

CHOICE HOTELS INTERNATIONAL INC /DE

Form 10-Q

August 09, 2006

Table of Contents

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

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006**

**OR**

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

**COMMISSION FILE NO. 001-13393**

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**CHOICE HOTELS INTERNATIONAL, INC.**

(Exact name of registrant as specified in its charter)

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

**10750 COLUMBIA PIKE**

**SILVER SPRING, MD. 20901**

(Address of principal executive offices)

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

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(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)

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Large accelerated filer  Accelerated filer  Non-accelerated filer

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

**SHARES OUTSTANDING**

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

**AT JUNE 30, 2006**  
66,286,278

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**Table of Contents**

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

**INDEX**

|   | <b>PAGE NO.</b> |
|---|-----------------|
| <b><u>PART I. FINANCIAL INFORMATION:</u></b>  |                 |
| <u>Item 1. Financial Statements</u>   | 3               |
| <u>Consolidated Statements of Income For the three and six months ended June 30, 2006 (Unaudited) and June 30, 2005 (Unaudited)</u> | 3               |
| <u>Consolidated Balance Sheets As of June 30, 2006 (Unaudited) and December 31, 2005</u>  | 4               |
| <u>Consolidated Statements of Cash Flows For the six months ended June 30, 2006 (Unaudited) and June 30, 2005 (Unaudited)</u>       | 5               |
| <u>Notes to Consolidated Financial Statements (Unaudited)</u>   | 6               |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                                | 13              |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>   | 22              |
| <u>Item 4. Controls and Procedures</u>  | 23              |
| <b><u>PART II. OTHER INFORMATION:</u></b>   |                 |
| <u>Item 1. Legal Proceedings</u>  | 23              |
| <u>Item 1A. Risk Factors</u>  | 23              |
| <u>Item 2. Unregistered Sales of Equity Securities, Use of Proceeds and Issuer Purchases of Equity Securities</u>                   | 23              |
| <u>Item 3. Defaults Upon Senior Securities</u>  | 23              |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u>  | 24              |
| <u>Item 5. Other Information</u>  | 24              |
| <u>Item 6. Exhibits</u>   | 24              |
| <b><u>SIGNATURE</u></b>   | 26              |

**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<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|--|--------------------------------|------------------|------------------------------|------------------|
|  | 2006                           | 2005             | 2006                         | 2005             |
| <b>REVENUES:</b>                                   |                                |                  |                              |                  |
| Royalty fees                                       | \$ 53,146                      | \$ 46,515        | \$ 93,010                    | \$ 80,157        |
| Initial franchise and relicensing fees             | 6,723                          | 6,591            | 12,366                       | 10,902           |
| Partner services                                   | 4,900                          | 4,596            | 7,682                        | 7,236            |
| Marketing and reservation                          | 72,742                         | 62,610           | 130,718                      | 111,653          |
| Hotel operations                                   | 1,180                          | 1,141            | 2,160                        | 2,061            |
| Other  | 1,849                          | 842              | 4,022                        | 1,454            |
| <b>Total revenues</b>                              | <b>140,540</b>                 | <b>122,295</b>   | <b>249,958</b>               | <b>213,463</b>   |
| <b>OPERATING EXPENSES:</b>                         |                                |                  |                              |                  |
| Selling, general and administrative                | 22,242                         | 19,199           | 40,517                       | 35,952           |
| Depreciation and amortization                      | 2,642                          | 2,256            | 4,991                        | 4,581            |
| Marketing and reservation                          | 72,742                         | 62,610           | 130,718                      | 111,653          |
| Hotel operations                                   | 800                            | 813              | 1,545                        | 1,561            |
| <b>Total operating expenses</b>                    | <b>98,426</b>                  | <b>84,878</b>    | <b>177,771</b>               | <b>153,747</b>   |
| <b>Operating income</b>                            | <b>42,114</b>                  | <b>37,417</b>    | <b>72,187</b>                | <b>59,716</b>    |
| <b>OTHER INCOME AND EXPENSES:</b>                  |                                |                  |                              |                  |
| Interest expense                                   | 4,044                          | 3,872            | 8,084                        | 7,479            |
| Interest and other investment (income) loss        | 174                            | (404)            | (530)                        | (273)            |
| Equity in net income of affiliates                 | (130)                          | (155)            | (388)                        | (354)            |
| Loss on extinguishment of debt                     | 342                            |                  | 342                          |                  |
| Other  |                                | (53)             |                              | (186)            |
| <b>Total other income and expenses, net</b>        | <b>4,430</b>                   | <b>3,260</b>     | <b>7,508</b>                 | <b>6,666</b>     |
| <b>Income before income taxes</b>                  | <b>37,684</b>                  | <b>34,157</b>    | <b>64,679</b>                | <b>53,050</b>    |
| <b>Income taxes</b>                                | <b>13,548</b>                  | <b>12,609</b>    | <b>22,878</b>                | <b>19,503</b>    |
| <b>Net income</b>                                  | <b>\$ 24,136</b>               | <b>\$ 21,548</b> | <b>\$ 41,801</b>             | <b>\$ 33,547</b> |
| <b>Weighted average shares outstanding-basic</b>   | <b>65,356</b>                  | <b>64,452</b>    | <b>65,070</b>                | <b>64,297</b>    |
| <b>Weighted average shares outstanding-diluted</b> | <b>67,105</b>                  | <b>66,677</b>    | <b>66,925</b>                | <b>66,498</b>    |

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|  |                |           |                |          |
|--|----------------|-----------|----------------|----------|
| <b>Basic earnings per share</b>          | <b>\$ 0.37</b> | \$ 0.33   | <b>\$ 0.64</b> | \$ 0.52  |
| <b>Diluted earnings per share</b>        | <b>\$ 0.36</b> | \$ 0.32   | <b>\$ 0.62</b> | \$ 0.50  |
| <b>Cash dividends declared per share</b> | <b>\$ 0.13</b> | \$ 0.1125 | <b>\$ 0.26</b> | \$ 0.225 |

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

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

|   | June 30,<br>2006<br>(Unaudited) | December 31,<br>2005 |
|---|---------------------------------|----------------------|
| <b>ASSETS</b>   |                                 |                      |
| <b>Current assets</b>   |                                 |                      |
| Cash and cash equivalents   | \$ 21,658                       | \$ 16,921            |
| Receivables (net of allowance for doubtful accounts of \$4,549 and \$5,111, respectively) | 40,724                          | 37,155               |
| Deferred income taxes   | 2,620                           | 2,616                |
| Other current assets  | 6,728                           | 6,308                |
| <b>Total current assets</b>   | <b>71,730</b>                   | <b>63,000</b>        |
| <b>Property and equipment, at cost, net</b>   | <b>44,581</b>                   | <b>46,281</b>        |
| <b>Goodwill</b>   | <b>65,813</b>                   | <b>65,828</b>        |
| <b>Franchise rights and other identifiable intangibles, net</b>                           | <b>36,285</b>                   | <b>38,267</b>        |
| <b>Receivable marketing fees</b>  | <b>16,565</b>                   | <b>13,225</b>        |
| <b>Investments, employee benefit plans, at fair value</b>                                 | <b>28,043</b>                   | <b>23,337</b>        |
| <b>Deferred income taxes</b>  | <b>5,197</b>                    | <b>3,289</b>         |
| <b>Other assets</b>   | <b>12,062</b>                   | <b>11,873</b>        |
| <b>Total assets</b>   | <b>\$ 280,276</b>               | <b>\$ 265,100</b>    |
| <b>LIABILITIES AND SHAREHOLDERS DEFICIT</b>   |                                 |                      |
| <b>Current liabilities</b>  |                                 |                      |
| Current portion of long-term debt   | \$ 146                          | \$ 146               |
| Accounts payable  | 42,817                          | 34,413               |
| Accrued expenses and other  | 43,496                          | 50,956               |
| Deferred revenue  | 35,734                          | 32,131               |
| Income taxes payable  | 7,314                           | 2,499                |
| <b>Total current liabilities</b>  | <b>129,507</b>                  | <b>120,145</b>       |
| <b>Long-term debt</b>   | <b>224,331</b>                  | <b>273,972</b>       |
| <b>Deferred compensation and retirement plan obligations</b>                              | <b>35,147</b>                   | <b>28,987</b>        |
| <b>Other liabilities</b>  | <b>9,314</b>                    | <b>9,172</b>         |
| <b>Total liabilities</b>  | <b>398,299</b>                  | <b>432,276</b>       |
| Commitments and contingencies   |                                 |                      |
| <b>SHAREHOLDERS DEFICIT</b>   |                                 |                      |
| Common stock, \$0.01 par value  | 663                             | 652                  |
| Additional paid-in-capital  | 77,019                          | 75,240               |
| Accumulated other comprehensive income  | 897                             | 859                  |
| Deferred compensation   |                                 | (798)                |
| Treasury stock  | (628,766)                       | (650,551)            |

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|   |                   |            |
|---|-------------------|------------|
| Retained earnings                                 | <b>432,164</b>    | 407,422    |
| <b>Total shareholders deficit</b>                 | <b>(118,023)</b>  | (167,176)  |
| <b>Total liabilities and shareholders deficit</b> | <b>\$ 280,276</b> | \$ 265,100 |

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)

|   | Six Months Ended<br>June 30, |                 |
|---|------------------------------|-----------------|
|   | 2006                         | 2005            |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                              |                 |
| Net income  | \$ 41,801                    | \$ 33,547       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |                 |
| Depreciation and amortization   | 4,991                        | 4,581           |
| Gain on sale of assets  |                              | (186)           |
| Provision for bad debts   | (127)                        | 68              |
| Loss on extinguishment of debt  | 342                          |                 |
| Non-cash stock compensation   | 5,550                        | 2,561           |
| Non-cash interest and other investment (income) loss                              | (107)                        | 87              |
| Equity in net income of affiliates  | (388)                        | (354)           |
| Changes in assets and liabilities:  |                              |                 |
| Receivables   | (3,414)                      | (2,778)         |
| Receivable - marketing and reservation fees, net                                  | 670                          | (5,754)         |
| Accounts payable  | 8,404                        | 10,109          |
| Accrued expenses and other  | (7,549)                      | (2,240)         |
| Income taxes payable  | 4,815                        | 13,610          |
| Deferred income taxes   | (1,912)                      | 309             |
| Deferred revenue  | 3,603                        | 4,255           |
| Other current assets  | (420)                        | 449             |
| Other liabilities   | 6,200                        | 5,014           |
| <b>Net cash provided by operating activities</b>                                  | <b>62,459</b>                | <b>63,278</b>   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                              |                 |
| Investment in property and equipment  | (4,045)                      | (8,023)         |
| Proceeds from disposition of assets   |                              | 1,812           |
| Issuance of notes receivable  | (1,277)                      | (449)           |
| Purchases of investments  | (5,784)                      | (6,508)         |
| Proceeds from sale of investments   | 1,387                        | 2,834           |
| Other items, net  | 232                          | (441)           |
| <b>Net cash used in investing activities</b>                                      | <b>(9,487)</b>               | <b>(10,775)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                              |                 |
| Principal payments of long-term debt  | (73)                         | (73)            |
| Net repayments pursuant to revolving credit facility                              | (49,600)                     | (23,704)        |
| Purchase of treasury stock  | (1,132)                      | (18,843)        |
| Excess tax benefits from stock-based compensation                                 | 11,983                       |                 |
| Debt issuance costs   | (472)                        | (193)           |
| Dividends paid  | (16,925)                     | (14,494)        |
| Proceeds from exercise of stock options   | 7,984                        | 9,255           |
| <b>Net cash used in financing activities</b>                                      | <b>(48,235)</b>              | <b>(48,052)</b> |
| <b>Net change in cash and cash equivalents</b>                                    | <b>4,737</b>                 | <b>4,451</b>    |

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|   |                  |                  |
|---|------------------|------------------|
| Cash and cash equivalents at beginning of period                        | <b>16,921</b>    | 28,518           |
| <b>Cash and cash equivalents at end of period</b>                       | <b>\$ 21,658</b> | <b>\$ 32,969</b> |
| <b>Supplemental disclosure of cash flow information:</b>                |                  |                  |
| <b>Cash payments during the period for:</b>                             |                  |                  |
| Income taxes, net of refunds  | <b>\$ 7,734</b>  | \$ 5,259         |
| Interest  | <b>\$ 8,115</b>  | \$ 7,166         |
| <b>Non-cash financing activities:</b>                                   |                  |                  |
| Declaration of dividends  | <b>\$ 17,059</b> | \$ 14,541        |
| Income tax benefit realized related to employee stock options exercised |                  | \$ 6,022         |
| Issuance of restricted shares of common stock                           | <b>\$ 6,549</b>  | \$ 5,158         |

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

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**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. 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 have been omitted. 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, 2005 and notes thereto included in the Company's Form 10-K, filed with the Securities and Exchange Commission on March 16, 2006 (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 accounting principles generally accepted in the United States 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.

