

CHOICE HOTELS INTERNATIONAL INC /DE

Form 10-Q

May 03, 2010

[Table of Contents](#)

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

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2010**

**OR**

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

**COMMISSION FILE NO. 001-13393**

**CHOICE HOTELS INTERNATIONAL, INC.**

(Exact name of registrant as specified in its charter)

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

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

**10750 COLUMBIA PIKE**

**SILVER SPRING, MD. 20901**

(Address of principal executive offices)

(Zip Code)

**(301) 592-5000**

(Registrant's telephone number, including area code)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

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

**SHARES OUTSTANDING AT MARCH 31, 2010**  
**59,558,393**

---

**Table of Contents**

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

**INDEX**

	<b>PAGE NO.</b>
<b>PART I. FINANCIAL INFORMATION:</b>	
Item 1. <u>Financial Statements (Unaudited)</u>	3
<u>Consolidated Statements of Income For the three months ended March 31, 2010 and 2009</u>	3
<u>Consolidated Balance Sheets As of March 31, 2010 and December 31, 2009</u>	4
<u>Consolidated Statements of Cash Flows For the three months ended March 31, 2010 and 2009</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	32
Item 4. <u>Controls and Procedures</u>	33
<b>PART II. OTHER INFORMATION:</b>	
Item 1. <u>Legal Proceedings</u>	33
Item 1A. <u>Risk Factors</u>	33
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	33
Item 3. <u>Defaults Upon Senior Securities</u>	33
Item 4. <u>(Removed and Reserved)</u>	33
Item 5. <u>Other Information</u>	34
Item 6. <u>Exhibits</u>	34
<b><u>SIGNATURE</u></b>	35

**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)**

	<b>Three Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>REVENUES:</b>		
Royalty fees	\$ 41,021	\$ 43,441
Initial franchise and relicensing fees	1,912	2,649
Procurement services	3,245	3,390
Marketing and reservation	58,840	62,042
Hotel operations	867	1,118
Other	1,536	1,518
<b>Total revenues</b>	<b>107,421</b>	<b>114,158</b>
<b>OPERATING EXPENSES:</b>		
Selling, general and administrative	21,816	21,461
Depreciation and amortization	2,172	2,115
Marketing and reservation	58,840	62,042
Hotel operations	756	785
<b>Total operating expenses</b>	<b>83,584</b>	<b>86,403</b>
<b>Operating income</b>	<b>23,837</b>	<b>27,755</b>
<b>OTHER INCOME AND EXPENSES, NET:</b>		
Interest expense	621	1,540
Interest and other investment (income) loss	(1,077)	832
Equity in net income of affiliates	(353)	(218)
<b>Total other income and expenses, net</b>	<b>(809)</b>	<b>2,154</b>
<b>Income before income taxes</b>	<b>24,646</b>	<b>25,601</b>
<b>Income taxes</b>	<b>8,853</b>	<b>9,293</b>
<b>Net income</b>	<b>\$ 15,793</b>	<b>\$ 16,308</b>
<b>Weighted average shares outstanding-basic</b>	<b>59,514</b>	<b>60,532</b>
<b>Weighted average shares outstanding-diluted</b>	<b>59,600</b>	<b>60,851</b>
<b>Basic earnings per share</b>	<b>\$ 0.27</b>	<b>\$ 0.27</b>

<b>Diluted earnings per share</b>	<b>\$ 0.26</b>	<b>\$ 0.27</b>
<b>Cash dividends declared per share</b>	<b>\$ 0.185</b>	<b>\$ 0.185</b>

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

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

	March 31, 2010	December 31, 2009
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 65,593	\$ 67,870
Receivables (net of allowance for doubtful accounts of \$7,170 and \$6,886, respectively)	41,642	41,898
Deferred income taxes	7,980	7,980
Other current assets	17,081	10,114
<b>Total current assets</b>	<b>132,296</b>	<b>127,862</b>
Property and equipment, at cost, net	45,159	43,627
Goodwill	66,040	65,813
Franchise rights and other identifiable intangibles, net	23,755	24,559
Receivable marketing and reservation fees	47,484	33,872
Investments, employee benefit plans, at fair value	22,319	20,931
Deferred income taxes	14,238	14,143
Other assets	9,349	9,230
<b>Total assets</b>	<b>\$ 360,640</b>	<b>\$ 340,037</b>
<b>LIABILITIES AND SHAREHOLDERS DEFICIT</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 37,287	\$ 33,859
Accrued expenses	26,506	37,074
Deferred revenue	60,934	51,765
Income taxes payable	10,821	6,310
Deferred compensation and retirement plan obligations	3,086	2,798
<b>Total current liabilities</b>	<b>138,634</b>	<b>131,806</b>
Long-term debt	293,900	277,700
Deferred compensation and retirement plan obligations	33,865	34,956
Other liabilities	9,195	9,787
<b>Total liabilities</b>	<b>475,594</b>	<b>454,249</b>
Commitments and Contingencies		
<b>SHAREHOLDERS DEFICIT</b>		
Common stock, \$0.01 par value, 160,000,000 shares authorized; 95,345,362 shares issued at March 31, 2010 and December 31, 2009 and 59,558,393 and 59,541,106 shares outstanding at March 31, 2010 and December 31, 2009, respectively	596	595
Additional paid-in capital	87,005	90,731
Accumulated other comprehensive income	339	333
Treasury stock (35,786,969 and 35,804,256 shares at March 31, 2010 and December 31, 2009, respectively), at cost	(872,147)	(870,302)

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

Retained earnings	<b>669,253</b>	664,431
<b>Total shareholders deficit</b>	<b>(114,954)</b>	(114,212)
<b>Total liabilities and shareholders deficit</b>	<b>\$ 360,640</b>	\$ 340,037

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

**Table of Contents****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(UNAUDITED, IN THOUSANDS)

	<b>Three Months Ended March 31</b>	
	<b>2010</b>	<b>2009</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 15,793	\$ 16,308
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,172	2,115
Provision for bad debts	856	350
Non-cash stock compensation and other charges	2,670	2,406
Non-cash interest and other (income) loss	(987)	949
Dividends received from equity method investments		166
Equity in net income of affiliates	(353)	(218)
Changes in assets and liabilities, net of acquisitions:		
Receivables	(435)	4,455
Receivable - marketing and reservation fees, net	(10,909)	(10,370)
Accounts payable	3,294	(9,095)
Accrued expenses	(10,611)	(8,708)
Income taxes payable/receivable	4,667	8,321
Deferred income taxes	(65)	
Deferred revenue	9,138	8,964
Other assets	(6,898)	456
Other liabilities	(1,352)	(5,643)
<b>Net cash provided by operating activities</b>	<b>6,980</b>	<b>10,456</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Investment in property and equipment	(4,558)	(2,068)
Acquisitions, net of cash acquired	(466)	
Issuance of notes receivable	(534)	(948)
Collections of notes receivable	10	2
Purchases of investments, employee benefit plans	(1,104)	(2,003)
Proceeds from sale of investments, employee benefit plans	522	1,149
Other items, net	(124)	(74)
<b>Net cash used in investing activities</b>	<b>(6,254)</b>	<b>(3,942)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net borrowings pursuant to revolving credit facility	16,200	25,400
Purchase of treasury stock	(8,936)	(19,308)
Excess tax benefits from stock-based compensation	49	694
Dividends paid	(10,945)	(11,157)
Proceeds from exercise of stock options	648	2,711
<b>Net cash used in financing activities</b>	<b>(2,984)</b>	<b>(1,660)</b>
<b>Net change in cash and cash equivalents</b>	<b>(2,258)</b>	<b>4,854</b>
<b>Effect of foreign exchange rate changes on cash and cash equivalents</b>	<b>(19)</b>	<b>(139)</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>67,870</b>	<b>52,680</b>



