b>	<b>28.27</b>	75.98	40.5%	30.76	(4.8%)	(140)bps	(8.1%)
<b>Midscale with Food &amp; Beverage</b>	<b>65.80</b>	<b>41.8%</b>	<b>27.52</b>	68.10	42.7%	29.08	(3.4%)	(90)bps	(5.4%)
<b>Econo Lodge</b>	<b>51.21</b>	<b>40.7%</b>	<b>20.87</b>	52.68	40.3%	21.24	(2.8%)	40 bps	(1.7%)
<b>Rodeway</b>	<b>47.06</b>	<b>40.7%</b>	<b>19.14</b>	50.41	40.0%	20.16	(6.6%)	70 bps	(5.1%)
<b>Economy</b>	<b>49.95</b>	<b>40.7%</b>	<b>20.34</b>	52.03	40.2%	20.93	(4.0%)	50 bps	(2.8%)
<b>MainStay</b>	<b>64.20</b>	<b>59.3%</b>	<b>38.06</b>	70.90	55.3%	39.19	(9.4%)	400 bps	(2.9%)
<b>Suburban</b>	<b>38.47</b>	<b>62.4%</b>	<b>24.01</b>	42.76	53.9%	23.05	(10.0%)	850 bps	4.2%
<b>Extended Stay</b>	<b>45.47</b>	<b>61.5%</b>	<b>27.98</b>	50.68	54.3%	27.51	(10.3%)	720 bps	1.7%
<b>Total</b>	<b>\$ 67.31</b>	<b>46.0%</b>	<b>\$ 30.98</b>	\$ 69.57	46.5%	\$ 32.37	(3.2%)	(50)bps	(4.3%)

\* Operating statistics represent hotel operations from December through May

There were 30 net domestic franchise additions during the six months ended June 30, 2010 compared to 96 net domestic franchise additions during the six months ended June 30, 2009. Gross domestic franchise additions decreased from 233 for the six months ended June 30, 2009 to 157 for the same period in 2010. New construction hotels represented 50 of the gross domestic additions during the six months ended June 30, 2010 compared to 73 hotels in the same period of the prior year. Gross domestic additions for conversion hotels during the six months ended June 30, 2010 declined by 53 to 107 hotels compared to the same period of the prior year. The decline in hotel openings is primarily due to a decline in new executed franchise agreements as the lack of new hotel construction financing and a decline in the real estate market for hotel sales transactions has been significantly impacted by the current economic environment. The Company expects the number of new franchise

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

additions that will open during 2010 to decline from 442 for the year ended December 31, 2009 to approximately 340 hotels.

Domestic franchise terminations decreased to 127 for the six months ended June 30, 2010 from 137 for the same period of the prior year. The Company has continued to execute its strategy to replace franchised hotels that do not meet our brand standards or are underperforming in their market. As the competition gets stronger and more focused on limited service franchising, the Company will continue to focus on improving its system of hotels and utilizing the domestic hotels under construction, awaiting conversion or approved for development as a strong platform for continued system growth.

International royalties increased \$1.5 million or 16% from \$9.2 million in the first six months of 2009 to \$10.7 million for the same period in 2010 primarily due to foreign currency fluctuations and growth of the international system.



**Table of Contents**

New domestic franchise agreements executed in the six months ended June 30, 2010 totaled 117 representing 9,989 rooms compared to 178 agreements representing 13,463 rooms executed in the first six months of 2009. During the first six months of 2010, 22 of the executed agreements were for new construction hotel franchises, representing 1,818 rooms, compared to 22 contracts, representing 1,678 rooms for the same period a year ago. Conversion hotel franchise executed contracts totaled 95 representing 8,171 rooms for the six months ended June 30, 2010 compared to 156 agreements representing 11,785 rooms for the same period a year ago. Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise agreements decreased 29% to \$2.9 million for the six months ended June 30, 2010 from \$4.1 million for the six months ended June 30, 2009. The decline in revenues primarily reflects fewer executed agreements compared to the same period of the prior year.

Based on the uncertainty around the current economic and credit market conditions, we expect the number of franchise applications received and therefore the number of new franchise agreements executed to remain below levels achieved in the most recent pre-economic recessionary periods. We believe this trend is likely to continue while the lodging industry experiences negative operating conditions and the availability of hotel financing continues to be limited. During prior lodging industry downturns, we experienced an increase in the number of new domestic franchise agreements from conversion hotels. While we believe that a greater percentage of new contracts will result from conversion hotel agreements, the length and breadth of the current economic crisis and the disruption of the credit markets could result in a prolonged downturn in the number of both conversion and new construction hotel contracts executed. This trend could have a material adverse affect on our financial results.