Certain amounts in the prior year's financial statements have been reclassified to conform with the current year presentation with no effect on previously reported net income or shareholders' deficit.

During the quarter ended March 31, 2006, the Company revised the accounting for deferred compensation related to stock awards accounted for under Statement of Financial Accounting Standards (SFAS) No. 123 Accounting for Stock-Based Compensation (SFAS No. 123). As a result of this revision, approximately \$11.6 million of deferred compensation previously included within shareholders' deficit as of December 31, 2005 was eliminated with a corresponding reduction of additional paid-in-capital. There was no effect on any other previously reported income statement, cash flow or balance sheet amounts.

**2. Stock Split**

On September 14, 2005, the Company's board of directors declared a two-for-one stock split effected in the form of a stock dividend. The stock dividend was distributed on October 21, 2005 to shareholders of record on October 7, 2005. As a result of the stock dividend, the accompanying consolidated financial statements reflect an increase in the number of outstanding shares of common stock and the transfer of the par value of these additional shares from paid-in-capital. Treasury shares were not split. Share data and earnings per share data in these consolidated financial statements reflect the stock split, applied retroactively, to all periods presented. Previously awarded stock options and restricted stock awards payable in the Company's common stock have been adjusted to reflect the stock dividend.

**3. Stock-Based Compensation**

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (Revised 2004), Share-Based Payment (SFAS No. 123R). SFAS No. 123R requires that compensation cost relating to share based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. Effective January 1, 2006, the Company adopted SFAS No. 123R using the modified prospective application method and began applying its provisions to (i) new awards, (ii) awards modified subsequent to the adoption date, (iii) any outstanding awards for which all requisite service has not yet been rendered. Under the modified-prospective application method, compensation costs will be recognized on the unvested portion of awards at January 1, 2006 based on the grant-date fair value used for pro-forma disclosures under SFAS No. 148 Accounting for Stock-Based Compensation-Transition and Disclosure over the remaining vesting period. Under this transition method, prior period results have not been restated. The adoption of SFAS No. 123R reduced both operating income and net income by approximately \$0.1 million for the three months ended June 30, 2006 and \$0.3 million and \$0.2 million for the six months ended June 30, 2006, respectively. The adoption did not have a material impact on reported earnings per share or the Company's financial statements since the Company has been expensing share-based awards granted since January 1, 2003 under the provisions of SFAS No. 123. Prior to January 1, 2003, the Company accounted for stock-based awards under APB Opinion No. 25 Accounting for Stock Issued to Employees (APB No. 25).

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SFAS No. 123R also requires the Company to calculate the pool of income tax benefits that were previously recorded in additional paid-in-capital and are available to absorb future income tax shortfalls that can result from the exercise or maturity of stock awards. The Company has calculated its windfall pool under the short-cut method based on the actual income tax benefits received from exercises and maturities of stock awards granted after October 15, 1997.

Prior to the adoption of SFAS No. 123R, no stock-based compensation cost was reflected in the accompanying consolidated statements of income related to the grant of stock options which occurred prior to January 1, 2003, because the Company accounted for those grants under APB No. 25 and all such stock options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. Therefore, the cost related to stock-based employee compensation included in the determination of net income for the three and six months ended June 30, 2005 is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective date of SFAS No. 123. The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to all outstanding and unvested awards during the three and six months ended June 30, 2005.

**Table of Contents**

(In thousands, except per share amounts)

|   | Three Months Ended<br>June 30, 2005 | Six Months Ended<br>June 30, 2005 |
|---|-------------------------------------|-----------------------------------|
| Net income, as reported   | \$ 21,548                           | \$ 33,547                         |
| Stock-based employee compensation cost included in reported net income, net of related tax effects                            | 777                                 | 1,444                             |
| Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects | (1,321)                             | (2,131)                           |
| Net income, pro forma   | \$ 21,004                           | \$ 32,860                         |
| <b>Earnings per share:</b>  |                                     |                                   |
| Basic, as reported  | \$ 0.33                             | \$ 0.52                           |
| Basic, pro forma  | \$ 0.33                             | \$ 0.51                           |
| Diluted, as reported  | \$ 0.32                             | \$ 0.50                           |
| Diluted, pro forma  | \$ 0.32                             | \$ 0.49                           |

The Company's stock-based compensation plans and related accounting policies are described more fully in Note 7.

**4. Receivable Marketing Fees & Cumulative Reservation Fees Collected in Excess of Expenses**

The marketing fees receivable at June 30, 2006 and December 31, 2005 was \$16.6 million and \$13.2 million, respectively. As of June 30, 2006 and December 31, 2005, cumulative reservation fees collected exceeded expenses by \$3.7 million and \$3.6 million, respectively, and the excess has been reflected as a long-term liability in the accompanying consolidated balance sheets. Depreciation and amortization expense attributable to marketing and reservation activities was \$2.0 million and \$1.9 million for the three months ended June 30, 2006 and 2005, respectively, and \$3.9 million for both the six months ended June 30, 2006 and 2005. Interest expense attributable to reservation activities was \$0.2 million and \$0.3 million for the three months ended June 30, 2006 and 2005, respectively, and \$0.4 million and \$0.5 million for the six months ended June 30, 2006 and 2005, respectively.

**5. Income Taxes**

The effective income tax rates for the 2006 and 2005 six-month periods of approximately 35.4% and 36.8%, respectively, differ from the statutory rate due to foreign income earned, which is taxed at lower rates than statutory federal income tax rates, state income taxes and certain federal and state income tax credits.

We have 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.

**6. Comprehensive Income**

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

| (In thousands)                                     | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2006                           | 2005      | 2006                         | 2005      |
| Net income   | \$ 24,136                      | \$ 21,548 | \$ 41,801                    | \$ 33,547 |
| Other comprehensive income (loss), net of tax:     |                                |           |                              |           |
| Unrealized losses on available for sale securities |                                | (12)      |                              | (25)      |
| Foreign currency translation adjustment, net       | 101                            | 12        | 71                           | (79)      |
| Amortization of deferred gain on hedge             | (16)                           | (17)      | (33)                         | (34)      |

|                                   |           |           |           |           |
|-----------------------------------|-----------|-----------|-----------|-----------|
| Other comprehensive income (loss) | 85        | (17)      | 38        | (138)     |
| Comprehensive income              | \$ 24,221 | \$ 21,531 | \$ 41,839 | \$ 33,409 |

## 7. Capital Stock

The Company has a stock compensation plan pursuant to which it is authorized to grant stock-based awards of up to 3.2 million shares of the Company's common stock, of which 3.2 million shares remain available for grant as of June 30, 2006. The Company's policy allows the issuance of new or treasury shares to satisfy stock-based awards. Restricted stock, stock options, stock appreciation rights and performance share awards may be granted to officers, key employees and non-employee directors with the contractual terms set by the Compensation Committee of the Board of Directors.

**Table of Contents***Stock Options*

The Company granted approximately 0.2 million and 0.4 million options to officers of the Company at a fair value of approximately \$2.8 million and \$3.6 million during the six months ending June 30, 2006 and 2005, respectively. No options were granted during the three months ending June 30, 2006 and 2005. 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:

|  | 2006 Grants | 2005 Grants |
|--|-------------|-------------|
| Risk-free interest rate                        | 4.69%       | 3.70%       |
| Expected volatility                            | 32.09%      | 36.07%      |
| Expected life of stock option                  | 4.3 years   | 5.5 years   |
| Dividend yield                                 | 1.07%       | 1.50%       |
| Requisite service period                       | 4 years     | 5 years     |
| Contractual life                               | 7 years     | 10 years    |
| Weighted average fair value of options granted | \$ 14.82    | \$ 10.11    |

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. 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, 2006 was \$128.6 million and \$87.3 million, respectively. The total intrinsic value of options exercised during the three months ended June 30, 2006 and 2005 was \$25.3 million and \$15.4 million, respectively, and \$40.5 million and \$29.1 million during the six months ended June 30, 2006 and 2005, respectively.

The Company received \$4.5 million and \$8.0 million in proceeds from the exercise of 0.6 million and 1.0 million employee stock options during the three and six months ended June 30, 2006, respectively. During the three and six months ended June 30, 2005, the Company received \$4.3 million and \$9.3 million in proceeds from the exercise of 0.6 million and 1.2 million employee stock options, respectively.

*Restricted Stock*

The Company granted approximately 0.02 million and 0.1 million restricted shares to employees and directors of the Company at a fair value of \$0.8 million and \$6.5 million during the three and six months ended June 30, 2006, respectively. During the three and six months ended June 30, 2005, the Company granted approximately 0.03 million and 0.2 million shares to employees of the Company at a fair value of \$1.0 million and \$5.2 million, respectively. 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 is measured by the average of the high and low market price of the Company's common stock on the date of grant. Restricted stock awards granted in 2006 generally vest ratably at 25 percent per year beginning with the first anniversary of the grant date. Restricted stock awards during the six months ended June 30, 2005 generally vest ratably at 20 percent per year beginning with the first anniversary of the grant date. The weighted average grant-date fair value of restricted shares granted during the six months ended June 30, 2006 and 2005 was \$49.17 and \$29.83 per share, respectively. The total fair value of shares vested during the three months ended June 30, 2006 and 2005 was \$0.9 million and \$0.5 million, respectively, and \$8.0 million and \$4.2 million during the six months ended June 30, 2006 and 2005, respectively.

*Performance Vested Restricted Stock*

During the first quarter of 2006, the Company granted performance vested restricted stock ( PVRSU ) to certain officers. The vesting of these stock awards is contingent upon the Company achieving specified earnings per share targets at the end of a three-year performance period 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 50% and 200% of the initial target. Under SFAS No. 123R, 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 performance target. The Company has currently estimated that 100% of the target will be achieved. The fair value is measured by the average of the high and low 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's that ultimately vest. There were no grants of PVRSU during the three months ended June 30, 2006 or six months ended June 30, 2005.