<b>Cash and cash equivalents at end of period</b>	<b>\$ 65,593</b>	\$ 57,395
---	------------------	-----------

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

Income taxes, net of refunds	<b>\$ 3,748</b>	\$ 230
Interest	<b>\$ 646</b>	\$ 1,893

**Non-cash financing activities:**

Declaration of dividends	<b>\$ 10,971</b>	\$ 11,167
Issuance of restricted shares of common stock	<b>\$ 8,163</b>	\$ 5,984
Issuance of performance vested restricted stock units	<b>\$ 256</b>	\$ 461
Issuance of treasury stock to employee stock purchase plan	<b>\$ 151</b>	\$ 161

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

**Table of Contents**

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

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

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

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

The preparation of consolidated financial statements in conformity with 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.

*Cash and Cash Equivalents*

The Company considers all highly liquid investments purchased with a maturity of three months or less at the date of purchase to be cash equivalents. As of March 31, 2010 and December 31, 2009, \$1.9 million and \$6.4 million, respectively, of book overdrafts representing outstanding checks in excess of funds on deposit are included in accounts payable in the accompanying consolidated balance sheets.

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

*Recently Adopted Accounting Guidance*

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

**Table of Contents****2. Notes Receivable**

	March 31, 2010	December 31, 2009
	(In thousands)	
Forgivable notes receivable	\$ 7,128	\$ 7,432
Mezzanine and other notes receivables	12,572	12,345
	<b>19,700</b>	19,777
Loan reserves	(9,491)	(9,531)
<b>Total</b>	<b>\$ 10,209</b>	\$ 10,246
Current portion, net	\$ 2,454	\$ 2,378
Long-term portion, net	7,755	7,868
<b>Total</b>	<b>\$ 10,209</b>	\$ 10,246

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

*Forgivable Notes Receivable*

From time to time, the Company provides financing to franchisees for property improvements and other purposes in the form of forgivable promissory notes. The terms of the notes range from 3 to 10 years, bearing market interest rates, and are forgiven and amortized over that time period if the franchisee remains in the system in good standing. As of March 31, 2010 and December 31, 2009, the unamortized balance of these notes totaled \$7.1 million and \$7.4 million, respectively. The Company recorded an allowance for credit losses on these forgivable notes receivable of \$0.7 million at both March 31, 2010 and December 31, 2009. Amortization expense included in the accompanying consolidated statements of income related to the notes was \$0.5 million for both the three months ended March 31, 2010 and March 31, 2009. At March 31, 2010, the Company had commitments to extend an additional \$5.2 million in forgivable notes receivable provided certain commitments are met by its franchisees.

*Mezzanine and Other Notes Receivable*

The Company has provided financing to franchisees in support of the development of Cambria Suites properties. These notes include non-interest bearing receivables as well as notes bearing market interest and are due upon maturity. Interest income associated with these notes receivable is reflected in the accompanying consolidated statements of income under the caption interest and other investment (income) loss. The Company does not accrue interest on notes receivable that are impaired. At March 31, 2010, notes receivable advanced totaled \$12.6 million of which \$10.8 million was determined to be impaired at March 31, 2010. The Company has recorded an \$8.6 million allowance for credit losses on these impaired loans at both March 31, 2010 and December 31, 2009. In addition, at both March 31, 2010 and December 31, 2009, the Company had provided loan reserves on non-impaired loans totaling \$0.2 million. The Company records bad debt expense in SG&A expenses in the accompanying consolidated statements of income.

**3. Receivable Marketing and Reservation Fees**

As of March 31, 2010 and December 31, 2009, the Company's balance sheet includes a receivable of \$25.2 million and \$19.2 million, respectively from cumulative marketing expenses incurred in excess of cumulative marketing fee revenues earned. The reservation fees receivable related to cumulative reservation expenses incurred in excess of cumulative reservation fee revenues earned was \$22.3 million and \$14.7 million at March 31, 2010 and December 31, 2009, respectively. Depreciation and amortization expense attributable to marketing and reservation activities was \$2.7 million and \$2.4 million for the three months ended March 31, 2010 and 2009, respectively. Interest expense attributable to reservation activities was approximately \$0.1 million for both the three months ended March 31, 2010 and 2009.



**Table of Contents****4. Deferred Revenue**

Deferred revenue consists of the following:

	March 31, 2010	December 31, 2009
	(In thousands)	
Loyalty programs	\$ 51,372	\$ 47,832
Initial, relicensing and franchise fees	3,109	2,160
Procurement service fees	1,841	884
Other	4,612	889
<b>Total</b>	<b>\$ 60,934</b>	<b>\$ 51,765</b>

**5. Debt**

On June 16, 2006, the Company entered into a \$350 million senior unsecured revolving credit agreement (the Revolver), with a syndicate of lenders. The Revolver allows the Company to borrow, repay and reborrow revolving loans up to \$350 million (which includes swingline loans for up to \$20 million and standby letters of credit of up to \$30 million) until the scheduled maturity date of June 16, 2011. The Company has the ability to request an increase in available borrowings under the Revolver by an additional amount of up to \$150 million by obtaining the agreement of the existing lenders to increase their lending commitments or by adding additional lenders. The rate of interest generally applicable for revolving loans under the Revolver is, at the Company's option, equal to either (i) the greater of the prime rate or the federal funds effective rate plus 50 basis points, or (ii) an adjusted LIBOR rate plus a margin between 22 and 70 basis points based on the Company's credit rating. The Revolver requires the Company to pay a quarterly facility fee, based upon the credit rating of the Company, at a rate between 8 and 17 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, excluding swingline loans, at all times when the amount borrowed under the Revolver exceeds 50% of the total commitment. The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. The Revolver also restricts the Company's ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions. As of March 31, 2010, the Company had \$293.9 million of revolving loans outstanding pursuant to the Revolver and the Company was in compliance with all covenants.