A summary of executed domestic franchise agreements by brand for the six months ended June 30, 2010 and 2009 is as follows:

	For the Six Months Ended June 30, 2010			For the Six Months Ended June 30, 2009			% Change		
	New			New			New		
	Construction	Conversion	Total	Construction	Conversion	Total	Construction	Conversion	Total
<b>Comfort Inn</b>	3	13	16	2	15	17	50%	(13%)	(6%)
<b>Comfort Suites</b>	8	1	9	5	1	6	60%	0%	50%
<b>Sleep</b>	2		2	7	2	9	(71%)	(100%)	(78%)
<b>Midscale without Food &amp; Beverage</b>	13	14	27	14	18	32	(7%)	(22%)	(16%)
<b>Quality</b>	1	31	32	2	64	66	(50%)	(52%)	(52%)
<b>Clarion</b>		6	6		14	14	NM	(57%)	(57%)
<b>Midscale with Food &amp; Beverage</b>	1	37	38	2	78	80	(50%)	(53%)	(53%)
<b>Econo Lodge</b>		22	22		29	29	NM	(24%)	(24%)
<b>Rodeway</b>	1	19	20	1	28	29	0%	(32%)	(31%)
<b>Economy</b>	1	41	42	1	57	58	0%	(28%)	(28%)
<b>MainStay</b>	3		3	1	1	2	200%	(100%)	50%
<b>Suburban</b>	1		1	2		2	(50%)	NM	(50%)
<b>Extended Stay</b>	4		4	3	1	4	33%	(100%)	0%
<b>Ascend Collection</b>		3	3		2	2	NM	50%	50%
<b>Cambria Suites</b>	3		3	2		2	50%	NM	50%
<b>Total Domestic System</b>	22	95	117	22	156	178	0%	(39%)	(34%)



**Table of Contents**

Relicensing fees include fees charged to the new owners of a franchised property whenever an ownership change occurs and the property remains in the franchise system as well as fees required to renew expiring franchise contracts. Relicensing and renewal contracts declined 40% from 81 during the six months ending June 30, 2009 to 49 for the same period of 2010. As a result of the decline in contracts, relicensing revenues declined \$0.8 million from \$2.5 million for the six months ended June 30, 2009 to \$1.7 million for the six months ended June 30, 2010. The Company's relicensing activity in 2010 and beyond is dependent on the availability and cost of capital as well as the presence of an active real estate market for hotel transactions.

Procurement services revenues declined \$0.3 million from \$10.2 million for the six months ended June 30, 2009 to \$9.9 million for the same period of the current year primarily due to a reduced volume of franchisee purchases from the Company's qualified vendors.

*Selling, General and Administrative Expenses:* The cost to operate the franchising business is reflected in SG&A on the consolidated statements of income. SG&A expenses were \$44.6 million for the six months ended June 30, 2010, a \$3.9 million or 8% decline from the six months ended June 30, 2009. Adjusted SG&A costs, which exclude certain items described above, for the six months ended June 30, 2010 totaled \$44.4 million compared to adjusted SG&A of \$46.3 million for the same period of the prior year. The \$1.9 million decline in adjusted SG&A was primarily attributable to lower variable franchise sales compensation and lower compensation expense recognized on deferred compensation arrangements as described in more detail in *Other Income and Expenses, Net*.

*Marketing and Reservations:* The Company's franchise agreements require the payment of franchise fees, which include marketing and reservation fees. The fees, which are primarily based on a percentage of the franchisees' gross room revenues, are used exclusively by the Company for expenses associated with providing franchise services such as central reservation systems, national marketing and media advertising. The Company is contractually obligated to expend the marketing and reservation fees it collects from franchisees in accordance with the franchise agreements; as such, no income or loss to the Company is generated.

Combined marketing and reservation fees were \$139.2 million and \$137.3 million for the six months ended June 30, 2010 and 2009, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$6.1 million for the six months ended June 30, 2010 compared to \$4.9 million for the six months ended June 30, 2009. Interest expense attributable to reservation activities was \$0.2 million for both the six month periods ended June 30, 2010 and 2009.

*Other Income and Expenses, Net:* Other income and expenses, net, which are a net expense, increased 0.8 million from less than \$0.1 million for the six months ended June 30, 2009 to \$0.8 million for the six months ended June 30, 2010. Interest expense decreased \$1.5 million from \$2.8 million for the six months ended June 30, 2009 to \$1.3 million for the same period of 2010. Interest expense decreased due to a decline in the Company's weighted average interest rate from 1.1% as of June 30, 2009 to 0.8% as of June 30, 2010. The decline in the weighted average interest rate is due to lower variable borrowing costs on the Company's \$350 million senior unsecured revolving credit agreement.

Interest and other investment income (loss) decreased \$2.4 million primarily due to the decline in the fair value of investments held in the Company's non-qualified employee benefit plans compared to an increase in the fair value of these investments in the prior year. As discussed in the accompanying critical accounting policies, the Company sponsors two non-qualified retirement and savings plans: the Non-Qualified Plan and the EDCP plan. The fair value of the Non-Qualified Plan investments declined \$0.2 million during the six months ended June 30, 2010 compared to an \$0.8 million appreciation in fair value during the six months ended June 30, 2009. The fair value of the Company's investments held in the EDCP plan declined \$0.2 million during the six months ended June 30, 2010 compared to an increase in fair value of \$1.4 million during the same period of the prior year.