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

|  | <b>Six Months Ended<br/>June 30, 2006</b> |
|--|---|
| Performance Vested Restricted Shares Granted     | <b>29,780</b>                             |
| Weighted Average Grant Date Fair Value Per Share | <b>\$ 48.72</b>                           |
| Aggregate Grant Date Fair Value (\$000)          | <b>\$ 1,451</b>                           |
| Requisite Service Period                         | <b>3 years</b>                            |

**Table of Contents**

A summary of stock-based award activity as of June 30, 2006, and changes during the six months ended are presented below:

|                                      | Six Months Ended June 30, 2006 |                                 |                                   |           | Performance Vested Restricted Stock    |        |  |
|--------------------------------------|--------------------------------|---------------------------------|-----------------------------------|-----------|--|--------|--|
|                                      | Stock Options                  |                                 | Restricted Stock                  |           | Performance Vested Restricted Stock    |        |  |
|                                      | Shares                         | Weighted Average Exercise Price | Weighted Average Contractual Term | Shares    | Weighted Average Grant Date Fair Value | Shares | Weighted Average Grant Date Fair Value |
| Outstanding at January 1, 2006       | 3,753,001                      | \$ 10.81                        |                                   | 689,865   | \$ 21.28                               |        | \$                                     |
| Granted                              | 190,548                        | 48.74                           |                                   | 133,207   | 49.17                                  | 29,780 | 48.72                                  |
| Exercised/Vested                     | (976,125)                      | 8.18                            |                                   | (167,206) | 17.24                                  |        |  |
| Forfeited/Expired                    | (35,116)                       | 10.07                           |                                   | (18,487)  | 28.66                                  |        |  |
| Outstanding at June 30, 2006         | 2,932,308                      | \$ 14.16                        | 5.3 years                         | 637,379   | \$ 27.95                               | 29,780 | \$ 48.72                               |
| Options exercisable at June 30, 2006 | 1,793,947                      | \$ 9.33                         | 4.3 years                         |           |  |        |  |

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

| (in millions)                       | Three Months Ended June 30, |        | Six Months Ended June 30, |        |
|-------------------------------------|-----------------------------|--------|---------------------------|--------|
|                                     | 2006                        | 2005   | 2006                      | 2005   |
| Stock options                       | \$ 0.8                      | \$ 0.5 | \$ 2.4                    | \$ 0.9 |
| Restricted stock                    | 1.3                         | 0.9    | 2.5                       | 1.7    |
| Performance vested restricted stock | 0.1                         |        | 0.6                       |        |
| Total                               | \$ 2.2                      | \$ 1.4 | \$ 5.5                    | \$ 2.6 |
| Income tax benefits                 | \$ 0.8                      | \$ 0.5 | \$ 2.1                    | \$ 1.0 |

Stock-based compensation expense on stock option and performance vested restricted stock grants made to a retirement eligible executive officer during the six months ended June 30, 2006 was recognized upon issuance of the grants rather than over the awards' vesting period since the terms of the grant provide that the awards will vest upon retirement of the employee. Compensation costs recognized related to the vesting upon retirement eligibility totaled \$0.9 million and \$0.4 million for stock options and performance vested restricted stock, respectively.

The total unrecognized compensation costs related to stock-based awards that have not yet vested and the related weighted average amortization period over which the costs are to be recognized as of June 30, 2006 are as follows:

|                                     | Unrecognized Compensation Expense on Unvested Awards (in millions) | Weighted Average Amortization Period |
|-------------------------------------|--|--------------------------------------|
| Stock options                       | \$ 6.6   | 2.9 years                            |
| Restricted stock                    | 15.9   | 3.3 years                            |
| Performance vested restricted stock | 0.9  | 2.6 years                            |

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|       |    |      |
|-------|----|------|
| Total | \$ | 23.4 |
|-------|----|------|

### *Dividends*

On May 2, 2006, the Company declared a cash dividend of \$0.13 per share (or approximately \$8.6 million in the aggregate), which was paid on July 21, 2006 to shareholders of record on July 7, 2006. On February 13, 2006, the Company declared a cash dividend of \$0.13 per share (or approximately \$8.5 million in the aggregate), which was paid on April 21, 2006 to shareholders of record on April 7, 2006.

In May 2005, the Company declared a cash dividend of \$0.1125 per share (or approximately \$7.3 million in the aggregate), which was paid on July 22, 2005 to shareholders of record on July 8, 2005. In March 2005, the Company declared a cash dividend of \$0.1125 per share (or approximately \$7.2 million in the aggregate), which was paid on April 22, 2005 to shareholders of record on April 8, 2005.

### *Stock Repurchase Program*

The Company did not repurchase common stock during the three and six months ended June 30, 2006 under its share repurchase program. During the three and six months ended June 30, 2005, the Company repurchased 0.1 million and 0.3 million shares, respectively, of its common stock under the share repurchase program at a total cost of \$4.8 million and \$18.8 million, respectively, including 0.1 million at a total cost of \$6.0 million from one of the Company's largest shareholders.

During the six months ended June 30, 2006 and 2005, the Company purchased 26,794 and 8,746 shares of common stock at a total cost of \$1.1 million

**Table of Contents**

and \$0.5 million, respectively, from employees to satisfy statutory minimum tax-withholding requirements from the vesting of restricted stock grants. These purchases were outside the share repurchase program initiated in June 1998. No shares were repurchased from employees to satisfy tax-withholding requirements during the three months ended June 30, 2006 and 2005.

**8. Earnings Per Share**

The following table reconciles the number of shares used in the basic and diluted earnings per share calculations.

|   | Three Months Ended June 30, |           | Six Months Ended June 30, |           |
|---|-----------------------------|-----------|---------------------------|-----------|
|   | 2006                        | 2005      | 2006                      | 2005      |
| <b>(In thousands, except per share amounts)</b>   |                             |           |                           |           |
| <b>Computation of Basic Earnings Per Share:</b>   |                             |           |                           |           |
| Net Income  | \$ 24,136                   | \$ 21,548 | \$ 41,801                 | \$ 33,547 |
| Weighted average shares outstanding-basic         | 65,356                      | 64,452    | 65,070                    | 64,297    |
| Basic earnings per share                          | \$ 0.37                     | \$ 0.33   | \$ 0.64                   | \$ 0.52   |
| <b>Computation of Diluted Earnings Per Share:</b> |                             |           |                           |           |
| Net income for diluted earnings per share         | \$ 24,136                   | \$ 21,548 | \$ 41,801                 | \$ 33,547 |
| Weighted average shares outstanding-basic         | 65,356                      | 64,452    | 65,070                    | 64,297    |
| Effect of Dilutive Securities:                    |                             |           |                           |           |
| Employee stock option and restricted stock plan   | 1,749                       | 2,225     | 1,855                     | 2,201     |
| Weighted average shares outstanding-diluted       | 67,105                      | 66,677    | 66,925                    | 66,498    |
| Diluted earnings per share                        | \$ 0.36                     | \$ 0.32   | \$ 0.62                   | \$ 0.50   |

Basic earnings per share exclude dilution and are computed by dividing net income by the weighted-average number of common shares outstanding. Diluted earnings per share assumes dilution and is computed based on the weighted-average number of common shares outstanding after consideration of the dilutive effect of stock options and unvested restricted stock. The effect of dilutive securities is computed using the treasury stock method and average market prices during the period. There were no anti-dilutive options at June 30, 2006 and 2005. However, at June 30, 2006, PVRsUs totaling 29,780 were excluded from the computation since the performance conditions had not been met at the reporting date.

**9. Acquisition of Suburban Franchise Holding Company, Inc.**

During 2005, the Company acquired 100% of the stock of Suburban Franchise Holding Company, Inc. ( Suburban ) (the Suburban Transaction ) and its wholly owned subsidiary, Suburban Franchise Systems, Inc. The initial purchase price for Suburban was \$12.8 million, which consisted of cash paid, net of cash acquired, of \$7.3 million, liabilities assumed of \$4.5 million and direct acquisition and exit costs totaling \$1.0 million. Included in the purchase price was a working capital look-back adjustment escrow totaling \$0.5 million, which was paid in the first quarter of 2006. The merger provides for contingent cash payments, of up to \$5 million, to be made upon the satisfaction of the following conditions:

\$2.5 million payable if at any time prior to the 3<sup>rd</sup> anniversary of closing, at least 84 Suburban franchises are open or under construction and at least 79 are open on that date;

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An additional \$2.5 million payable if at any time prior to the 3<sup>rd</sup> anniversary of closing, but in no event prior to the 2<sup>nd</sup> anniversary of closing, at least 100 Suburban franchises are open or under construction and at least 90 are open on that date;

Both contingent payments are subject to at least 51 of the existing Suburban franchises open at the acquisition date, remaining open when the contingent payment is otherwise earned.

No liabilities have been recorded related to the contingent cash payments. If the contingent consideration is earned, the purchase price of Suburban will be adjusted at that time. The results of operations for Suburban have been included in the Company's results of operations since September 28, 2005.

The Company accounted for the Suburban Transaction in accordance with SFAS No. 141, Business Combinations. The Company allocated the purchase price based upon an assessment of the fair value of assets acquired and liabilities assumed as of September 28, 2005. The total purchase price was allocated based on an analysis by management of the respective fair values of the acquired assets and liabilities as follows:

|                                 | <b>Estimated Fair<br/>Value<br/>(\$000)</b> |
|---------------------------------|---|
| Tangible assets                 | \$ 401                                      |
| Intangible assets               | 7,201                                       |
| Goodwill                        | 5,193                                       |
| <br>                            |   |
| Total assets acquired           | 12,795                                      |
| Liabilities assumed             | (5,481)                                     |
| <br>                            |   |
| Cash paid, net of cash acquired | \$ 7,314                                    |

**Table of Contents**

Suburban is the franchisor of Suburban Extended Stay Hotel, a 67-unit, 8,942 room (at the date of consolidation) lodging chain operating in the economy extended stay segment primarily in the southeastern United States. The acquisition of Suburban allowed the Company to enter, on an accelerated basis, the economy extended stay segment, a market in which it did not previously compete. The purchase price of Suburban was based on the projected business growth and cash flows of Suburban over the next several years and indicated a value that was in excess of the current net book value of the business, resulting in the recognition of various identifiable intangible assets and goodwill as follows:

|                           | Estimated Fair<br>Value<br>(\$000) | Estimated<br>Useful Lives |
|---------------------------|------------------------------------|---------------------------|
| Franchise Contracts       | \$ 6,187                           | 10 years                  |
| Trademarks and Tradenames | 1,014                              | Indefinite life           |
| Goodwill                  | 5,193                              | Indefinite life           |
|                           | \$ 12,394                          |                           |

Goodwill and intangible assets are not deductible for tax purposes. The pro forma results of operations as if Suburban had been combined at the beginning of 2005, would not be materially different from the Company's reported results for that period.

**10. Pension Plans**

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. The Company accounts for the SERP in accordance with SFAS No. 87, Employers Accounting for Pensions. For the three and six months ended June 30, 2006, the Company recorded \$0.3 million and \$0.6 million, respectively, of expense related to the SERP which is included in selling, general and administrative expense in the accompanying consolidated statements of income. For the three and six months ended June 30, 2005, the company recorded \$0.2 million and \$0.4 million, respectively, of expense related to the SERP. Based on the plan retirement age of 65 years old, no benefit payments are anticipated during the current fiscal year. The following table presents the components of net periodic benefit costs for the three and six months ended June 30, 2006 and 2005.

| (In thousands)                           | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |        |
|--|--------------------------------|--------|------------------------------|--------|
|  | 2006                           | 2005   | 2006                         | 2005   |
| Components of net periodic pension cost: |                                |        |                              |        |
| Service cost                             | \$ 170                         | \$ 128 | \$ 339                       | \$ 256 |
| Interest cost                            | 87                             | 66     | 175                          | 132    |
| Amortizations                            |                                |        |                              |        |
| Prior service cost                       | 14                             | 14     | 28                           | 28     |
| (Gain)/Loss                              | 19                             | 9      | 38                           | 18     |
| Net periodic pension cost                | \$ 290                         | \$ 217 | \$ 580                       | \$ 434 |

**11. Debt**

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 proceeds from the Revolver were used to refinance and terminate the revolving credit facility under the Company's existing senior credit facility (the Old Credit Facility). 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 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 are, 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

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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 1/2 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 1/2 basis points, on the amount outstanding under the commitment, 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, 2006, the Company had \$124.1 million of revolving loans outstanding pursuant to the Revolver.

The Company accounted for the refinancing of the Old Credit Facility in accordance with Emerging Issues Task Force ( EITF ) Issue No. 98-14, Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements. Pursuant to this accounting pronouncement, the Company recorded a loss on extinguishment of debt of approximately \$0.3 million.