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

As of March 31, 2010, total debt outstanding for the Company was \$293.9 million. No outstanding debt amounts at March 31, 2010 were scheduled to mature during the twelve months ending March 31, 2011.

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

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

**7. Pension Plan**

The Company sponsors an unfunded non-qualified defined benefit plan ( SERP ) for certain senior executives. No assets are held with respect to the plan; therefore benefits are funded as paid to participants. For both the three months ended March 31, 2010 and 2009, the Company recorded \$0.1 million and \$0.3 million, respectively, for the expenses related to the SERP which are included in SG&A expense in the accompanying consolidated statements of income. Benefit payments totaling \$0.4 million are currently scheduled to be remitted within the next twelve months.

**Table of Contents**

The following table presents the components of net periodic benefit costs for the three months ended March 31, 2010 and 2009:

(In thousands)	Three Months Ended March 31	
	2010	2009
Components of net periodic pension cost:		
Service cost	\$	\$ 101
Interest cost	135	148
Amortization:		
Prior service cost		57
Net periodic pension cost	\$ 135	\$ 306

The 2010 monthly net periodic pension costs are approximately \$45,000. The components of projected pension costs for the year ended December 31, 2010 are as follows:

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

The following is a reconciliation of the changes in the projected benefit obligation for the three months ended March 31, 2010:

(in thousands)	
Projected benefit obligation, December 31, 2009	\$ 9,176
Service cost	
Interest cost	135
Benefit payments	(103)
Projected benefit obligation, March 31, 2010	\$ 9,208

The amounts in accumulated other comprehensive income that have not yet been recognized as components of net periodic benefit costs at March 31, 2010 are as follows:

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

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

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



---

**Table of Contents**

In 2002, the Company adopted the Choice Hotels International, Inc. Executive Deferred Compensation Plan ( EDCP ) which became effective January 1, 2003. Under the EDCP, certain executive officers may defer a portion of their salary into an irrevocable trust. A participant may elect an investment return of either the annual yield of the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points, or a return based on a selection of available diversified investment options. Effective January 1, 2010, the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points is no longer an investment option for salary deferrals made on compensation earned after December 31, 2009. As of March 31, 2010 and December 31, 2009, the Company recorded a deferred compensation liability of \$16.8 million and \$17.6 million, respectively related to these deferrals and credited investment returns. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. Compensation expense recorded in SG&A for both the three months ended March 31, 2010 and 2009 were \$0.2 million.

The Company has invested the employee salary deferrals in diversified long-term investments which are intended to provide investment returns that partially offset the earnings credited to the participants. The diversified investments held in the trusts totaled \$12.3 million and \$10.9 million as of March 31, 2010 and December 31, 2009, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore, the changes in the fair value of the diversified assets is included in other income and expenses, net in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended March 31, 2010 and 2009 totaling \$0.5 million and (\$0.7 million), respectively.

In 1997, the Company adopted the Choice Hotels International, Inc. Nonqualified Retirement Savings and Investment Plan ( Non-Qualified Plan ). The Non-Qualified Plan allows certain employees who do not participate in the EDCP to defer a portion of their salary and invest these amounts in a selection of available diversified investment options. As of March 31, 2010 and December 31, 2009, the Company had recorded a deferred compensation liability of \$10.9 million and \$11.0 million, respectively related to these deferrals. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. The net increase (decrease) in compensation expense recorded in SG&A for the three months ended March 31, 2010 and 2009 was \$0.4 million and (\$0.3) million, respectively.

The diversified investments held in the trusts were \$10.0 million and \$10.1 million as of March 31, 2010 and December 31, 2009, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other income and expenses, net in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended March 31, 2010 and 2009 of \$0.3 million and (\$0.2) million, respectively. In addition, the Non-Qualified Plan held shares of the Company's common stock with a market value of \$0.9 million at both March 31, 2010 and December 31, 2009.

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

**9. Fair Value Measurements**

The Company estimates the fair value of our financial instruments utilizing a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. The following summarizes the three levels of inputs, as well as the assets that the Company values using those levels of inputs.

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

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

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

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

<b>Assets (in thousands)</b>	<b>Fair Value Measurements at Reporting Date Using</b>			
	<b>March 31, 2010</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Investments, employee benefits plans, at fair value	\$ 22,319	\$ 20,155	\$ 2,164	\$
<b>Total Assets</b>	\$ 22,319	\$ 20,155	\$ 2,164	\$

**Table of Contents****10. Income Taxes**

The effective income tax rate 35.9% and 36.3% for the three months ended March 31, 2010 and 2009, respectively, differs from the statutory rate primarily due to foreign income earned, which is taxed at lower rates than statutory federal income tax rates and state income taxes.

As of both March 31, 2010 and December 31, 2009, the Company had \$4.2 million of total unrecognized tax benefits of which approximately \$2.5 million would affect the effective tax rate if recognized. These unrecognized tax benefits relate principally to state tax positions and stock-based compensation deductions. Estimated interest and penalties related to the underpayment of income taxes are classified as a component of income tax expense in the consolidated statement of income. Accrued interest and penalties included in other liabilities on the Company's consolidated balance sheet were \$0.9 million and \$0.8 million at March 31, 2010 and December 31, 2009, respectively. The Company believes it is reasonably possible it will recognize tax benefits of up to \$2.1 million within the next twelve months related to the anticipated lapse of applicable statutes of limitations regarding state tax positions and stock-based compensation deductions.

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

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

**11. Share-Based Compensation and Capital Stock***Stock Options*

The Company granted 0.2 million and 0.5 million options to certain employees of the Company at a fair value of \$2.5 million and \$3.7 million during the three months ended March 31, 2010 and 2009, respectively. The stock options granted by the Company had an exercise price equal to the market price of the Company's common stock on the date of grant. The fair value of the options granted was estimated on the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2010 Grants	2009 Grants
Risk-free interest rate	2.18%	1.80%
Expected volatility	41.92%	39.58%
Expected life of stock option	4.4 years	4.4 years
Dividend yield	2.27%	2.75%
Requisite service period	4 years	4 years
Contractual life	7 years	7 years
Weighted average fair value of options granted	\$ 9.98	\$ 7.33

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

The aggregate intrinsic value of the stock options outstanding and exercisable at March 31, 2010 was \$9.4 million and \$5.4 million, respectively. The total intrinsic value of options exercised during the three months ended March 31, 2010 and 2009 was \$0.8 million and \$4.8 million, respectively.

**Table of Contents**

The Company received \$0.6 million and \$2.7 million in proceeds from the exercise of approximately 0.04 million and 0.3 million employee stock options during the three month periods ended March 31, 2010 and 2009, respectively.