The Company accounts for the Non-Qualified Plan in accordance with accounting for deferred compensation arrangements when investments are held in a rabbi trust and invested. As a result, the Company also recognizes compensation expense in SG&A related to changes in the fair value of investments held in the Non-Qualified Plan, excluding investments in the Company's stock. Therefore, during the six months ended June 30, 2010, the Company's SG&A expense was reduced by \$0.3 million due to the decline in the fair value of these investments. During the six months ended June 30, 2009, the Company recognized additional SG&A expense totaling \$0.7 million due to the appreciation in the fair value of these investments.

*Income Taxes:* The Company's effective income tax rate was 35.8% for the six months ended June 30, 2010, compared to an effective income tax rate of 36.5% for the six months ended June 30, 2009. The effective income tax rate for the six months ended June 30, 2010, declined from the same period of the prior year primarily due to a decrease in effective state and foreign tax rates. Depending upon the outcome of certain income tax contingencies, up to an additional \$2.1 million of additional tax benefits may be reflected in our 2010 results of operations from the resolution of tax contingency reserves.

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

*Net income:* Net income for the six months ended June 30, 2010 increased by 2% to \$42.8 million from \$41.8 million in the same period of the prior year. Adjusted net income, as adjusted for certain items described above, declined by \$0.2 million to \$43.0 million for the six months ended June 30, 2010 from \$43.2 million for the same period of the prior year.

---

## **Table of Contents**

*Diluted EPS:* Diluted EPS increased \$0.03 per share from \$0.69 for the six months ended June 30, 2009 to \$0.72 for 2010. Adjusted diluted EPS, which excludes certain items described above, totaled \$0.72 for the six months ended June 30, 2010 compared to \$0.71 for the same period of the prior year.

### **Liquidity and Capital Resources**

Net cash provided by operating activities declined \$6.8 million to \$41.6 million for the six months ended June 30, 2010 from \$48.4 million for the same period of 2009. The decline in cash flows from operating activities primarily reflects the timing of working capital items.

Net cash advanced for marketing and reservations activities totaled \$18.0 million and \$19.5 million during the six months ended June 30, 2010 and 2009, respectively. Cash advances during the six months ended June 30, 2010 related primarily to the timing of advertising and promotional cost spending versus fees collected, investments in information technology initiatives as well as the seasonality of the business. Based on the current economic conditions, the Company expects marketing and reservation activities to be a net use of cash ranging between \$15 million and \$20 million in 2010.

Cash utilized for investing activities totaled \$21.4 million and \$7.7 million for the six months ended June 30, 2010 and 2009, respectively. The increase in cash utilized for investing activities was primarily due to an increase in capital expenditures as well as an increase in financing provided to franchisees. During the six months ended June 30, 2010 and 2009, capital expenditures totaled \$12.2 million and \$5.0 million, respectively. Capital expenditures for 2010 primarily include upgrades of system-wide property and yield management systems, improvements related to newly leased office space and information systems infrastructure and the purchase of computer software and equipment.

The Company occasionally provides financing to franchisees for property improvements, hotel development efforts and other purposes. During the six months ended June 30, 2010 and 2009, the Company advanced \$8.0 million and \$1.3 million, respectively for these purposes. At June 30, 2010, the Company had commitments to extend an additional \$7.2 million for these purposes provided certain conditions are met by its franchisees, of which \$3.3 million is expected to be advanced in the next twelve months.

Financing cash flows relate primarily to the Company's borrowings under its credit lines, treasury stock purchases and dividends. On June 16, 2006, the Company entered into a new \$350 million senior unsecured revolving credit agreement (the Revolver), with a syndicate of lenders. The Revolver allows the Company to borrow, repay and reborrow revolving loans up to \$350 million (which includes swingline loans for up to \$20 million and standby letters of credit of up to \$30 million) until the scheduled maturity date of June 16, 2011. The Company has the ability to request an increase in available borrowings under the Revolver by an additional amount of up to \$150 million by obtaining the agreement of the existing lenders to increase their lending commitments or by adding additional lenders. The rate of interest generally applicable for revolving loans under the Revolver is, at the Company's option, equal to either (i) the greater of the prime rate or the federal funds effective rate plus 50 basis points, or (ii) an adjusted LIBOR rate plus a margin between 22 and 70 basis points based on the Company's credit rating. The Revolver requires the Company to pay a quarterly facility fee, based upon the credit rating of the Company, at a rate between 8 and 17<sup>1/2</sup> basis points, on the full amount of the commitment (regardless of usage). The Revolver also requires the payment of a quarterly usage fee, based upon the credit rating of the Company, at a rate between 10 and 12<sup>1/2</sup> basis points, on the amount outstanding under the commitment, excluding swingline loans, at all times when the amount borrowed under the Revolver exceeds 50% of the total commitment. As of June 30, 2010, the Company had \$291.1 million of revolving loans outstanding pursuant to the Revolver.