**Table of Contents**

As of June 30, 2006, in addition to the Revolver and \$100 million of Senior Notes, the Company had a line of credit with a bank providing up to an aggregate of \$10 million of borrowings, which is due upon demand. The line of credit ranks pari-pasu (or equally) with the Company's Revolver and includes customary financial and other covenants that require the maintenance of certain ratios identical to those included in the Company's Revolver. Borrowings under the line of credit bear interest at rates established at the time of borrowing based on prime rate minus 175 basis points. As of June 30, 2006, the Company had no amounts outstanding pursuant to this line of credit.

Effective July 14, 2006, the Company's Senior Notes are guaranteed fully and unconditionally by 7 wholly-owned subsidiaries. Choice Hotels International, Inc. along with these subsidiaries represent approximately 95% of the Company's revenues and operating income. There are no legal or regulatory restrictions on the payment of dividends to Choice Hotels International, Inc. from subsidiaries that do not guarantee the Senior Notes.

As of June 30, 2006, total debt outstanding for the Company was \$224.5 million, of which \$0.1 million was scheduled to mature in the twelve months ending June 30, 2007.

**12. 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, partner services revenue and other revenue. The Company is obligated under its franchise agreements to provide marketing and reservation services appropriate for the successful 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 central 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, 2006 |                    |                   | Three Months Ended June 30, 2005 |                   |              |
|--------------------------------|----------------------------------|--------------------|-------------------|----------------------------------|-------------------|--------------|
|                                | Franchising                      | Corporate & Other  | Consolidated      | Franchising                      | Corporate & Other | Consolidated |
| <b>Revenues</b>                | <b>\$ 139,360</b>                | <b>\$ 1,180</b>    | <b>\$ 140,540</b> | \$ 121,154                       | \$ 1,141          | \$ 122,295   |
| <b>Operating income (loss)</b> | <b>\$ 54,665</b>                 | <b>\$ (12,551)</b> | <b>\$ 42,114</b>  | \$ 47,404                        | \$ (9,987)        | \$ 37,417    |

  

| (In thousands)                 | Six Months Ended June 30, 2006 |                    |                   | Six Months Ended June 30, 2005 |                   |              |
|--------------------------------|--------------------------------|--------------------|-------------------|--------------------------------|-------------------|--------------|
|                                | Franchising                    | Corporate & Other  | Consolidated      | Franchising                    | Corporate & Other | Consolidated |
| <b>Revenues</b>                | <b>\$ 247,798</b>              | <b>\$ 2,160</b>    | <b>\$ 249,958</b> | \$ 211,402                     | \$ 2,061          | \$ 213,463   |
| <b>Operating income (loss)</b> | <b>\$ 95,031</b>               | <b>\$ (22,844)</b> | <b>\$ 72,187</b>  | \$ 78,728                      | \$ (19,012)       | \$ 59,716    |

**13. Commitments and Contingencies**

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

In March 2006, the Company guaranteed \$1 million of a bank loan funding a franchisee's construction of a Cambria Suites in Green Bay, Wisconsin. The guaranty expires in June 2010. The Company has received personal guarantees from several of the franchisee's principal owners related to repayment of any amounts paid by the Company under this guaranty.

In the ordinary course of business, the Company enters into numerous agreements that contain standard guarantees and indemnities whereby the Company indemnifies another party for breaches of representations and warranties. Such guarantees or 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) other operating agreements. The guarantees or 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, and (v) underwriters in debt or equity security issuances. In addition, these parties are also indemnified against any third party claim resulting from the transaction that is contemplated in the underlying agreement. While some of these guarantees 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 guarantees, nor is the Company able to develop an estimate of the maximum potential amount of future payments to be made under these guarantees as the triggering events are not subject to predictability. With respect to certain of the aforementioned guarantees, 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 any potential payments to be made.

#### **14. Recently Issued Accounting Standards**

In March 2006, the EITF issued EITF Issue 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). A tentative consensus was reached that a company should disclose its accounting policy (i.e. gross or net presentation) regarding the presentation of taxes within the scope of EITF 06-3 in the income statement. If taxes are significant, a company should disclose its policy of presenting taxes. In addition, for any such taxes that are reported on a gross basis, the company should disclose the amounts of those taxes. The guidance is effective for periods beginning after December 15, 2006. We present company sales net of sales taxes. This issue will not impact the method for recording these sales taxes in our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We are currently evaluating the potential impact of this interpretation.

## **Table of Contents**

### **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 5,284 hotels open and 752 hotels under development as of June 30, 2006, with 431,474 rooms and 59,758 rooms, respectively, in 49 states, the District of Columbia and more than 40 countries and territories outside the United States. Our brand names include Comfort Inn, Comfort Suites, Quality, Clarion, Sleep Inn, Econo Lodge, Rodeway Inn, MainStay Suites, Cambria Suites, Suburban Extended Stay Hotel and Flag Hotels.

The Company conducts its international franchise operations primarily through master franchising and investments in non-domestic lodging franchise companies which allow the use of our brands by third parties in foreign countries. As a result, although international hotels represents approximately 22% of hotels in our franchise system, approximately 95% of the Company's revenues are derived from hotels directly franchised in the United States.

During 2005, the Company acquired 100% of the stock of Suburban Franchise Holding Company, Inc. ( Suburban ) and its wholly owned subsidiary, Suburban Franchise Systems, Inc for \$12.8 million. Suburban is the franchisor of Suburban Extended Stay Hotel and at acquisition had 67 units (8,942 rooms) operating in the economy extended stay segment, primarily in the southeastern United States. The acquisition allowed the Company to enter, on an accelerated basis, the economy extended stay segment, a market in which it did not previously compete. The results of Suburban have been consolidated with the Company since September 28, 2005.

On September 14, 2005, the Company's board of directors declared a two-for one stock split effected in the form of a stock dividend. The stock dividend was distributed on October 21, 2005 to shareholders of record on October 7, 2005. Share data and earnings per share data included in MD&A reflect the stock split, applied retroactively, to all periods presented.

Our Company generates revenues, income and cash flows primarily from initial and continuing royalty fees attributable to our franchise agreements. Revenues are also generated from partner services endorsed 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.

We are contractually required by our franchise agreements to use the marketing and reservation 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 customers' profitability by providing our customers 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: One that focuses on delivering guests to our franchised hotels and reducing costs for our hotel owners. We strive every day to continuously improve our franchise offerings to enhance our customers' profitability and create the highest return on investment of any hotel franchise.

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

*Profitable Growth.* 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 endorsed 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.

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*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. 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. 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. We have repurchased 33.6 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 \$711.9 million since the program's inception. Considering the effect of the two-for-one stock split, the Company has repurchased 66.6 million shares at an average price of \$10.69 per share. Our cash flows from operations support our ability to complete the repurchase of approximately 5.1 million shares presently remaining under our current board of directors' authorization. The Company expects to continue to return value to its shareholders through a combination of dividends and share repurchases, subject to market and other conditions and upon completion of the current authorization we will evaluate the propriety of additional share repurchases with our board of directors. During the second quarter of 2006, we paid cash dividends totaling approximately \$8.5 million and we presently expect to continue to pay dividends in the future. On May 2, 2006, our board of directors declared a cash dividend of \$0.13 on outstanding common shares payable on July 21, 2006 to shareholders of record on July 7, 2006. Based on our present dividend rate and outstanding share count, aggregate annual dividends would be approximately \$34.1 million.

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.

## **Table of Contents**

*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, 2006, royalty fees revenue and operating income totaled approximately \$53.1 million and \$42.1 million, respectively, increases of 14% and 13%, respectively from the same period in 2005. Net income for the three months ended June 30, 2006 increased to \$24.1 million, an increase of \$2.6 million over the three months ended June 30, 2005, a 12% increase. Diluted earnings per share for the first quarter of 2006 were \$0.36, a 12.5% improvement over the three months ended June 30, 2005 resulting primarily from increased net income. These measurements will continue to be a key management focus in 2006 and beyond.

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

*Liquidity and Capital Resources:* The Company generates significant cash flows from operations. In the six months ended June 30, 2006 and 2005, net cash provided by operating activities was \$62.5 million and \$63.3 million, respectively. Since our business does not 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 are 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.

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

## **Operations Review**

### **Comparison of Operating Results for the Three-Month Periods Ended June 30, 2006 and June 30, 2005**

The Company recorded net income of \$24.1 million for the three months ended June 30, 2006, an increase of \$2.6 million, or 12% from \$21.5 million for the quarter ended June 30, 2005. The increase in net income for the three months ended June 30, 2006 is primarily attributable to a \$4.7 million improvement in operating income and a decline in the effective income tax rate from 36.9% to 36.0%. The effective income tax rate declined primarily due to an increase in the proportion of foreign income earned over the prior year period, which is taxed at lower rates than statutory U.S. income tax rates. Operating income increased as a result of an \$8.1 million, or 13.8% increase in franchising revenues (total revenues excluding marketing and reservation revenues and hotel operations) partially offset by a \$3.0 million increase in selling, general and administrative expense and a \$0.4 million increase in depreciation and amortization. The \$1.2 million increase in net other income and expenses, net, was primarily related to investment losses on assets held in the Company's non-qualified employee benefit plans, a \$0.3 million loss on extinguishment of debt and additional interest expense due to an increase in the Company's short-term borrowing rates.

**Table of Contents**

Summarized financial results for the three months ended June 30, 2006 and 2005 are as follows:

(in thousands, except per share amounts)

|  | 2006             | 2005             |
|--|------------------|------------------|
| <b>REVENUES:</b>                                   |                  |                  |
| Royalty fees                                       | \$ 53,146        | \$ 46,515        |
| Initial franchise and relicensing fees             | 6,723            | 6,591            |
| Partner services                                   | 4,900            | 4,596            |
| Marketing and reservation                          | 72,742           | 62,610           |
| Hotel operations                                   | 1,180            | 1,141            |
| Other  | 1,849            | 842              |
| <b>Total revenues</b>                              | <b>140,540</b>   | <b>122,295</b>   |
| <b>OPERATING EXPENSES:</b>                         |                  |                  |
| Selling, general and administrative                | 22,242           | 19,199           |
| Depreciation and amortization                      | 2,642            | 2,256            |
| Marketing and reservation                          | 72,742           | 62,610           |
| Hotel operations                                   | 800              | 813              |
| <b>Total operating expenses</b>                    | <b>98,426</b>    | <b>84,878</b>    |
| <b>Operating income</b>                            | <b>42,114</b>    | <b>37,417</b>    |
| <b>OTHER INCOME AND EXPENSES:</b>                  |                  |                  |
| Interest expense                                   | 4,044            | 3,872            |
| Interest and other investment (income) loss        | 174              | (404)            |
| Equity in net income of affiliates                 | (130)            | (155)            |
| Loss on extinguishment of debt                     | 342              |                  |
| Other  |                  | (53)             |
| <b>Total other income and expenses, net</b>        | <b>4,430</b>     | <b>3,260</b>     |
| <b>Income before income taxes</b>                  | <b>37,684</b>    | <b>34,157</b>    |
| <b>Income taxes</b>                                | <b>13,548</b>    | <b>12,609</b>    |
| <b>Net income</b>                                  | <b>\$ 24,136</b> | <b>\$ 21,548</b> |
| <b>Weighted average shares outstanding diluted</b> | <b>67,105</b>    | <b>66,677</b>    |
| <b>Diluted earnings per share</b>                  | <b>\$ 0.36</b>   | <b>\$ 0.32</b>   |

Management analyzes its business based on franchising revenues, which is total revenues excluding marketing and reservation revenues and hotel operations, and franchise operating expenses that are reflected as selling, general and administrative expenses.

*Franchising Revenues:* Franchising revenues were \$66.6 million for the three months ended June 30, 2006 compared to \$58.5 million for the three months ended June 30, 2005. The growth in franchising revenues is primarily due to increases in royalty revenues, partner services and other revenues of 14%, 7% and 120%, respectively.