*Restricted Stock*

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

	Three Months Ended March 31,	
	2010	2009
Restricted share grants	250,390	222,609
Weighted average grant date fair value per share	\$ 32.60	\$ 26.88
Aggregate grant date fair value (\$000)	\$ 8,163	\$ 5,984
Restricted shares forfeited	8,194	9,555
Vesting service period of shares granted	3-4 years	4 years
Grant date fair value of shares vested (\$000)	\$ 4,406	\$ 2,954

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

*Performance Vested Restricted Stock Units*

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

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

	Three Months Ended March 31,	
	2010	2009
Performance vested restricted stock units granted at target	33,517	9,588
Weighted average grant date fair value per share	\$ 32.60	\$ 26.88
Average aggregate grant date fair value (\$000)	\$ 1,093	\$ 258
Stock units forfeited	9,650	4,011
Requisite service period	3 years	2 years

During the three months ended March 31, 2010, PVRSU grants totaling 10,880 vested at a fair value of \$0.3 million. These PVRSU grants were initially granted at a target of 15,541 units, however, since the Company achieved only 70% of the targeted performance conditions contained in the stock awards granted in prior periods, 4,661 shares out of the initial grant were forfeited. In addition, during the three months ended March 31, 2010, 4,989 units were forfeited since the performance targets of the applicable PVRSU grant were not achieved. During the three months ended March 31, 2009, PVRSU grants totaling 19,761 vested at a fair value of \$0.5 million. These PVRSU grants were initially granted at a target of 14,638 units, however, since the Company exceeded targeted performance conditions contained in the stock awards granted in prior periods by 35%, an additional 5,123 shares were earned and issued.



**Table of Contents**

A summary of stock-based award activity as of March 31, 2010 and changes during the three months ended are presented below:

	Three Months Ended March 31, 2010						
	Shares	Stock Options		Restricted Stock		Performance Vested Restricted Stock Units	
		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, 2010	1,658,844	\$ 30.05		539,341	\$ 31.68	118,385	\$ 34.58
Granted	248,488	32.60		250,390	32.60	33,517	32.60
Exercised/Vested	(41,553)	15.58		(132,192)	33.33	(10,880)	40.65
Forfeited/Expired	(19,661)	8.57		(8,194)	31.03	(9,650)	36.74
Outstanding at March 31, 2010	1,846,118	\$ 30.95	5.5 years	649,345	\$ 31.71	131,372	\$ 33.42
Options exercisable at March 31, 2010	782,644	\$ 30.35	4.8 years				

The components of the Company's pretax stock-based compensation expense and associated income tax benefits are as follows for the three months ended March 31, 2010 and 2009:

(in millions)	Three Months Ended March 31,	
	2010	2009
Stock options	\$ 0.6	\$ 0.5
Restricted stock	1.7	1.6
Performance vested restricted stock units	0.1	0.2
Total	\$ 2.4	\$ 2.3
Income tax benefits	\$ 0.9	\$ 0.9

*Dividends*

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

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

*Stock Repurchase Program*

During the three months ended March 31, 2010 and 2009, the Company purchased 0.2 million and 0.7 million shares of common stock under the share repurchase program at a total cost of \$6.9 million and \$18.0 million, respectively.

During the three months ended March 31, 2010 and 2009, the Company redeemed 65,133 and 48,968 shares of common stock at a total cost of \$2.1 million and \$1.3 million, respectively, from employees to satisfy statutory minimum tax requirements from the vesting of restricted stock and PVRSU grants. These redemptions were outside the share repurchase program initiated in June 1998.



**Table of Contents****12. Comprehensive Income**

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

(In thousands)	Three Months Ended March 31,	
	2010	2009
Net income	\$ 15,793	\$ 16,308
Other comprehensive income (loss), net of tax:		
Amortization of pension related costs, net of tax		
Prior service costs		36
Foreign currency translation adjustment, net	6	(259)
Other comprehensive income (loss), net of tax	6	(223)
Comprehensive income	\$ 15,799	\$ 16,085

**13. Earnings Per Share**

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

(In thousands, except per share amounts)	Three Months Ended March 31,	
	2010	2009
<b>Computation of Basic Earnings Per Share:</b>		
Net income	\$ 15,793	\$ 16,308
Income allocated to participating securities	(157)	(145)
Net income available to common shareholders	\$ 15,636	\$ 16,163
Weighted average common shares outstanding basic	58,924	59,993
Basic earnings per share	\$ 0.27	\$ 0.27
<b>Computation of Diluted Earnings Per Share:</b>		
Net income	\$ 15,793	\$ 16,308
Income allocated to participating securities	(157)	(145)
Net income available to common shareholders	\$ 15,636	\$ 16,163
Weighted average common shares outstanding basic	58,924	59,993
Diluted effect of stock options and PVRsUs	86	319
Weighted average shares outstanding-diluted	59,010	60,312
Diluted earnings per share	\$ 0.26	\$ 0.27



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

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

At March 31, 2010 and 2009, the Company had 1.8 million and 2.1 million outstanding stock options, respectively. Stock options are included in the diluted earnings per share calculation using the treasury stock method and average market prices during the period, unless the stock options would be anti-dilutive. For the three months ended March 31, 2010, the Company excluded 0.7 million of anti-dilutive stock options from the diluted earnings per share calculation. In addition, the Company excluded 1.5 million of anti-dilutive options from the computation for diluted earnings per share for the three months ended March 31, 2009.

PVRSUs are also included in the diluted earnings per share calculation assuming the performance conditions have been met at the reporting date. However, at March 31, 2010 and 2009, PVRSUs totaling 131,372 and 120,420, respectively were excluded from the computation since the performance conditions had not been met.

**Table of Contents**

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

	Three Months Ended March 31,	
	2010	2009
Weighted average common shares outstanding	58,924	59,993
Weighted average participating shares outstanding	590	539
Weighted average shares outstanding - basic	59,514	60,532
Effect of dilutive securities:		
Employee stock options and PVRsUs	86	319
Weighted average shares outstanding - dilutive	59,600	60,851

**14. Reportable Segment Information**

The Company has a single reportable segment encompassing its franchising business. Revenues from the franchising business include royalty fees, initial franchise and relicensing fees, marketing and reservation fees, procurement services revenue and other revenue. The Company is obligated under its franchise agreements to provide marketing and reservation services appropriate for the operation of its systems. These services do not represent separate reportable segments as their operations are directly related to the Company's franchising business. The revenues received from franchisees that are used to pay for part of the Company's ongoing operations are included in franchising revenues and are offset by the related expenses paid for marketing and reservation activities to calculate franchising operating income. Corporate and other revenue consists of hotel operations. Except as described in Note 3, 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 March 31, 2010			Three Months Ended March 31, 2009		
	Franchising	Other & Corporate	Consolidated	Franchising	Other & Corporate	Consolidated
<b>Revenues</b>	\$ 106,554	\$ 867	\$ 107,421	\$ 113,040	\$ 1,118	\$ 114,158
<b>Operating income (loss)</b>	\$ 33,068	\$ (9,231)	\$ 23,837	\$ 36,497	\$ (8,742)	\$ 27,755

**15. 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 Company's legal counsel, the ultimate outcome of any such lawsuit individually will not have a material adverse effect on the Company's business, financial position, results of operations or cash flows.