The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. The Revolver also restricts the Company's ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions. The maximum leverage ratio requires the Company to maintain a consolidated indebtedness to consolidated earnings before interest, taxes, depreciation and amortization (EBITDA) ratio, as defined in the Revolver, of less than 3.25x. At June 30, 2010, the Company maintained a ratio of approximately 1.8x. Furthermore, the Revolver requires the Company to maintain a consolidated EBITDA to interest expense ratio of at least 3.75x. At June 30, 2010, the Company maintained a ratio of approximately 51.1x. At June 30, 2010, the Company was in compliance with all covenants under the Revolver.

The proceeds of the Revolver are used for general corporate purposes, including working capital, debt repayment, stock repurchases, dividends and investments.

The Company has a line of credit with a bank through August 31, 2010 providing up to an aggregate of \$5 million of borrowings, which is due upon demand. Borrowings under the line of credit bear interest at the lender's sole option at either of the following rates (i) prime rate or (ii) LIBOR rate plus 0.80% per annum; due monthly and upon demand for final payment. As of June 30, 2010, no amounts were outstanding pursuant to this line of credit.



## **Table of Contents**

As of June 30, 2010, total debt outstanding for the Company was \$291.1 million which is scheduled to mature on June 16, 2011. The Company expects to refinance these obligations prior to its scheduled maturity.

The Company's existing \$350 million revolving credit facility carries an interest rate of LIBOR plus approximately 50 basis points and matures in June 2011. The Company projects that it will begin the process of refinancing its Revolver during the year ended December 31, 2010. Based on the current credit environment, the Company estimates that the refinancing of the Company's existing Revolver during 2010 would result in increased borrowing costs.

On February 16, 2010, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on April 16, 2010 to shareholders of record on April 5, 2010. On April 29, 2010, the Company's board of directors declared a quarterly cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on July 16, 2010 to shareholders of record as of July 2, 2010.

The Company currently maintains the payment of a quarterly dividend on its common shares outstanding, however, the declaration of future dividends are subject to the discretion of our board of directors. We expect that cash dividends will continue to be paid in the future, subject to future business performance, economic conditions and changes in tax regulations. Based on our present dividend rate and outstanding share count, aggregate annual dividends for 2010 would be approximately \$43.8 million.

During the six months ended June 30, 2010, the Company repurchased 0.2 million shares of its common stock under the share repurchase program at a total cost of \$6.9 million for an average price of \$31.75 per share. Since the program's inception through June 30, 2010, we have repurchased 43.1 million shares (including 33.0 million prior to the two-for-one stock split effected in October 2005) of common stock at a total cost of \$1.0 billion. Considering the effect of the two-for-one stock split, the Company has repurchased 76.1 million shares at an average price of \$13.33 per share through June 30, 2010. At June 30, 2010 the Company had 3.6 million shares remaining under the current stock repurchase authorization. Upon completion of the current authorization, our board of directors will evaluate the advisability of additional share repurchases.

Our Board previously authorized us to enter into programs which permit us to offer financing, investment and guaranty support to qualified franchisees as well as to acquire and resell real estate to incent franchise development for certain brands in top markets. Recent market conditions have resulted in an increase in opportunities to incentivize development under these programs. As a result, during the six months ended June 30, 2010, the Company has invested approximately \$10.2 million pursuant to these programs (of which \$5 million has been repaid to the Company subsequent to June 30, 2010). Subsequent to June 30, 2010 and through August 9, 2010, the Company invested an additional \$7.6 million under these programs.

Over the next several years, we expect to continue to deploy capital opportunistically pursuant to these programs to promote growth of our emerging brands. The amount and timing of the investment in these programs will be dependent on market and other conditions. Our current expectation is that our annual investment in these programs will range from \$20 million to \$40 million. Notwithstanding these programs, the company expects to continue to return value to its shareholders through a combination of share repurchases and dividends, subject to market and other conditions.

During the six months ended June 30, 2010, the Company recorded one-time employee termination charges totaling \$0.7 million in SG&A and marketing and reservation expenses. These charges related to salary and benefits continuation payments for employees separating from service with the Company. At June 30, 2010, the Company had approximately \$0.2 million of these salary and benefits continuation payments remaining to be remitted. In addition, the Company has approximately \$2.9 million of benefits remaining to be paid on termination benefits incurred during prior years. The Company expects to remit \$2.4 million of the remaining \$3.2 million of benefits payable during the next twelve months. In addition, the Company expects to satisfy approximately \$2.5 million of deferred compensation and retirement plan obligations during the next twelve months.

The Company believes that cash flows from operations and available financing capacity are adequate to meet the expected future operating, investing and financing needs of the business.

## **Critical Accounting Policies**

Our accounting policies comply with principles generally accepted in the United States. We have described below those policies that we believe are critical or require the use of complex judgment or significant estimates in their application. Additional discussion of these policies is included in Note 1 to our consolidated financial statements as of and for the year ended December 31, 2009 included in our Annual Report on Form 10-K.