Royalty fees increased \$6.6 million to \$53.1 million from \$46.5 million in the three months ended June 30, 2005, an increase of 14.3%. Excluding the franchises obtained in the acquisition of Suburban, the increase in royalties is attributable to a combination of factors including a 2.1% increase in the number of domestic franchised hotel rooms, a 7.7% increase in RevPAR from \$37.95 to \$40.87 and an increase in the

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effective royalty rate of the domestic hotel system to 4.12% from 4.09%. The acquisition of Suburban contributed approximately \$0.8 million of royalty fees in the three months ended June 30, 2006.

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

|                               | For the Three Months Ended |              |                 | For the Three Months Ended |           |          | Change             |           |        |
|-------------------------------|----------------------------|--------------|-----------------|----------------------------|-----------|----------|--------------------|-----------|--------|
|                               | June 30, 2006              |              |                 | June 30, 2005              |           |          |                    |           |        |
|                               | Average Daily Rate         | Occupancy    | RevPAR          | Average Daily Rate         | Occupancy | RevPAR   | Average Daily Rate | Occupancy | RevPAR |
| <b>Comfort Inn</b>            | <b>\$ 71.84</b>            | <b>64.0%</b> | <b>\$ 45.97</b> | \$ 67.32                   | 61.7%     | \$ 41.51 | 6.7%               | 230 bps   | 10.7%  |
| <b>Comfort Suites</b>         | <b>83.04</b>               | <b>69.5%</b> | <b>57.72</b>    | 77.37                      | 67.3%     | 52.09    | 7.3%               | 220 bps   | 10.8%  |
| <b>Quality</b>                | <b>66.18</b>               | <b>56.5%</b> | <b>37.36</b>    | 64.39                      | 55.0%     | 35.44    | 2.8%               | 150 bps   | 5.4%   |
| <b>Clarion</b>                | <b>77.77</b>               | <b>53.5%</b> | <b>41.63</b>    | 73.33                      | 53.8%     | 39.46    | 6.1%               | (30) bps  | 5.5%   |
| <b>Sleep</b>                  | <b>66.69</b>               | <b>65.2%</b> | <b>43.47</b>    | 62.49                      | 62.5%     | 39.07    | 6.7%               | 270 bps   | 11.3%  |
| <b>Mainstay</b>               | <b>67.43</b>               | <b>70.3%</b> | <b>47.39</b>    | 63.75                      | 66.7%     | 42.55    | 5.8%               | 360 bps   | 11.4%  |
| <b>Econo Lodge</b>            | <b>52.09</b>               | <b>47.5%</b> | <b>24.75</b>    | 49.68                      | 48.4%     | 24.05    | 4.9%               | (90) bps  | 2.9%   |
| <b>Rodeway</b>                | <b>49.98</b>               | <b>44.5%</b> | <b>22.23</b>    | 46.93                      | 47.2%     | 22.15    | 6.5%               | (270) bps | 0.4%   |
| <b>Total Domestic System*</b> | <b>\$ 69.01</b>            | <b>59.2%</b> | <b>\$ 40.87</b> | \$ 65.30                   | 58.1%     | \$ 37.95 | 5.7%               | 110 bps   | 7.7%   |

\* Amounts exclude Suburban activity from April 1, 2006 through June 30, 2006 because comparable pre-acquisition data for Q2 2005 is not available.

**Table of Contents**

Including franchises acquired from Suburban, the number of domestic rooms on-line increased to 332,656 as of June 30, 2006 from 317,477 as of June 30, 2005, an increase of 4.8%. The total number of domestic hotels on-line grew 4.8% to 4,116 as of June 30, 2006 from 3,926 as of June 30, 2005. International rooms on-line increased to 98,818 as of June 30, 2006 from 97,211 as of June 30, 2005, a 1.7% increase. The total number of international hotels on-line also increased from 1,161 as of June 30, 2005 to 1,168 as of June 30, 2006, an increase of 0.6%. A summary of the domestic hotels and rooms on-line at June 30, 2006 and June 30, 2005 by brand is as follows:

|                                  | June 30, 2006 |         | June 30, 2005 |         | Variance |         |        |        |
|----------------------------------|---------------|---------|---------------|---------|----------|---------|--------|--------|
|                                  | Hotels        | Rooms   | Hotels        | Rooms   | Hotels   | Rooms   | %      | %      |
| <b>COMFORT INN</b>               | 1,411         | 110,440 | 1,448         | 114,023 | (37)     | (3,583) | (2.6)% | (3.1)% |
| <b>COMFORT SUITES</b>            | 417           | 32,786  | 402           | 31,648  | 15       | 1,138   | 3.7%   | 3.6%   |
| <b>QUALITY</b>                   | 692           | 68,407  | 612           | 61,783  | 80       | 6,624   | 13.1%  | 10.7%  |
| <b>CLARION</b>                   | 157           | 23,262  | 155           | 23,543  | 2        | (281)   | 1.3%   | (1.2)% |
| <b>SLEEP</b>                     | 320           | 24,133  | 317           | 24,169  | 3        | (36)    | 0.9%   | (0.1)% |
| <b>MAINSTAY</b>                  | 27            | 2,047   | 28            | 2,189   | (1)      | (142)   | (3.6)% | (6.5)% |
| <b>SUBURBAN</b>                  | 64            | 8,439   |               |         | 64       | 8,439   | NM     | NM     |
| <b>ECONO LODGE</b>               | 825           | 50,673  | 795           | 49,741  | 30       | 932     | 3.8%   | 1.9%   |
| <b>RODEWAY</b>                   | 203           | 12,469  | 169           | 10,381  | 34       | 2,088   | 20.1%  | 20.1%  |
| <b>TOTAL DOMESTIC FRANCHISES</b> | 4,116         | 332,656 | 3,926         | 317,477 | 190      | 15,179  | 4.8%   | 4.8%   |

As of June 30, 2006, the Company had 687 franchised hotels with 53,765 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 471 hotels and 36,058 rooms at June 30, 2005. The Company had an additional 65 franchised hotels with 5,993 rooms under development in its international system as of June 30, 2006 compared to 92 hotels and 8,329 rooms at June 30, 2005. 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.

Net domestic franchise additions during the three months ended June 30, 2006 were 46 compared to 58 for the same period a year ago. Gross domestic franchise additions increased from 102 for the three months ended June 30, 2005 to 114 for the same period of 2006. Net franchise terminations increased to 68 for the three months ended June 30, 2006 from 44 in the same period of 2005. During the second quarter of 2006, 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. This strategy has resulted in a slightly lower annual growth rate in our domestic franchised rooms than historically achieved. As the competition gets stronger and more focused on limited service franchising, the Company will continue to focus on improving its system hotels and utilizing the domestic hotels under development as a strong platform for continued system growth.

Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise agreements decreased 5% to \$3.7 million for the three months ended June 30, 2006 from \$3.9 million for the three months ended June 30, 2005. The Company executed 155 new domestic franchise agreements in the three months ended June 30, 2006 representing 12,956 rooms compared to 173 agreements representing 14,432 rooms executed in the three months ended June 30, 2005, both decreases of 10%. During the three months ended June 30, 2006, 58 of the executed agreements were for new construction hotel franchises, representing 4,320 rooms, compared to 59 contracts, representing 4,629 rooms for the same period a year ago, decreases of approximately 2% and 7%, respectively. As a result of the continued positive lodging industry cycle, conversion hotel franchise executed contracts declined 15% from 114 for the three months ended June 30, 2005 to 97 for the quarter ended June 30, 2006. During the three months ended June 30, 2006, the Company executed 5 new franchise agreements for its Cambria brand bringing the total contracts executed since its launch in January 2005 to 28. A summary of executed domestic franchise agreements by brand for the three months ended June 30, 2006 and 2005 is as follows:

|                       | For the Three Months Ended<br>June 30, 2006 |            |       | For the Three Months Ended<br>June 30, 2005 |            |       | % Change            |            |       |
|-----------------------|---|------------|-------|---|------------|-------|---------------------|------------|-------|
|                       | New<br>Construction                         | Conversion | Total | New<br>Construction                         | Conversion | Total | New<br>Construction | Conversion | Total |
| <b>COMFORT INN</b>    | 9   | 5          | 14    | 12  | 15         | 27    | (25)%               | (67)%      | (48)% |
| <b>COMFORT SUITES</b> | 29  | 2          | 31    | 16  | 3          | 19    | 81%                 | (33)%      | 63%   |
| <b>QUALITY</b>        | 3   | 32         | 35    | 1   | 42         | 43    | 200%                | (24)%      | (19)% |
| <b>CLARION</b>        |   | 9          | 9     |   | 5          | 5     | NM                  | 80%        | 80%   |

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|                              |           |           |            |           |              |            |               |              |              |
|------------------------------|-----------|-----------|------------|-----------|--------------|------------|---------------|--------------|--------------|
| <b>SLEEP</b>                 | <b>7</b>  | <b>7</b>  | <b>15</b>  | <b>15</b> | <b>(53)%</b> | <b>NM</b>  | <b>(53)%</b>  |              |              |
| <b>MAINSTAY</b>              | <b>1</b>  | <b>1</b>  | <b>9</b>   | <b>9</b>  | <b>(89)%</b> | <b>NM</b>  | <b>(89)%</b>  |              |              |
| <b>SUBURBAN</b>              | <b>3</b>  | <b>2</b>  | <b>5</b>   |           | <b>NM</b>    | <b>NM</b>  | <b>NM</b>     |              |              |
| <b>CAMBRIA SUITES</b>        | <b>5</b>  | <b>5</b>  | <b>5</b>   | <b>5</b>  | <b>0%</b>    | <b>NM</b>  | <b>0%</b>     |              |              |
| <b>ECONO LODGE</b>           |           | <b>14</b> | <b>14</b>  | <b>1</b>  | <b>33</b>    | <b>34</b>  | <b>(100)%</b> | <b>(58)%</b> | <b>(59)%</b> |
| <b>RODEWAY</b>               | <b>1</b>  | <b>33</b> | <b>34</b>  |           | <b>16</b>    | <b>16</b>  | <b>NM</b>     | <b>106%</b>  | <b>113%</b>  |
| <b>TOTAL DOMESTIC SYSTEM</b> | <b>58</b> | <b>97</b> | <b>155</b> | <b>59</b> | <b>114</b>   | <b>173</b> | <b>(2)%</b>   | <b>(15)%</b> | <b>(10)%</b> |

Relicensing fees increased 11% to \$3.0 million for the three months ended June 30, 2006 from \$2.7 million for the three months ended June 30, 2005. Relicensing fees are charged to the new property owner of a franchised property whenever an ownership change occurs and the property remains in the franchise system. During the three months ended June 30, 2006, relicensings increased 10% from 83 in the second quarter of 2005 to 91 for the three months ended June 30, 2006.

Partner services revenue increased 7% to \$4.9 million resulting primarily from increased vendor sponsorship of our annual franchisee convention. Other income increased \$1.0 million to \$1.8 million for the three months ended June 30, 2006 primarily due to an increase in liquidated damage collections related to the early termination of franchise agreements.

**Table of Contents**

*Franchise Expenses:* The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative ( SG&A ) expenses were \$22.2 million for the three months ended June 30, 2006, an increase of \$3.0 million from the three months ended June 30, 2005 total of \$19.2 million. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 33.4% for the three months ended June 30, 2006 compared to 32.8% for the three months ended June 30, 2005. Expenses increased primarily due to higher compensation costs related to stock compensation, the launch of the Company's Cambria Suites brand and the acquisition of Suburban.

*Depreciation and Amortization:* Expenses increased \$0.4 million to \$2.6 million for the three months ended June 30, 2006 due to the acceleration of depreciation resulting from the renovation and replacement of furniture, fixtures and equipment at two of the Company-owned Mainstay Suites.

*Marketing and Reservations:* The Company's franchise agreements require the payment of franchise fees, which include marketing and reservation fees. The fees, which are 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.