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

In June 2008, the Company guaranteed \$1 million of a bank loan funding a franchisee's construction of a Cambria Suites in Columbus, Ohio. The guaranty will terminate on the earlier of (i) the repayment of all outstanding obligations under the bank loan that it supports (the current initial loan term runs through June 2013), or (ii) when the franchisee achieves certain debt service coverage ratios outlined in the underlying bank loan agreement. The Company has received a pledge of an equity interest in the entity constructing the property as well as personal guarantees from several of the franchisee's principal owners related to the repayment of any amounts the Company may be required to pay under this guaranty.

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

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

The Company has made commitments to purchase various parcels of real estate to support the development of certain of its brands. Providing certain conditions are met by the seller, the Company expects to acquire these parcels of land for approximately \$8.9 million during the year ended December 31, 2010.

## **Table of Contents**

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

### **16. Termination Charges**

During the three months ended March 31, 2010, the Company recorded one-time employee termination charges totaling \$0.8 million in SG&A and marketing and reservation expenses. These charges related to salary and benefits continuation payments for employees separating from service with the Company. At March 31, 2010, the Company had approximately \$0.5 million of these salary and benefits continuation payments remaining to be remitted. The Company also has approximately \$3.8 million of benefits remaining to be paid on termination benefits incurred prior to January 1, 2010.

At March 31, 2010 and December 31, 2009, approximately \$4.3 million and \$5.5 million, respectively, of benefits remained unpaid and are included as current and non-current liabilities in the Company's consolidated financial statements. At March 31, 2010, the Company expects \$3.3 million of these benefits to be paid within the next twelve months.

### **17. Future Adoption of Accounting Standards**

On September 23, 2009, the FASB ratified Emerging Issues Task Force ( EITF ) Issue No. 08-1, Revenue Arrangements with Multiple Deliverables ( EITF 08-1 ). EITF 08-1 updates the current guidance pertaining to multiple-element revenue arrangements included in ASC Subtopic 605-25, which originated primarily from EITF 00-21, also titled Revenue Arrangements with Multiple Deliverables. EITF 08-1 will be effective for annual reporting periods beginning January 1, 2011 for calendar year entities with earlier adoption permitted. The Company is currently evaluating the impact of EITF 08-1 on its financial position, results of operations, cash flows, and disclosures, if any.

### **18. Subsequent Events**

On April 29, 2010, the Company's board of directors declared a quarterly cash dividend of \$0.185 per share of common stock. The dividend is payable on July 16, 2010 to shareholders of record as of July 2, 2010. Based on the Company's share count at March 31, 2010, the total dividends to be paid is approximately \$11.0 million.

On April 20, 2010, the Company entered into a three-year \$4.25 million loan agreement with a franchisee. On the loan closing date, the Company advanced \$2.1 million to the franchisee and may advance up to an additional \$2.2 million under the terms of the agreement. The note bears interest at rates ranging from 8% to 15% per annum and is due upon maturity. The loan is secured by a senior construction mortgage deed on the hotel site, a pledge of 100% of the ownership interests in the franchisee, and joint and several personal guarantees from the principals of the franchisee's ownership.

## **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.



---

## **Table of Contents**

### **Overview**

We are a hotel franchisor with franchise agreements representing 6,032 hotels open and 759 hotels under construction, awaiting conversion or approved for development as of March 31, 2010, with 487,264 rooms and 60,704 rooms, respectively, in 49 states, the District of Columbia and over 40 countries and territories outside the United States. Our brand names include Comfort Inn®, Comfort Suites®, Quality®, Clarion®, Ascend Collection®, Sleep Inn®, Econo Lodge®, Rodeway Inn®, MainStay Suites®, Suburban Extended Stay Hotel®, and Cambria Suites® (collectively, the Choice brands ).

The Company conducts its international franchise operations through a combination of direct franchising and master franchising relationships. Master franchising relationships allow the use of our brands by third parties in foreign countries. The Company has made equity investments in certain non-domestic lodging franchise companies that conduct franchise operations for the Choice brands under master franchising relationships. As a result of our use of master franchising relationships and international market conditions, total revenues from international franchising operations comprised only 9% of our total revenues for the three months ended March 31, 2010, while representing approximately 19% of hotels open at March 31, 2010.

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

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

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

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

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

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

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

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

**Table of Contents**

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

*Maximizing Financial Returns and Creating Value for Shareholders.* Our capital allocation decisions, including capital structure and uses of capital, are intended to maximize our return on invested capital and create value for our shareholders. We believe our strong and predictable cash flows create a strong financial position that provides us a competitive advantage. Currently, our business does not require significant capital to operate and grow. Therefore, we can maintain a capital structure that generates high financial returns and use our excess cash flow to increase returns to our shareholders. Historically, we have returned value to our shareholders in two primary ways: share repurchases and dividends. In 1998, we instituted a share repurchase program which has generated substantial value for our shareholders. During the three months ended March 31, 2010, the Company repurchased 0.2 million shares of its common stock under the share repurchase program at a total cost of \$6.9 million. Since the program's inception through March 31, 2010, we have repurchased 43.1 million shares (including 33.0 million prior to the two-for-one stock split effected in October 2005) of common stock at a total cost of \$1.0 billion. Considering the effect of the two-for-one stock split, the Company has repurchased 76.1 million shares at an average price of \$13.33 per share. We currently believe that our cash flows from operations will support our ability to complete the current board of directors repurchase authorization of approximately 3.6 million shares remaining as of March 31, 2010. Upon completion of the current authorization, our board of directors will evaluate the propriety of additional share repurchases. During the three months ended March 31, 2010, we paid cash dividends totaling approximately \$10.9 million and we presently expect to continue to pay dividends in the future, subject to future business performance, economic conditions and changes in income tax regulations. Based on our present dividend rate and outstanding share count, aggregate annual dividends for 2010 would be approximately \$43.8 million.

Our board of directors has authorized us to enter into programs which permit us to offer investment, financing and guaranty support to qualified franchisees as well as acquire and resell real estate to incent franchise development in top markets for certain brands. Based on market and other conditions, we expect to deploy this capital opportunistically over the next several years. Notwithstanding these programs, the Company expects to continue to return value to its shareholders through a combination of share repurchases and dividends, subject to market and other conditions.

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

*Results of Operation:* Royalty fees, operating income, net income and diluted earnings per share (EPS) represent key measurements of these value drivers. In the three months ended March 31, 2010, royalty fees revenue totaled \$41.0 million, a 6% decrease from the same period in 2009. Operating income totaled \$23.8 million for the three months ended March 31, 2010, a \$3.9 million or 14% decline from the same period in 2009. Net income decreased \$0.5 million or 3% from the same period of the prior year to \$15.8 million. Diluted earnings per share for the quarter ended March 31, 2010 were \$0.26 compared to \$0.27 for the three months ended March 31, 2009. These measurements will continue to be a key management focus in 2010 and beyond.