## **Table of Contents**

### ***Revenue Recognition.***

We recognize continuing franchise fees, including royalty, marketing and reservations system fees, when earned and receivable from our franchisees. Franchise fees are typically based on a percentage of gross room revenues of each franchisee. Our estimate of the allowance for uncollectible royalty fees is charged to SG&A expense and to marketing and reservation expenses for uncollectible marketing and reservation system fees.

Initial franchise and relicensing fees are recognized, in most instances, in the period the related franchise agreement is executed because the initial franchise and relicensing fees are non-refundable and the Company is not required to provide initial services to the franchisee prior to hotel opening. We defer the initial franchise and relicensing fee revenue related to franchise agreements which include incentives until the incentive criteria are met or the agreement is terminated, whichever occurs first.

The Company may also enter into master development agreements (MDAs) with developers that grant limited exclusive development rights and preferential franchise agreement terms for one-time, non-refundable fees. When these fees are not contingent upon the number of agreements executed under the MDA, the Company recognizes the up-front fees over the MDA's contractual life. Fees that are contingent upon the execution of franchise agreements under the MDA are recognized upon execution of the franchise agreement.

The Company recognizes procurement services revenues from qualified vendors when the services are performed or the product delivered, evidence of an arrangement exists, the fee is fixed and determinable and collectability is probable. We defer the recognition of procurement services revenues related to certain upfront fees and recognize them over a period corresponding to the Company's estimate of the life of the arrangement.

### ***Marketing and Reservation Revenues and Expenses.***

The Company's franchise agreements require the payment of certain marketing and reservation system fees, which are used exclusively by the Company for expenses associated with providing franchise services such as national marketing, media advertising, central reservation systems and technology services. The Company is contractually obligated to expend the marketing and reservation system fees it collects from franchisees in accordance with the franchise agreements; as such, no income or loss to the Company is generated. In accordance with our contracts, we include in marketing and reservation expenses an allocation of costs for certain activities, such as human resources, facilities, legal, accounting, etc., required to carry out marketing and reservation activities.

The Company records marketing and reservation revenues and expenses on a gross basis since the Company is the primary obligor in the arrangement, maintains the credit risk, establishes the price and nature of the marketing or reservation services and retains discretion in supplier selection. In addition, net advances to and repayments from the franchise system for marketing and reservation activities are presented as cash flows from operating activities.

Reservation fees and marketing fees not expended in the current year are carried over to the next fiscal year and expended in accordance with the franchise agreements. Shortfall amounts are similarly recovered in subsequent years. Cumulative excess or shortfall amounts from the operation of these programs are recorded as a marketing or reservation fee payable or receivable. Under the terms of the franchise agreements, the Company may advance capital as necessary for marketing and reservation activities and recover such advances through future fees. Our current assessment is that the credit risk associated with the marketing and reservation fees receivable is mitigated due to our contractual right to recover these amounts from a large geographically dispersed group of franchisees. However, our ability to recover these receivables may be adversely impacted by certain factors, including, among others, declines in the ability of our franchisees to generate revenues at properties they franchise from us, lower than expected franchise system growth of certain brands and/or lower than expected international franchise system growth. An extended period of occupancy or room rate declines or a decline in the number of hotel rooms in our franchise system could result in the generation of insufficient funds to recover marketing and reservation advances as well as meet the ongoing marketing and reservation needs of the overall system.

Choice Privileges is our frequent guest incentive marketing program. Choice Privileges enables members to earn points based on their spending levels with our franchisees and, to a lesser degree, through participation in affiliated partners' programs, such as those offered by credit card companies. The points, which we accumulate and track on the members' behalf, may be redeemed for free accommodations or other benefits.

We provide Choice Privileges as a marketing program to franchised hotels and collect a percentage of program members' room revenue from franchises to operate the program. Revenues are deferred in an amount equal to the estimated fair value of the future redemption obligation. A third-party actuary estimates the eventual redemption rates and point values using various actuarial methods. These judgmental factors determine the required liability attributable to outstanding points. Upon redemption of points, the Company



## **Table of Contents**

recognizes the previously deferred revenue as well as the corresponding expense relating to the cost of the awards redeemed. Revenues in excess of the estimated future redemption obligation are recognized when earned to reimburse the Company for costs incurred to operate the program, including administrative costs, marketing, promotion and performing member services. Costs to operate the program, excluding estimated redemption values, are expensed when incurred.

### ***Impairment Policy.***

The Company evaluates the potential impairment of property and equipment and other long-lived assets, including franchise rights and other definite-lived intangibles, on an annual basis or whenever an event or other circumstances indicates that we may not be able to recover the carrying value of the asset. Recoverability is measured based on net, undiscounted expected cash flows. Assets are considered to be impaired if the net, undiscounted expected cash flows are less than the carrying amount of the assets. Impairment charges are recorded based upon the difference between the carrying value and the fair value of the asset. Significant management judgment is involved in developing these projections, and they include inherent uncertainties. If different projections are used in the current period, the balances for non-current assets could be materially impacted. Furthermore, if management uses different projections or if different conditions occur in future periods, future-operating results could be materially impacted.