Total marketing and reservations revenues were \$72.7 million and \$62.6 million for the three months ended June 30, 2006 and 2005, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$2.0 million and \$1.9 million for the three months ended June 30, 2006 and 2005, respectively. Interest expense attributable to reservation activities was \$0.2 million and \$0.3 million for the three months ended June 30, 2006 and 2005, respectively. Marketing and reservation activities generated \$0.7 million of positive operating cash flow for the six months ended June 30, 2006. Cash advances for marketing and reservations activities totaled \$5.8 million for the six months ended June 30, 2005. As of June 30, 2006, the Company's balance sheet includes a receivable of \$16.6 million for marketing fees and a payable of \$3.7 million for reservation fees. At December 31, 2005, the Company's balance sheet contained a receivable for marketing fees of \$13.2 million and a payable of \$3.6 million for reservation fees. This receivable is 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 reservations 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. Cumulative reservation and marketing fees not expended are recorded as a payable in the financial statements and are carried over to the next period and expended in accordance with the franchise agreements.

*Other Income and Expenses:* Other income and expense, net, increased \$1.1 million to an expense of \$4.4 million for the three months ended June 30, 2006 from \$3.3 million for the same period in 2005. This increase resulted primarily from a \$0.3 million decline in fair value of investments held in non-qualified employee benefit plans versus a \$0.3 million appreciation of these investments in the prior year period and a loss on extinguishment of debt of \$0.3 million attributable to the refinancing of our senior credit facility during 2006. In addition, interest expense increased \$0.2 million due to an increase in short-term borrowing rates. The Company's weighted average interest rate as of June 30, 2006 was 6.34% compared to 5.04% as of June 30, 2005.

*Income Taxes:* The Company's effective income tax provision rate was 36.0% for the three months ended June 30, 2006, a decrease of 90 basis points from the effective income tax provision rate of 36.9% for the three months ended June 30, 2005. The effective income tax rate declined primarily due to an increase in the proportion of foreign income earned over the prior year period, which is taxed at lower rates than statutory federal income tax rates. The 2006 and 2005 effective income tax rates include \$0.3 million and \$0.2 million of provisions for income tax contingencies, respectively. Depending upon the outcome of certain income tax contingencies during the third and fourth quarter of 2006 up to \$13.7 million and \$0.4 million, respectively, of additional income tax benefits may be reflected in our 2006 results of operations from the reversal of reserves.

Net income for the three months ended June 30, 2006 increased by 12.0% to \$24.1 million, and diluted earnings per share increased 12.5% to \$0.36 for the three months ended June 30, 2006 from \$0.32 reported for the three months ended June 30, 2005.

**Comparison of Operating Results for the Six-Month Periods Ended June 30, 2006 and June 30, 2005**

The Company recorded net income of \$41.8 million for the six months ended June 30, 2006, an increase of \$8.3 million, or 25% from \$33.5 million for the same period in 2005. The increase in net income for the six months ended June 30, 2006 is primarily attributable to a \$12.5 million improvement in operating income and a decline in the effective income tax rate from 36.8% to 35.4%. The effective income tax rate declined primarily due to an increase in the proportion of foreign income earned over the prior year period, which is taxed at lower rates than statutory U.S. income tax rates. Operating income increased as a result of a \$17.3 million, or 17.4% increase in franchising revenues (total

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revenues excluding marketing and reservation revenues and hotel operations) partially offset by a \$4.6 million increase in selling, general and administrative expense. The \$0.8 million increase in net other income and expenses, net, was primarily related to a \$0.3 million loss on extinguishment of debt in the second quarter of 2006 and additional interest expense due to an increase in the Company's short-term borrowing rates, offset by increases in investment income earned on assets held in the Company's non-qualified employee benefit plans.

**Table of Contents**

Summarized financial results for the six months ended June 30, 2006 and 2005 are as follows:

(in thousands, except per share amounts)

|  | 2006             | 2005             |
|--|------------------|------------------|
| <b>REVENUES:</b>                                   |                  |                  |
| Royalty fees                                       | \$ 93,010        | \$ 80,157        |
| Initial franchise and relicensing fees             | 12,366           | 10,902           |
| Partner services                                   | 7,682            | 7,236            |
| Marketing and reservation                          | 130,718          | 111,653          |
| Hotel operations                                   | 2,160            | 2,061            |
| Other  | 4,022            | 1,454            |
| <b>Total revenues</b>                              | <b>249,958</b>   | <b>213,463</b>   |
| <b>OPERATING EXPENSES:</b>                         |                  |                  |
| Selling, general and administrative                | 40,517           | 35,952           |
| Depreciation and amortization                      | 4,991            | 4,581            |
| Marketing and reservation                          | 130,718          | 111,653          |
| Hotel operations                                   | 1,545            | 1,561            |
| <b>Total operating expenses</b>                    | <b>177,771</b>   | <b>153,747</b>   |
| <b>Operating income</b>                            | <b>72,187</b>    | <b>59,716</b>    |
| <b>OTHER INCOME AND EXPENSES:</b>                  |                  |                  |
| Interest expense                                   | 8,084            | 7,479            |
| Interest and other investment income               | (530)            | (273)            |
| Equity in net income of affiliates                 | (388)            | (354)            |
| Loss on extinguishment of debt                     | 342              |                  |
| Other  |                  | (186)            |
| <b>Total other income and expenses, net</b>        | <b>7,508</b>     | <b>6,666</b>     |
| <b>Income before income taxes</b>                  | <b>64,679</b>    | <b>53,050</b>    |
| <b>Income taxes</b>                                | <b>22,878</b>    | <b>19,503</b>    |
| <b>Net income</b>                                  | <b>\$ 41,801</b> | <b>\$ 33,547</b> |
| <b>Weighted average shares outstanding diluted</b> | <b>66,925</b>    | <b>66,498</b>    |
| <b>Diluted earnings per share</b>                  | <b>\$ 0.62</b>   | <b>\$ 0.50</b>   |

*Franchising Revenues:* Franchising revenues were \$117.1 million for the six months ended June 30, 2006 compared to \$99.7 million for the six months ended June 30, 2005. The growth in franchising revenues is primarily due to increases in royalty revenues, initial and relicensing fees and other revenues of 16%, 13% and 177%, respectively.

Royalty fees increased \$12.8 million to \$93.0 million from \$80.2 million in the six months ended June 30, 2005, an increase of 16.0%. Excluding the franchises obtained in the acquisition of Suburban, the increase in royalties is attributable to a combination of factors including a 2.1% increase in the number of domestic franchised hotel rooms, an 8.4% increase in RevPAR from \$33.32 to \$36.12 and an increase in the effective royalty rate of the domestic hotel system to 4.10% from 4.08%. The acquisition of Suburban contributed approximately \$1.5 million of royalty fees in the six months ended June 30, 2006.

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

|                               | For the Six Months Ended |              |                 | For the Six Months Ended |           |          | Change        |           |        |
|-------------------------------|--------------------------|--------------|-----------------|--------------------------|-----------|----------|---------------|-----------|--------|
|                               | June 30, 2006            |              |                 | June 30, 2005            |           |          |               |           |        |
|                               | Average Daily            |              |                 | Average Daily            |           |          | Average Daily |           |        |
|                               | Rate                     | Occupancy    | RevPAR          | Rate                     | Occupancy | RevPAR   | Rate          | Occupancy | RevPAR |
| <b>Comfort Inn</b>            | <b>\$ 69.76</b>          | <b>57.9%</b> | <b>\$ 40.40</b> | \$ 65.58                 | 55.7%     | \$ 36.51 | 6.4%          | 220 bps   | 10.7%  |
| <b>Comfort Suites</b>         | <b>81.30</b>             | <b>64.3%</b> | <b>52.24</b>    | 75.65                    | 61.5%     | 46.52    | 7.5%          | 280 bps   | 12.3%  |
| <b>Quality</b>                | <b>64.26</b>             | <b>50.8%</b> | <b>32.63</b>    | 62.17                    | 49.5%     | 30.78    | 3.4%          | 130 bps   | 6.0%   |
| <b>Clarion</b>                | <b>77.11</b>             | <b>48.1%</b> | <b>37.11</b>    | 71.87                    | 47.8%     | 34.35    | 7.3%          | 30 bps    | 8.0%   |
| <b>Sleep</b>                  | <b>64.64</b>             | <b>58.6%</b> | <b>37.87</b>    | 60.39                    | 56.4%     | 34.06    | 7.0%          | 220 bps   | 11.2%  |
| <b>Mainstay</b>               | <b>66.48</b>             | <b>63.7%</b> | <b>42.33</b>    | 62.37                    | 60.6%     | 37.80    | 6.6%          | 310 bps   | 12.0%  |
| <b>Econo Lodge</b>            | <b>50.52</b>             | <b>43.3%</b> | <b>21.89</b>    | 48.13                    | 43.6%     | 21.00    | 5.0%          | (30) bps  | 4.2%   |
| <b>Rodeway</b>                | <b>48.57</b>             | <b>41.9%</b> | <b>20.33</b>    | 46.22                    | 43.4%     | 20.05    | 5.1%          | (150) bps | 1.4%   |
| <b>Total Domestic System*</b> | <b>\$ 67.21</b>          | <b>53.7%</b> | <b>\$ 36.12</b> | \$ 63.51                 | 52.5%     | \$ 33.32 | 5.8%          | 120 bps   | 8.4%   |

\* Amounts exclude Suburban activity from January 1, 2006 through June 30, 2006 because comparable pre-acquisition data for the six months ended June 30, 2005 is not available.

Net domestic franchise additions during the six months ended June 30, 2006 were 68 compared to 92 for the same period a year ago. Gross domestic franchise additions declined from 190 for the six months ended June 30, 2005 to 186 for the same period of 2006. Net franchise terminations increased to

**Table of Contents**

118 for the six months ended June 30, 2006 from 98 in the same period of 2005. During the first six months of 2006, 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. This strategy has resulted in a slightly lower annual growth rate in our domestic franchised rooms than historically achieved. As the competition gets stronger and more focused on limited service franchising, the Company will continue to focus on improving its system hotels and utilizing the domestic hotels under development as a strong platform for continued system growth.

Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise agreements increased 8% to \$6.8 million for the six months ended June 30, 2006 from \$6.3 million for the six months ended June 30, 2005. The increased revenues reflect increased sales of our new construction brands, most notably with our Cambria Suites and Comfort Suites offerings, which carry a higher average initial fee than our conversion brands. New domestic franchise agreements executed in the six months ended June 30, 2006 totaled 275 representing 23,648 rooms compared to 276 agreements representing 23,238 rooms executed in the six months ended June 30, 2005. During the six months ended June 30, 2006, 106 of the executed agreements were for new construction hotel franchises, representing 8,337 rooms, compared to 93 contracts, representing 7,055 rooms for the same period a year ago, increases of approximately 14% and 18%, respectively. As a result of the continued positive lodging industry cycle, conversion hotel franchise executed contracts declined 8% from 183 for the six months ended June 30, 2005 to 169 for the same period of 2006. During the six months ended June 30, 2006, the Company executed 15 new franchise agreements for its Cambria brand bringing the total contracts executed since its launch in January 2005 to 28. A summary of executed domestic franchise agreements by brand for the six months ended June 30, 2006 and 2005 is as follows:

|                              | For the Six Months Ended<br>June 30, 2006 |            |            | For the Six Months Ended<br>June 30, 2005 |            |            | % Change            |             |           |
|------------------------------|---|------------|------------|---|------------|------------|---------------------|-------------|-----------|
|                              | New<br>Construction                       | Conversion | Total      | New<br>Construction                       | Conversion | Total      | New<br>Construction | Conversion  | Total     |
| COMFORT INN                  | 24  | 18         | 42         | 20  | 25         | 45         | 20%                 | (28)%       | (7)%      |
| COMFORT SUITES               | 41  | 2          | 43         | 29  | 3          | 32         | 41%                 | (33)%       | 34%       |
| QUALITY                      | 5   | 57         | 62         | 2   | 72         | 74         | 150%                | (21)%       | (16)%     |
| CLARION                      | 1   | 18         | 19         | 1   | 8          | 9          | 0%                  | 125%        | 111%      |
| SLEEP                        | 10  |            | 10         | 22  | 1          | 23         | (55)%               | (100)%      | (57)%     |
| MAINSTAY                     | 3   | 1          | 4          | 9   |            | 9          | (67)%               | NM          | (56)%     |
| SUBURBAN                     | 6   | 2          | 8          |   |            |            | NM                  | NM          | NM        |
| CAMBRIA SUITES               | 15  |            | 15         | 6   |            | 6          | 150%                | NM          | 150%      |
| ECONO LODGE                  |   | 23         | 23         | 4   | 49         | 53         | (100)%              | (53)%       | (57)%     |
| RODEWAY                      | 1   | 48         | 49         |   | 25         | 25         | NM                  | 92%         | 96%       |
| <b>TOTAL DOMESTIC SYSTEM</b> | <b>106</b>                                | <b>169</b> | <b>275</b> | <b>93</b>                                 | <b>183</b> | <b>276</b> | <b>14%</b>          | <b>(8)%</b> | <b>0%</b> |

Relicensing fees increased 22% to \$5.6 million for the six months ended June 30, 2006 from \$4.6 million for the six months ended June 30, 2005. Relicensing fees are charged to the new property owner of a franchised property whenever an ownership change occurs and the property remains in the franchise system. During the six months ended June 30, 2006, relicensings increased 19% from 145 in the first half of 2005 to 173 for the six months ended June 30, 2006.