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

*Liquidity and Capital Resources:* Historically, the Company has generated significant cash flows from operations. In the three months ended March 31, 2010 and 2009, net cash provided by operating activities was \$7.0 million and \$10.5 million, respectively. Since our business does not currently require significant reinvestment of capital, we utilize cash in ways that management believes provide the greatest returns to our shareholders, which include share repurchases and dividends. We believe the Company's cash flow from operations and available financing capacity are sufficient to meet the expected future operating, investing, and financing needs of the business. However, events over the past year, including recent failures and near failures of a number of large financial service companies have made the capital markets increasingly volatile. As a result of the dislocation in the credit markets, the availability of reasonably priced credit may be limited and therefore, reduce the Company's ability to return value to shareholders through dividends and its share repurchase program.

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



**Table of Contents****Operations Review****Comparison of Operating Results for the Three-Month Periods Ended March 31, 2010 and March 31, 2009**

The Company recorded net income of \$15.8 million for the three months ended March 31, 2010, a \$0.5 million, or 3% decline from the \$16.3 million for the quarter ended March 31, 2009. The decrease in net income for the three months ended March 31, 2010, is primarily attributable to a \$3.9 million or 14% decline in operating income partially offset by lower interest expense and the appreciation in the fair value of investments held in the Company's non-qualified employee benefit plans compared to the prior year.

Summarized financial results for the three months ended March 31, 2010 and 2009 are as follows:

(in thousands, except per share amounts)	2010	2009
<b>REVENUES:</b>		
Royalty fees	\$ 41,021	\$ 43,441
Initial franchise and relicensing fees	1,912	2,649
Procurement services	3,245	3,390
Marketing and reservation	58,840	62,042
Hotel operations	867	1,118
Other	1,536	1,518
<b>Total revenues</b>	<b>107,421</b>	<b>114,158</b>
<b>OPERATING EXPENSES:</b>		
Selling, general and administrative	21,816	21,461
Depreciation and amortization	2,172	2,115
Marketing and reservation	58,840	62,042
Hotel operations	756	785
<b>Total operating expenses</b>	<b>83,584</b>	<b>86,403</b>
<b>Operating income</b>	<b>23,837</b>	<b>27,755</b>
<b>OTHER INCOME AND EXPENSES, NET:</b>		
Interest expense	621	1,540
Interest and other investment (income) loss	(1,077)	832
Equity in net income of affiliates	(353)	(218)
<b>Total other income and expenses, net</b>	<b>(809)</b>	<b>2,154</b>
<b>Income before income taxes</b>	<b>24,646</b>	<b>25,601</b>
<b>Income taxes</b>	<b>8,853</b>	<b>9,293</b>
<b>Net income</b>	<b>\$ 15,793</b>	<b>\$ 16,308</b>
<b>Weighted average shares outstanding diluted</b>	<b>59,600</b>	<b>60,851</b>
<b>Diluted earnings per share</b>	<b>\$ 0.26</b>	<b>\$ 0.27</b>

The Company utilizes certain measures such as adjusted net income, adjusted diluted EPS, adjusted SG&A, adjusted operating income and franchising revenues which do not conform to United States GAAP when analyzing and discussing its results with the investment community. This information should not be considered as an alternative to any measure of performance as promulgated under GAAP, such as net income, diluted EPS, SG&A, operating income and total revenues. The Company's calculation of these measurements may be different from the

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

calculations used by other companies and therefore comparability may be limited. We have included a reconciliation of these measures to the comparable GAAP measurement below as well as our reason for reporting these non-GAAP measures.

*Franchising Revenues:* The Company utilizes franchising revenues which exclude marketing and reservation revenues and hotel operations rather than total revenues when analyzing the performance of the business. Marketing and reservation activities are excluded from revenues since the Company is contractually required by its franchise agreements to use these fees collected for marketing and reservation activities; as such, no income or loss to the Company is generated. Cumulative reservation and marketing fees not expended are recorded as a payable on the Company's financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements. Cumulative marketing and reservation expenditures in excess of fees collected for marketing and reservation activities are recorded as a receivable on the Company's financial statements. Hotel operations are excluded since they do not reflect the most accurate measure of the Company's core franchising business. This non-GAAP measure is a commonly used measure of performance in our industry and facilitates comparisons between the Company and its competitors.

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

	<b>Three Months Ended March 31, (dollar amounts in thousands)</b>	
	<b>2010</b>	<b>2009</b>
<b>Franchising Revenues:</b>		
<b>Total Revenues</b>	<b>\$ 107,421</b>	<b>\$ 114,158</b>
Adjustments:		
Marketing and reservation revenues	<b>(58,840)</b>	<b>(62,042)</b>
Hotel operations	<b>(867)</b>	<b>(1,118)</b>
<b>Franchising Revenues</b>	<b>\$ 47,714</b>	<b>\$ 50,998</b>

*Adjusted Net Income, Adjusted Diluted EPS, Adjusted SG&A and Adjusted Operating Income:* We also use adjusted net income, adjusted diluted EPS, adjusted SG&A and adjusted operating income which exclude employee termination benefits for the three months ended March 31, 2010 and 2009. The Company utilizes these non-GAAP measures to enable investors to perform meaningful comparisons of past, present and future operating results and as a means to emphasize the results of on-going operations.

**Calculation of Adjusted Operating Income**

	<b>Three Months Ended March 31, (dollar amounts in thousands)</b>	
	<b>2010</b>	<b>2009</b>
<b>Operating Income</b>	<b>\$ 23,837</b>	<b>\$ 27,755</b>
Adjustments:		
Employee termination benefits	<b>352</b>	<b>374</b>
<b>Adjusted Operating Income</b>	<b>\$ 24,189</b>	<b>\$ 28,129</b>

**Calculation of Adjusted SG&A**

	<b>Three Months Ended March 31, (dollar amounts in thousands)</b>	
	<b>2010</b>	<b>2009</b>
<b>SG&amp;A</b>	<b>\$ 21,816</b>	<b>\$ 21,461</b>
Adjustments:		
Employee termination benefits	<b>(352)</b>	<b>(374)</b>
<b>Adjusted SG&amp;A</b>	<b>\$ 21,464</b>	<b>\$ 21,087</b>