The Company evaluates the impairment of goodwill and trademarks with indefinite lives on an annual basis, or during the year if an event or other circumstance indicates that we may not be able to recover the carrying amount of the asset. Since the Company has one reporting unit, the fair value of the Company's net assets is used to determine if goodwill may be impaired. Indefinite life trademarks are considered to be impaired if the net, undiscounted expected cash flows associated with the trademark are less than their carrying amount.

The Company evaluates the collectability of notes receivable on a periodic basis. We consider that a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. The Company reviews outstanding notes receivable on a periodic basis to ensure that each is fully collectible. We measure loan impairment based on the present value of expected future cash flows discounted at the loan's original effective interest rate or the estimated fair value of the collateral. For impaired loans, we establish a specific impairment reserve for the difference between the recorded investment in the loan and the present value of the expected future cash flows or the estimated fair value of the collateral. We apply our loan impairment policy individually to all loans in the portfolio and do not aggregate loans for the purpose of applying such policy. The Company records bad debt expense in SG&A expenses in the accompanying consolidated statements of income. For loans that we have determined to be impaired, we recognize interest income on a cash basis.

### ***Stock Compensation.***

The Company's policy is to recognize compensation cost related to share-based payment transactions in the financial statements based on the fair value of the equity or liability instruments issued. Compensation expense related to the fair value of share-based awards is recognized over the requisite service period based on an estimate of those awards that will ultimately vest. The Company estimates the share-based compensation expense for awards that will ultimately vest upon inception of the grant and adjusts the estimate of share-based compensation for those awards with performance and/or service requirements that will not be satisfied so that compensation cost is recognized only for awards that ultimately vest.

### ***Income Taxes.***

Our income tax expense and related balance sheet amounts involve significant management estimates and judgments. Judgments regarding realization of deferred tax assets and the ultimate outcome of tax-related contingencies represent key items involved in the determination of income tax expense and related balance sheet accounts.

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been included in the financial statements or income tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted rates expected to apply to taxable income in the years in which those differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Deferred tax assets represent items to be used as a tax deduction or credit in future tax returns for which we have already properly recorded the tax benefit in our income statement. Realization of our deferred tax assets reflects our tax planning strategies. We establish valuation allowances for deferred tax assets that we do not believe will be realized.

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

The Company does not provide additional United States income taxes on undistributed earnings of consolidated foreign subsidiaries included in retained earnings. Currently it is not practical for the Company to calculate the deferred tax related to the outside basis differences. Such earnings could become taxable upon the sale or liquidation of these foreign subsidiaries or upon dividend repatriation. The Company's intent is for such earnings to be reinvested by the subsidiaries.

**Table of Contents**

The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Judgment is required in determining the worldwide income tax provision. In the ordinary course of global business, there are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of cost reimbursement arrangements among related entities. Although the Company believes the estimates are reasonable, no assurance can be given that the final tax outcome of these matters will not be different than that which is reflected in the historical income tax provisions and accruals. Tax assessments and resolution of tax contingencies may arise several years after tax returns have been filed. Predicting the outcome of such tax assessments involves uncertainty; however, the Company believes that recorded tax liabilities adequately account for our analysis of probable outcomes. Resolution of these uncertainties in a manner inconsistent with the Company's expectations could have a material impact on the Company's results of operations.

The Company has established a recognition threshold a tax position is required to meet before being recognized in the financial statements. As of June 30, 2010, the Company had \$4.2 million of total unrecognized tax benefits of which \$2.5 million would affect the consolidated statements of income if recognized. We have reviewed our uncertain income tax positions and the Company believes it is reasonably possible it will recognize tax benefits of up to \$2.1 million within the next twelve months. This is due to the anticipated lapse of applicable statutes of limitations regarding state tax positions and stock-based compensation deductions.

The Company's uncertain tax positions are related to tax years that remain subject to examination by the relevant tax authorities. The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of multiple state and foreign jurisdictions. The Company has substantially concluded all U.S. federal income tax matters for years through 2005. Substantially all material state and local and foreign income tax matters have been concluded for years through 2005. U.S. federal income tax returns for 2006 through 2008 are currently open for examination.

***Pension, Profit Sharing and Incentive Plans***

The Company sponsors two non-qualified retirement savings and investment plans for certain employees and senior executives. Employee and Company contributions are maintained in separate irrevocable trusts. Legally, the assets of the trusts remain those of the Company; however, access to the trusts' assets is severely restricted. The trusts cannot be revoked by the Company or an acquirer, but the assets are subject to the claims of the Company's general creditors. The participants do not have the right to assign or transfer contractual rights in the trusts.