Other income increased \$2.6 million to \$4.0 million for the six months ended June 30, 2006 primarily due to an increase in liquidated damage collections related to the early termination of franchise agreements.

*Franchise Expenses:* The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative ( SG&A ) expenses were \$40.5 million for the six months ended June 30, 2006, an increase of \$4.5 million from the six months ended June 30, 2005 total of \$36.0 million. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 34.6% for the six months ended June 30, 2006 compared to 36.0% for the six months ended June 30, 2005. Expenses increased primarily due to higher compensation costs related to stock compensation, the launch of the Company's Cambria Suites brand and the acquisition of Suburban. Despite the increase in expenses, SG&A as a percentage of franchise revenues declined since our variable overhead costs associated with franchise system growth have historically been less than incremental royalty fees generated from new franchises.

*Depreciation and Amortization:* Expenses increased \$0.4 million to \$5.0 million for the six months ended June 30, 2006 due to the acceleration of depreciation resulting from the renovation and replacement of furniture, fixtures and equipment at two of the Company-owned Mainstay Suites during the second quarter.

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*Marketing and Reservations:* The Company's franchise agreements require the payment of franchise fees, which include marketing and reservation fees. The fees, which are 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.

Total marketing and reservations revenues were \$130.7 million and \$111.7 million for the six months ended June 30, 2006 and 2005, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$3.9 million for both the six months ended June 30, 2006 and 2005. Interest expense attributable to reservation activities was \$0.4 million and \$0.5 million for the six months ended June 30, 2006 and 2005, respectively.

*Other Income and Expenses:* Other income and expenses, net, increased \$0.8 million to an expense of \$7.5 million for the six months ended June 30, 2006 from \$6.7 million for the same period in 2005. This increase resulted primarily from a \$0.6 million increase in interest expense resulting from higher average interest rates on the Company's variable rate debt and a loss on extinguishment of debt of \$0.3 million attributable to the refinancing of our senior credit facility during the second quarter of 2006, offset by an increase of \$0.3 million in the appreciation of investments held in non-qualified employee benefit plans versus the prior year period. The Company's weighted average interest rate as of June 30, 2006 was 6.34% compared to 5.04% as of June 30, 2005.

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**Table of Contents**

*Income Taxes:* The Company's effective income tax provision rate was 35.4% for the six months ended June 30, 2006, a decrease of 140 basis points from the effective income tax provision rate of 36.8% for the six months ended June 30, 2005. The effective income tax rate declined primarily due to an increase in the proportion of foreign income earned over the prior year period, which is taxed at lower rates than statutory federal income tax rates. The 2006 and 2005 effective income tax rates include \$0.2 million and \$0.5 million of provisions for income tax contingencies, respectively. Depending upon the outcome of certain income tax contingencies during the third and fourth quarter of 2006 up to \$13.7 million and \$0.4 million, respectively, of additional income tax benefits may be reflected in our 2006 results of operations from the reversal of reserves.

Net income for the six months ended June 30, 2006 increased by 24.6% to \$41.8 million, and diluted earnings per share increased 24.0% to \$0.62 for the six months ended June 30, 2006 from \$0.50 reported for the six months ended June 30, 2005.

**Liquidity and Capital Resources**

Net cash provided by operating activities was \$62.5 million and \$63.3 million for the six months ended June 30, 2006 and 2005, respectively. Cash flows from operating activities declined primarily due to the reclassification of excess tax benefits from stock-based compensation from operating to financing activities due to the adoption of SFAS No.123R beginning on January 1, 2006. Operating cash flows for the six months ended June 30, 2005 included \$6.0 million of these tax benefits. Excluding these amounts, net cash flow provided by operating activities increased by \$5.2 million primarily due to improvements in operating income over the prior year period.

Net cash provided related to marketing and reservation activities totaled \$0.7 million during the six months ended June 30, 2006 compared to net cash advances of \$5.8 million during the six months ended June 30, 2005. The increase in cash flows from marketing and reservation activities relates primarily to the timing of advertising and promotional costs spending versus the prior year. The Company expects marketing and reservation activities to generate positive cash flows of between \$9 million and \$13 million in 2006.

Cash used in investing activities for the six months ended June 30, 2006 and 2005 was \$9.5 million and \$10.8 million, respectively. As a lodging franchisor, Choice has relatively low capital expenditure requirements. During the six months ended June 30, 2006 and 2005, capital expenditures totaled \$4.0 million and \$8.0 million, respectively. Capital expenditures primarily include renovations of the Company's three owned MainStay Suites and the installation and upgrades of system-wide property and yield management systems.

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 proceeds from the Revolver were used to refinance and terminate the revolving credit facility under the Company's existing senior credit facility (the "Old Credit Facility"). 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 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 are, 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 1/2 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 1/2 basis points, on the amount outstanding under the commitment, 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, 2006, the Company had \$124.1 million of revolving loans outstanding pursuant to the Revolver.

In 1998, the Company completed a \$100 million senior unsecured note offering (the "Senior Notes"), bearing a coupon rate of 7.13% with an effective rate of 7.22%. The Senior Notes will mature on May 1, 2008, with interest to be paid semi-annually. The Company used the net proceeds from the offering of approximately \$99 million to repay amounts outstanding under the Company's previous credit facility. The Senior Notes contain a call provision that would require the Company to pay a premium if the Senior Notes were redeemed prior to their maturity.

Effective July 14, 2006, the Company's Senior Notes are guaranteed fully and unconditionally by 7 wholly-owned subsidiaries. Choice Hotels International, Inc. along with these subsidiaries represent approximately 95% of the Company's revenues and operating income. There are no legal or regulatory restrictions on the payment of dividends to Choice Hotels International, Inc. from subsidiaries that do not guarantee the Senior Notes.

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The Company has a line of credit with a bank providing up to an aggregate of \$10 million of borrowings which is due upon demand. The line of credit ranks pari-pasu (or equally) with the Revolver. Borrowings under the line of credit bear interest at rates established at the time of the borrowings based on prime minus 175 basis points. As of June 30, 2006, no amounts were outstanding pursuant to this line of credit.

As of June 30, 2006, the total debt outstanding for the Company was \$224.5 million, of which \$0.1 million was scheduled to mature in the twelve months ending June 30, 2007.

Through June 30, 2006, the Company had purchased 33.6 million shares (including 33.0 million prior to the two-for-one stock split) of its common stock under its share repurchase program at a total cost of \$711.9 million. Considering the effect of the two-for-one stock split in October 2005, the Company has repurchased 66.6 million shares at an average price of \$10.69 per share. The Company did not purchase any shares under its repurchase program during the six months ended June 30, 2006. At June 30, 2006, the Company had approximately 66.3 million shares of common stock outstanding and had remaining authorization to purchase up to 5.1 million shares.

In the fourth quarter of 2003, the Company initiated a cash dividend on its common stock. In September 2004, the Company's board of directors increased the quarterly dividend rate to \$0.1125, a 12.5% increase from the previous quarterly rate of \$0.10. This increase raised the annual dividend rate on the Company's common stock from \$0.40 to \$0.45 per share. In September 2005, the Company's board of directors again increased the quarterly dividend

## **Table of Contents**

rate to \$0.13, a 15.6% increase from the previous quarter rate of \$0.1125. This increase raised the annual dividend rate on the Company's common stock from \$0.45 to \$0.52 per share. Dividends paid in the first six months of 2006 were approximately \$16.9 million and we expect dividends in 2006 to be approximately \$34.1 million.

The Company expects to continue to return value to its shareholders through a combination of dividends and share repurchases, subject to market conditions.

The Company believes that cash flows from operations and available financing capacity are adequate to meet 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 and 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, 2005 included in our Annual Report on Form 10-K.

### *Revenue Recognition.*

We recognize continuing franchise fees, including royalty, marketing and reservations 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 selling, general and administrative expense.

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 has no continuing obligations related to the franchisee. 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.

We account for partner services revenues from endorsed vendors in accordance with Staff Accounting Bulletin No. 104, ( SAB 104 ) Revenue Recognition. SAB 104 provides guidance on the recognition, presentation and disclosure of revenue in financial statements. Pursuant to SAB 104, the Company recognizes partner services revenues when the services are performed or the product delivered, evidence of an arrangement exists, the fee is fixed and determinable and collectibility is probable. We defer the recognition of partner 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 records marketing and reservation revenues and expenses in accordance with Emerging Issues Task Force ( EITF ) Issue No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, which requires that these revenues and expenses be recorded gross. 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 fee receivable is mitigated due to our contractual right to recover these amounts from a large geographically dispersed group of franchisees.

Choice Privileges is our frequent guest incentive marketing program. Choice Privileges enables members to earn points based on their spending levels at participating brands and, to a lesser degree, through participation in affiliated partners' programs, such as those offered by credit card companies. The points may be redeemed for free accommodations or other benefits. Points cannot be redeemed for cash.

The Company collects a percentage of program members' room revenue from participating franchises. Revenues are deferred in an amount equal to the 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 for outstanding points. Upon redemption of the points, the Company recognizes the previously deferred revenue as well as the corresponding expense relating to the cost of the awards redeemed. Revenues in excess

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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.*

We evaluate the fair value of goodwill to assess potential impairments 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. We evaluate impairment of goodwill by comparing the fair value of our net assets with the carrying amount of goodwill. We evaluate the potential impairment of property and equipment and other long-lived assets, including franchise rights whenever an event or other circumstance indicates that we may not be able to recover the carrying value of the asset. Our evaluation is based upon future cash flow projections. These projections reflect management's best assumptions and estimates. Significant management judgment is involved in developing these projections, and they include inherent uncertainties. If different projections had been used in the current period, the balances for non-current assets could have been 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 reviews outstanding notes receivable on a periodic basis to ensure that each is fully collectible by reviewing the financial condition of its debtors. If the Company concludes that it will be unable to collect all amounts due, the Company will record an impairment charge.