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

	<b>Three Months Ended March 31,</b> <b>(In thousands, except per share amounts)</b>	
	<b>2010</b>	<b>2009</b>
<b>Net Income</b>	<b>\$ 15,793</b>	<b>\$ 16,308</b>
Adjustments:		
Employee termination benefits	<b>220</b>	234
<b>Adjusted Net Income</b>	<b>\$ 16,013</b>	<b>\$ 16,542</b>
<b>Weighted average shares outstanding-diluted</b>	<b>59,600</b>	60,851
<b>Diluted EPS</b>	<b>\$ 0.26</b>	<b>\$ 0.27</b>
Adjustments:		
Employee termination benefits	<b>0.01</b>	
<b>Adjusted Diluted EPS</b>	<b>\$ 0.27</b>	<b>\$ 0.27</b>

The Company recorded adjusted net income of \$16.0 million for the three months ended March 31, 2010, a \$0.5 million or 3% decline from \$16.5 million for the three months ended March 31, 2009. The decline in adjusted net income for the three months ended March 31, 2010 is primarily attributable to a \$3.9 million decline in adjusted operating income partially offset by lower interest expense and the appreciation in the fair value of investments held in the Company's non-qualified employee benefit plans compared to declines in these investments during the three months ended March 31, 2009. Adjusted operating income declined \$3.9 million as the Company's franchising revenues for the three months ended March 31, 2010 declined \$3.3 million or 6% from the same period of the prior year. This decline was primarily due to a 10.3% decline in RevPAR and fewer initial and relicensing fee contracts executed compared to the same period of the prior year.

*Franchising Revenues:* Franchising revenues were \$47.7 million for the three months ended March 31, 2010 compared to \$51.0 million for the three months ended March 31, 2009. The decline in franchising revenues is primarily due to a 6% decrease in royalty revenues and a 28% decrease in initial franchise and relicensing fees.

Domestic royalty fees for the three months ended March 31, 2010 decreased \$3.2 million to \$36.0 million from \$39.2 million in the three months ended March 31, 2009, a decrease of 8.2%. The decline in royalties is attributable to a combination of factors including a 10.3% decline in RevPAR, offset by a 2.4% increase in the number of domestic franchised hotel rooms and an increase in the effective royalty rate of the domestic hotel system from 4.26% to 4.34%. System-wide RevPAR declined due to a 230 basis point decline in occupancy and a 4.9% decline in average daily rates.

**Table of Contents**

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

	For the Three Months Ended March 31, 2010*			For the Three Months Ended March 31, 2009*			Change		
	Average Daily Rate	Occupancy	RevPAR	Average Daily Rate	Occupancy	RevPAR	Average Daily Rate	Occupancy	RevPAR
<b>Comfort Inn</b>	<b>\$ 71.02</b>	<b>42.8%</b>	<b>\$ 30.36</b>	\$ 73.96	45.9%	\$ 33.96	(4.0)%	(310)bps	(10.6)%
<b>Comfort Suites</b>	<b>79.21</b>	<b>43.7%</b>	<b>34.64</b>	84.48	47.1%	39.77	(6.2)%	(340)bps	(12.9)%
<b>Sleep</b>	<b>64.76</b>	<b>41.2%</b>	<b>26.67</b>	67.49	44.9%	30.32	(4.0)%	(370)bps	(12.0)%
<b>Midscale without Food &amp; Beverage</b>	<b>72.24</b>	<b>42.8%</b>	<b>30.89</b>	75.56	46.0%	34.79	(4.4)%	(320)bps	(11.2)%
<b>Quality</b>	<b>61.59</b>	<b>37.0%</b>	<b>22.77</b>	64.73	39.1%	25.29	(4.9)%	(210)bps	(10.0)%
<b>Clarion</b>	<b>69.45</b>	<b>33.6%</b>	<b>23.32</b>	74.03	37.0%	27.35	(6.2)%	(340)bps	(14.7)%
<b>Midscale with Food &amp; Beverage</b>	<b>63.19</b>	<b>36.2%</b>	<b>22.89</b>	66.57	38.6%	25.72	(5.1)%	(240)bps	(11.0)%
<b>Econo Lodge</b>	<b>49.58</b>	<b>35.6%</b>	<b>17.65</b>	51.65	37.1%	19.14	(4.0)%	(150)bps	(7.8)%
<b>Rodeway</b>	<b>45.44</b>	<b>36.3%</b>	<b>16.51</b>	49.60	37.0%	18.34	(8.4)%	(70)bps	(10.0)%
<b>Economy</b>	<b>48.31</b>	<b>35.8%</b>	<b>17.31</b>	51.07	37.0%	18.92	(5.4)%	(120)bps	(8.5)%
<b>MainStay</b>	<b>63.11</b>	<b>52.1%</b>	<b>32.86</b>	71.08	50.5%	35.90	(11.2)%	160bps	(8.5)%
<b>Suburban</b>	<b>37.22</b>	<b>58.8%</b>	<b>21.89</b>	42.60	52.0%	22.15	(12.6)%	680bps	(1.2)%
<b>Extended Stay</b>	<b>44.02</b>	<b>56.9%</b>	<b>25.03</b>	50.25	51.6%	25.92	(12.4)%	530bps	(3.4)%
<b>Total</b>	<b>\$ 65.01</b>	<b>40.1%</b>	<b>\$ 26.03</b>	\$ 68.39	42.4%	\$ 29.02	(4.9)%	(230)bps	(10.3)%

\* Operating statistics represent hotel operations from December through February and exclude Ascend Collection and Cambria Suites. The number of domestic rooms on-line increased to 387,246 as of March 31, 2010 from 378,246 as of March 31, 2009, an increase of 2.4%. The total number of domestic hotels on-line grew 2.9% to 4,905 as of March 31, 2010 from 4,767 as of March 31, 2009.

**Table of Contents**

A summary of domestic hotels and rooms on-line at March 31, 2010 and 2009 by brand is as follows:

	March 31, 2010		March 31, 2009		Hotels	Variance		%
	Hotels	Rooms	Hotels	Rooms		%	Rooms	
<b>Comfort Inn</b>	<b>1,445</b>	<b>113,266</b>	1,452	114,008	(7)	(0.5)%	(742)	(0.7)%
<b>Comfort Suites</b>	<b>620</b>	<b>48,180</b>	560	43,694	60	10.7%	4,486	10.3%
<b>Sleep</b>	<b>389</b>	<b>28,377</b>	366	26,956	23	6.3%	1,421	5.3%
<b>Midscale without Food &amp; Beverage</b>	<b>2,454</b>	<b>189,823</b>	2,378	184,658	76	3.2%	5,165	2.8%
<b>Quality</b>	<b>976</b>	<b>88,394</b>	926	85,943	50	5.4%	2,451	2.9%
<b>Clarion</b>	<b>168</b>	<b>24,336</b>	155	22,562	13	8.4%	1,774	7.9%
<b>Midscale with Food &amp; Beverage</b>	<b>1,144</b>	<b>112,730</b>	1,081	108,505	63	5.8%	4,225	3.9%
<b>Econo Lodge</b>	<b>786</b>	<b>48,519</b>	821	51,288	(35)	(4.3)%	(2,769)	(5.4)%
<b>Rodeway</b>	<b>373</b>	<b>21,118</b>	352	20,442	21	6.0%	676	3.3%
<b>Economy</b>	<b>1,159</b>	<b>69,637</b>	1,173	71,730	(14)	(1.2)%	(2,093)	(2.9)%
<b>MainStay</b>	<b>36</b>	<b>2,797</b>	37	2,867	(1)	(2.7)%	(70)	(2.4)%
<b>Suburban</b>	<b>62</b>	<b>7,474</b>	64	7,675	(2)	(3.1)%	(201)	(2.6)%
<b>Extended Stay</b>	<b>98</b>	<b>10,271</b>	101	10,542	(3)	(3.0)%	(271)	(2.6)%
<b>Ascend Collection</b>	<b>30</b>	<b>2,459</b>	21	1,363	9	42.9%	1,096	80.4%
<b>Cambria Suites</b>	<b>20</b>	<b>2,326</b>	13	1,448	7	53.8%	878	60.6%
<b>Total Domestic Franchises</b>	<b>4,905</b>	<b>387,246</b>	4,767	378,246	138	2.9%	9,000	2.4%