In 2002, the Company adopted the Choice Hotels International, Inc. Executive Deferred Compensation Plan (EDCP) which became effective January 1, 2003. Under the EDCP, certain executive officers may defer a portion of their salary into an irrevocable trust. Prior to January 1, 2010, participants could elect an investment return of either the annual yield of the Moody's Average Corporate Bond Yield Index plus 300 basis points or a return based on a selection of available diversified investment options. Effective January 1, 2010, the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points is no longer an investment option for salary deferrals made on compensation earned after December 31, 2009. As of June 30, 2010 and December 31, 2009, the Company recorded a deferred compensation liability of \$16.6 million and \$17.6 million, respectively related to these deferrals and credited investment returns. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. Compensation expense recorded in SG&A for the three months ended June 30, 2010 and 2009 were \$0.1 million and \$0.3 million, respectively. Compensation expense recorded in SG&A for the six months ended June 30, 2010 and 2009 was \$0.3 million and \$0.5 million, respectively.

The Company has invested the employee salary deferrals in diversified long-term investments which are intended to provide investment returns that partially offset the earnings credited to the participants. The diversified investments held in the trusts totaled \$11.6 million and \$10.9 million as of June 30, 2010 and December 31, 2009, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore, the changes in the fair value of the diversified assets is included in other income and expenses, net in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended June 30, 2010 and 2009 totaling (\$0.7 million) and \$2.2 million, respectively. The Company recorded investment gains (losses) during the six months ended June 30, 2010 and 2009 totaling (\$0.2 million) and \$1.4 million, respectively.

In 1997, the Company adopted the Choice Hotels International, Inc. Nonqualified Retirement Savings and Investment Plan (Non-Qualified Plan). The Non-Qualified Plan allows certain employees who do not participate in the EDCP to defer a portion of their salary and invest these amounts in a selection of available diversified investment options. As of June 30, 2010 and December 31, 2009, the Company had recorded a deferred compensation liability of \$10.0 million and \$11.0 million, respectively related to these deferrals. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of



**Table of Contents**

diversified investments. The net increase (decrease) in compensation expense recorded in SG&A for the three months ended June 30, 2010 and 2009 was (\$0.7 million) and \$1.0 million, respectively. The net increase (decrease) in compensation expense recorded in SG&A for the six months ended June 30, 2010 and 2009 was (\$0.3 million) and \$0.7 million, respectively.

The diversified investments held in the trusts were \$9.2 million and \$10.1 million as of June 30, 2010 and December 31, 2009, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other income and expenses, net in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended June 30, 2010 and 2009 of (\$0.6 million) and \$1.0 million, respectively. The Company recorded investment gains (losses) during the six months ended June 30, 2010 and 2009 of (\$0.2 million) and \$0.8 million, respectively. In addition, the Non-Qualified Plan held shares of the Company's common stock with a market value of \$0.8 million and \$0.9 million at June 30, 2010 and December 31, 2009, respectively.

The Company is subject to risk from changes in debt and equity prices from our non-qualified retirement savings plan investments in debt securities and common stock. The diversified investments held in the Non-Qualified Plan and EDCP include investments primarily in equity and debt securities, and cash and cash equivalents.

**Recently Issued Accounting Standards**

In October 2009, the FASB issued ASU 2009-13, *Revenue Recognition: Multiple-Deliverable Arrangements* now included in ASC 605-25, *Revenue Recognition*. This guidance modifies the fair value requirements of revenue recognition on multiple element arrangements by allowing the use of the best estimate of selling price in addition to vendor specific objective evidence and third-party evidence for determining the selling price of a deliverable. ASU 2009-13 also establishes a selling price hierarchy for determining the selling price of a deliverable. In addition, this guidance eliminates the residual method allocation and expands the disclosure requirements for such arrangements. This guidance is effective for contracts entered into during fiscal periods beginning on or after June 15, 2010. The Company does not expect this guidance to have a significant impact on our consolidated financial statements.

In July 2010, the FASB issued ASU No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, (ASU 2010-20), which is included in the codification under ASC 815, *Derivatives and Hedging* (ASC 815). ASU 2010-20 sets forth requirements to improve financial reporting by companies with financial receivables (as defined in ASU 2010-20) and to provide more relevant and reliable information to the users of the financial statements. A significant change in ASU 2010-20 is that companies will be required to provide information for both the financing receivable and the related allowance on credit losses at disaggregated levels. ASU 2010-20 will be effective for both interim and annual reporting periods ending after December 15, 2010. The Company is currently evaluating the impact of this guidance on its consolidated financial statements, if any.

**FORWARD-LOOKING STATEMENTS**

Certain matters discussed in this quarterly report constitute forward-looking statements within the meaning of federal securities law. Generally, our use of words such as expect, estimate, believe, anticipate, will, forecast, plan, project, assume or similar words of futurity identify matters that are forward-looking and that we intend to be included within the Safe Harbor protections provided by Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934. Such forward-looking statements are based on management's current beliefs, assumptions and expectations regarding future events, which in turn are based on information currently available to management. Such statements may relate to projections of the Company's revenue, earnings and other financial and operational measures, Company debt levels, payment of stock dividends, and future operations or other matters. We caution you not to place undue reliance on any forward-looking statements, which are made as of the date of this quarterly report. Forward-looking statements do not guarantee future performance and involve known and unknown risks, uncertainties and other factors.