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## **Table of Contents**

### *Stock Compensation.*

In December 2004, the FASB issued SFAS No. 123 (Revised 2004), *Share-Based Payment* ( SFAS No. 123R ). SFAS No. 123R requires that the compensation cost relating to share based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. Effective January 1, 2006, the Company adopted SFAS No. 123R using the modified prospective application method and began applying its provisions to (i) new awards, (ii) awards modified subsequent to the adoption date, (iii) any outstanding awards for which all requisite service has not yet been rendered. Under the modified-prospective application method, compensation costs will be recognized on the unvested portion of awards at January 1, 2006 based on the grant-date fair value used for pro-forma disclosures under SFAS No. 148 *Accounting for Stock-Based Compensation-Transition and Disclosure* over the remaining vesting period. Under this transition method, prior period results have not been restated. The adoption of SFAS No. 123R reduced both operating income and net income by approximately \$0.1 million for the three months ended June 30, 2006 and \$0.3 million and \$0.2 million for the six months ended June 30, 2006, respectively. The adoption did not have a material impact on reported earnings per share or the Company's financial statements since the Company has been expensing share-based awards granted since January 1, 2003 under the provisions of SFAS No. 123. Prior to January 1, 2003, the Company accounted for stock-based awards under APB Opinion No. 25 *Accounting for Stock Issued to Employees* ( APB No. 25 ).

Prior to the adoption of SFAS No. 123R, no stock-based compensation cost was reflected in the accompanying consolidated statements of income related to the grant of stock options which occurred prior to January 1, 2003, because the Company accounted for those grants under APB Opinion No. 25 and all such stock options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. Therefore, the cost related to stock-based employee compensation included in the determination of net income for the six months ended June 30, 2005 is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective date of SFAS 123. The effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 148 to all stock compensation for the three and six months ended June 30, 2005 is set forth in Note 3 to our consolidated financial statements.

### *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.

The Company does not provide additional United States income taxes on undistributed earnings of consolidated foreign subsidiaries included in retained earnings. 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 or to be repatriated only when required for domestic business operations, tax or cash reasons.

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.

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, we believe that recorded tax liabilities adequately account for our analysis of probable outcomes.

In March 2006, the EITF issued EITF Issue 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)*. A tentative consensus was reached that a company should disclose its accounting policy (i.e. gross or net presentation) regarding the presentation of taxes within the scope of EITF 06-3 in the income statement. If taxes are significant, a company should disclose its policy of presenting taxes. In addition, for any such taxes that are reported on a gross basis, the company should disclose the amounts of those taxes. The guidance is effective for periods beginning after December 15, 2006. We present company sales net of sales taxes. This issue will not impact the method for recording these sales taxes in our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes* (an interpretation of FASB Statement No. 109) which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We are currently evaluating the potential impact of this interpretation.

## **FORWARD-LOOKING STATEMENTS**

Certain statements contained in this quarterly report, including those in the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operation that are not historical facts constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act. Words such as believes, anticipates, expects, intends, estimates, projects, and other similar expressions, are predictions of or indicate future events and trends, typically identify forward-looking statements. Such statements are subject to a number of risks and uncertainties which could cause actual results to differ materially from those projected, including: competition; business strategies and their intended results; the balance between supply of and demand for hotel rooms; our ability to obtain new franchise agreements; our ability to develop and maintain positive relations with current and potential hotel owners; the effect of international, national and regional economic conditions and geopolitical events such as acts of god, acts of war, terrorism or epidemics; the availability of capital to allow us and potential hotel owners to fund investments and construction of hotels; the cost and other effects of legal proceedings; and other risks described from time to time in our filings with the Securities and Exchange Commission, including those set forth under Risk Factors in our Report on Form 10-K for the year ended December 31, 2005. Given these uncertainties, you are cautioned not to place undue reliance on such statements. We also undertake no obligation to publicly update or revise any forward-looking statement to reflect current or future events or circumstances.

### **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. The Company does not foresee any significant changes in exposure in these areas or in how such exposure is managed in the near future.

**Table of Contents**

At June 30, 2006 and December 31, 2005, the Company had \$224.5 million and \$274.1 million of debt outstanding at an effective interest rate of 6.3% and 6.0%, respectively. A hypothetical change of 10% in the Company's effective interest rate from June 30, 2006 levels would increase or decrease annual interest expense by \$0.7 million. Prior to scheduled maturities, the Company expects to refinance its long-term debt obligations.

The Company does not presently have any derivative financial instruments.

**ITEM 4. CONTROLS AND PROCEDURES**

The Company formed 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 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, 2006.

There has been no change in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2006 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**

Incorporated by reference to the description of legal proceedings in the Commitments and Contingencies footnote in the financial statements set forth in Part I. Financial Information.

**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, 2005, 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.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES****Issuer Purchases of Equity Securities**

The following table sets forth purchases of Choice Hotels International, Inc. common stock made by the Company during the six months ended June 30, 2006.

| Month Ending      | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that may yet be Purchased Under the Plans or Programs, End of Period |
|-------------------|----------------------------------|------------------------------|--|---|
| January 31, 2006  | 813                              | \$ 42.16                     |  | 5,102,701   |
| February 28, 2006 | 25,981                           | 47.81                        |  | 5,102,701   |
| March 31, 2006    |                                  |                              |  | 5,102,701   |
| April 30, 2006    |                                  |                              |  | 5,102,701   |
| May 31, 2006      |                                  |                              |  | 5,102,701   |
| June 30, 2006     |                                  |                              |  | 5,102,701   |

|       |        |          |           |
|-------|--------|----------|-----------|
| Total | 26,794 | \$ 47.64 | 5,102,701 |
|-------|--------|----------|-----------|

During the six months ended June 30, 2006, the Company purchased 26,794 shares of common stock from employees to satisfy statutory minimum tax-withholding requirements from the vesting of restricted stock grants. These purchases were outside the share repurchase program initiated in June 1998.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**Table of Contents****ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

The Annual Meeting of Shareholders of the Company was held on May 1, 2006. At the meeting, Fiona Dias, Charles A. Ledsinger, Jr. and Larry R. Levitan were each elected to a three-year term expiring in 2009. Raymond E. Schultz ended his service after the Annual Meeting of Shareholders. The terms of the following directors continued after the meeting:

William L. Jews

John T. Schwieters

David C. Sullivan

Stewart Bainum, Jr.

Ervin R. Shames

Gordon A. Smith

The Company's shareholders voted to ratify the Board of Directors approval of the Choice Hotels International, Inc., 2006 Long-Term Incentive Plan ( 2006 LTIP ) and the appointment of PricewaterhouseCoopers LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2006.

The following table summarizes the results of the voting for each matter voted upon at the annual meeting.

|   | Votes Cast |           |          |             | Broker Non-Votes |
|---|------------|-----------|----------|-------------|------------------|
|   | For        | Against   | Withheld | Abstentions |                  |
| Election of Fiona Dias                                    | 60,370,208 |           | 140,091  |             |                  |
| Election of Charles A. Ledsinger, Jr.                     | 60,212,536 |           | 297,763  |             |                  |
| Election of Larry R. Levitan                              | 60,375,323 |           | 134,976  |             |                  |
| Ratification of the Approval of the 2006 LTIP             | 63,666,524 | 1,386,117 |          | 138,983     |                  |
| Ratification of Appointment of PricewaterhouseCoopers LLP | 60,443,106 | 28,397    |          | 38,795      |                  |

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS****(a) 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(a) | Amended and Restated Bylaws of Choice Hotels International, Inc.  |
| 4.01(l) | Senior Unsecured Revolving Credit Facility agreement dated June 16, 2006 among Choice Hotels International, Inc., Wachovia Bank, National Association, as Agents, SunTrust Bank, as Syndication Agent, Bank of America, N.A., as Documentation Agent, |

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Wachovia Capital Markets, LLC, as Lead Arranger and Sole Book Manager, and the additional lenders named in the credit agreement.

- 4.02(f) Registration Agreement dated April 28, 1998 between Choice Hotels International, Inc. and Salomon Brothers, Inc., Bear Stearns & Co. Inc. and Lehman Brothers Inc.
- 4.03(f) Indenture dated as of May 4, 1998, by and among Choice Hotels International, Inc., Quality Hotels Europe, Inc., QH Europe Partnership and Marine Midland Bank, as Trustee, with respect to the 7.125% Senior Notes due 2008.
- 4.04(f) Specimen certificate of 7.125% Senior Note due 2008 (Original Note) (Attached as an exhibit to the Indenture set forth as Exhibit 4.03)
- 4.05(f) Specimen certificate of 7.125% Senior Note due 2008 (Exchange Note) (Attached as an exhibit to the Indenture set forth as Exhibit 4.03)
- 4.07(m) Agreement to furnish certain debt agreements
- 10.01(n) Second Amended and Restated Employment Agreement between Choice Hotels International, Inc. and Charles A. Ledsinger, Jr. dated December 20, 2005
- 10.02(i) Amended and Restated Chairman's Service Agreement dated May 4, 2004 by and between Choice Hotels International, Inc. and Stewart Bainum, Jr.
- 10.03(d) Amended and Restated Employment Agreement dated April 13, 1999 by and between Choice Hotels International, Inc. and Thomas Mirgon
- 10.04(e) Choice Hotels International, Inc. 2006 Long-Term Incentive Plan
- 10.05(g) Second Amended and Restated Employment Agreement dated April 13, 1999 between Choice Hotels International, Inc. and Michael J. DeSantis
- 10.06(h) Commercial Lease dated May 29, 1998 among Columbia Pike I, LLC and Colesville Road, LLC (each an assignee of Manor Care, Inc.) and Choice Hotels International, Inc.
- 10.07(j) Employment Agreement dated June 3, 1999 between Choice Hotels International, Inc. and Joseph M. Squeri
- 10.08(k) Employment Agreement dated May 3, 2000 between Choice Hotels International, Inc. and Daniel Rothfeld
- 10.09(k) Employment Agreement dated August 18, 2000 between Choice Hotels International, Inc. and Wayne Wielgus

**Table of Contents**

|          |  |
|----------|--|
| 10.10(c) | Amended and Restated Supplemental Executive Retirement Plan  |
| 10.11(b) | Choice Hotels International, Inc. Executive Deferred Compensation Plan                                   |
| 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 |

\* 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 Annual Report on Form 10-K for the year ended December 31, 2002, filed March 31, 2003.
- (c) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2000, filed April 2, 2001.
- (d) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 1999, filed on June 4, 1999.
- (e) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Current Report on form 8-K dated May 1, 2006, filed on May 5, 2006.
- (f) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q filed for the quarterly period ended March 31, 1998, filed on May 15, 1998.
- (g) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q filed for the quarter ended June 30, 1998, filed on August 11, 1998.
- (h) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 1998, filed on March 30, 1999.
- (i) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2004, filed March 16, 2005.
- (j) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1999, filed on August 16, 1999.
- (k) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2000, filed November 14, 2000.
- (l) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Current Report on Form 8-K dated June 16, 2006, filed June 21, 2006.
- (m) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2005, filed March 16, 2006.
- (n) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Current Report on Form 8-K dated December 20, 2005, filed December 22, 2005.

**(b) Reports on Form 8-K**

The Company filed a report on Form 8-K, dated April 25, 2006, reporting that a press release had been issued reporting the Company s earnings for the quarter ended March 31, 2006.

The Company filed a report on Form 8-K, dated April 28, 2006, releasing a presentation presented at the Jefferies Gaming, Lodging, Media & Entertainment Conference held on May 8, 2006 in Las Vegas, NV.

The Company filed a report on Form 8-K dated May 1, 2006, reporting that at the Company s annual meeting of stockholders held May 1, 2006, the stockholders of the Company approved the Choice Hotels International, Inc., 2006 Long-Term Incentive Plan ( 2006 LTIP ). The 2006 LTIP replaced the 1997 Long-Term Incentive Plan, the 1997 Non-Employee Director Stock Compensation Plan, and the Non-Employee Director Stock Option and Deferred Compensation Stock Purchase Plan.

The Company filed a report on Form 8-K dated June 16, 2006, reporting that the Company entered into a \$350 million senior unsecured revolving credit agreement with a syndicate of lenders. The new credit facility replaced the Company s existing \$350 million senior unsecured revolving credit agreement dated as of July 2004.

**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 8, 2006

By: /s/ Joseph M. Squeri  
Joseph M. Squeri  
Executive Vice President, Operations and Chief Financial Officer

26