Several factors could cause actual results, performance or achievements of the Company to differ materially from those expressed in or contemplated by the forward-looking statements. Such risks include, but are not limited to, changes to general, domestic and foreign economic conditions; operating risks common in the lodging and franchising industries; changes to the desirability of our brands as viewed by hotel operators and customers; changes to the terms or termination of our contracts with franchisees; our ability to keep pace with improvements in technology utilized for reservations systems and other operating systems; fluctuations in the supply and demand for hotels rooms; and our ability to manage effectively our indebtedness, among other factors. These and other risk factors are discussed in detail in Item 1A *Risk Factors* of the Company's Form 10-K for the year ended December 31, 2009, filed with the Securities and Exchange Commission on March 1, 2010. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as may be required by law.





## **Table of Contents**

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company is exposed to market risk from changes in interest rates and the impact of fluctuations in foreign currencies on the Company's foreign investments and operations. The Company manages its exposure to these market risks through the monitoring of its available financing alternatives including in certain circumstances the use of derivative financial instruments. We are also subject to risk from changes in debt and equity prices from our non-qualified retirement savings plan investments in debt securities and common stock, which had carrying values of \$20.9 million at both June 30, 2010 and December 31, 2009, respectively. The Company will continue to monitor the exposure in these areas and make the appropriate adjustments as market conditions dictate.

At June 30, 2010 and December 31, 2009, the Company had \$291.1 million and \$277.7 million of debt outstanding at a weighted average effective interest rate of 0.8% and 0.7%, respectively. A hypothetical change of 10% in the Company's effective interest rate from June 30, 2010 levels would increase or decrease interest expense by \$0.2 million. The Company expects to refinance its debt obligations prior to their scheduled maturities.

### **ITEM 4. CONTROLS AND PROCEDURES**

The Company has a disclosure review committee whose membership includes the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), among others. The CEO and CFO consider the disclosure review committee's procedures in performing their evaluations of the Company's disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) and in assessing the accuracy and completeness of the Company's disclosures.

An evaluation was performed under the supervision and with the participation of the Company's CEO and CFO of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of June 30, 2010.

There has been no change in the Company's internal controls over financial reporting that occurred during the quarter ended June 30, 2010, that materially affected, or is reasonably likely to materially affect the Company's internal controls over financial reporting.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

None.

### **ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2009, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

**Table of Contents****ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Issuer Purchases of Equity Securities**

The following table sets forth purchases and redemptions of Choice Hotels International, Inc. common stock made by the Company during the six months ended June 30, 2010:

Month Ending	Total Number of Shares Purchased or Redeemed	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>(1),(2)</sup>	Maximum Number of Shares that may yet be Purchased Under the Plans or Programs, End of Period
January 31, 2010	57,866	\$ 32.00	45,161	3,795,473
February 28, 2010	222,432	31.64	171,400	3,624,073
March 31, 2010	1,396	34.73		3,624,073
April 30, 2010				3,624,073
May 31, 2010	8,092	35.78		3,624,073
June 30, 2010	471	31.78		3,624,073
<b>Total</b>	<b>290,257</b>	<b>\$ 31.84</b>	<b>216,561</b>	<b>3,624,073</b>

(1) The Company's share repurchase program was initially approved by the board of directors on June 25, 1998. The program has no fixed dollar amount or expiration date.

(2) During the six months ended June 30, 2010, the Company redeemed 73,696 shares of common stock from employees to satisfy minimum tax-withholding requirements related to the vesting of restricted stock and performance vested restricted stock unit grants. These redemptions were not part of the board repurchase authorization.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. (REMOVED AND RESERVED)****ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS****Exhibit Number and Description****Exhibit**

Number	Description
3.01(a)	Restated Certificate of Incorporation of Choice Hotels Franchising, Inc. (renamed Choice Hotels International, Inc.)
3.02(b)	Amended and Restated Bylaws of Choice Hotels International, Inc.

## Edgar Filing: CHOICE HOTELS INTERNATIONAL INC /DE - Form 10-Q

- 31.1\* Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
- 31.2\* Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
- 32\* Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350
- 101\* The following statements from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, filed on August 9, 2010, formatted in XBRL: (i) Consolidated Statements of Income, (ii) Consolidated Balance Sheets, (iii) Consolidated Statements of Cash Flows, (iv) Notes to Financial Statements, tagged as blocks of text.

**Table of Contents**

- \* Filed herewith
- (a) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc.'s Registration Statement on Form S-4, filed August 31, 1998 (Reg. No. 333-62543).
- (b) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels international, Inc.'s Current Report on Form 8-K dated February 15, 2010, filed February 16, 2010.

**Table of Contents**

**SIGNATURE**

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.

CHOICE HOTELS INTERNATIONAL, INC.

Date: August 5, 2010

By: */s/* DAVID L. WHITE  
**David L. White**  
**Senior Vice President, Chief Financial Officer & Treasurer**

45