International available rooms increased 2.1% to 100,018 as of March 31, 2010 from 97,989 as of March 31, 2009. The total number of international hotels increased 2.5% from 1,099 as of March 31, 2009 to 1,127 as of March 31, 2010.

As of March 31, 2010, the Company had 657 franchised hotels with 52,483 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 896 hotels and 70,381 rooms at March 31, 2009. The number of new construction franchised hotels in the Company's domestic pipeline decreased 28% to 482 at March 31, 2010 from 671 at March 31, 2009. The number of conversion franchised hotels in the Company's domestic pipeline declined by 50 or 22% from March 31, 2009 to 175 hotels at March 31, 2010. The domestic system hotels under construction, awaiting conversion or approved for development declined 27% from the prior year primarily due to the decline in new executed franchise agreements over the trailing twelve months due to the current economic environment coupled with the opening of 408 franchised units over the twelve months ending March 31, 2010. The Company had an additional 102 franchised hotels with 8,221 rooms under construction, awaiting conversion or approved for development in its international system as of March 31, 2010 compared to 111 hotels and 9,114 rooms at March 31, 2009. While the Company's hotel pipeline provides a strong platform for growth, a hotel in the pipeline does not always result in an open and operating hotel due to various factors.

**Table of Contents**

A summary of the domestic franchised hotels under construction, awaiting conversion or approved for development at March 31, 2010 and 2009 by brand is as follows:

	March 31, 2010			March 31, 2009			Conversion		Variance New Construction		Total	
	Conversion	New Construction	Total	Conversion	New Construction	Total	Units	%	Units	%	Units	%
<b>Comfort Inn</b>	43	81	124	48	118	166	(5)	(10%)	(37)	(31%)	(42)	(25%)
<b>Comfort Suites</b>		154	154	2	253	255	(2)	(100%)	(99)	(39%)	(101)	(40%)
<b>Sleep Inn</b>	1	115	116	1	151	152		0%	(36)	(24%)	(36)	(24%)
<b>Midscale without Food &amp; Beverage</b>	44	350	394	51	522	573	(7)	(14%)	(172)	(33%)	(179)	(31%)
<b>Quality</b>	39	13	52	64	13	77	(25)	(39%)		0%	(25)	(32%)
<b>Clarion</b>	16	6	22	27	7	34	(11)	(41%)	(1)	(14%)	(12)	(35%)
<b>Midscale with Food &amp; Beverage</b>	55	19	74	91	20	111	(36)	(40%)	(1)	(5%)	(37)	(33%)
<b>Econo Lodge</b>	39	4	43	35	4	39	4	11%		0%	4	10%
<b>Rodeway</b>	33	3	36	48	3	51	(15)	(31%)		0%	(15)	(29%)
<b>Economy</b>	72	7	79	83	7	90	(11)	(13%)		0%	(11)	(12%)
<b>MainStay</b>		39	39		36	36		NM	3	8%	3	8%
<b>Suburban</b>		26	26		30	30		NM	(4)	(13%)	(4)	(13%)
<b>Extended Stay</b>		65	65		66	66		NM	(1)	(2%)	(1)	(2%)
<b>Ascend Collection</b>	4	4	8		1	1	4	NM	3	300%	7	700%
<b>Cambria Suites</b>		37	37		55	55		NM	(18)	(33%)	(18)	(33%)
<b>Total</b>	175	482	657	225	671	896	(50)	(22%)	(189)	(28%)	(239)	(27%)

There was one net domestic franchise termination during the three months ended March 31, 2010, compared to 51 net domestic franchise additions during the three months ended March 31, 2009. Gross domestic franchise additions decreased from 112 for the three months ended March 31, 2009 to 78 for the same period of 2010. New construction hotels represented 28 of the gross domestic additions during the three months ended March 31, 2010 compared to 35 hotels in the same period of the prior year. Gross domestic additions for conversion hotels during the three months ended March 31, 2010 declined by 27 to 50 hotels compared to the same period of the prior year. The Company expects the number of new franchise additions that will open during 2010 to decline from 442 for the year ended December 31, 2009 to approximately 343 hotels. This decline is expected to be primarily driven by new construction units as the lack of available hotel financing due to the current economic environment has impacted the franchise sales efforts.

Domestic franchise terminations increased from 61 in the three months ended March 31, 2009 to 79 for the three months ended March 31, 2010 primarily due to increased terminations related to the removal of hotels that do not meet our brand standards as well as an increase in terminations related to the non-payment of franchise fees. The Company has continued to execute its strategy to replace franchised hotels that do not meet our brand standards or are underperforming in their market. As the competition gets stronger and more focused on limited service franchising, the Company will continue to focus on improving its system of hotels and utilizing the domestic hotels under construction, awaiting conversion or approved for development as a strong platform for continued system growth.

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

International royalties increased by \$0.8 million or 19% from \$4.2 million in the first quarter of 2009 to \$5.0 million for the same period of 2010 primarily due to foreign currency fluctuations.



**Table of Contents**

New domestic franchise agreements executed in the three months ended March 31, 2010 totaled 55 representing 4,511 rooms compared to 60 agreements representing 5,037 rooms executed in the first quarter of 2009. During the first quarter of 2010, 10 of the executed agreements were for new construction hotel franchises representing 709 rooms compared to 6 contracts representing 429 rooms for the same period a year ago. Conversion hotel executed franchise agreements totaled 45 representing 3,802 rooms for the three months ended March 31, 2010 compared to 54 agreements representing 4,608 rooms for the same period a year ago. Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise agreements decreased 26% to \$1.3 million for the three months ended March 31, 2010 from \$1.7 million for the three months ended March 31, 2009. The decline in revenues primarily reflects an 8% decline in the number of executed agreements compared to the prior year, a decline in average initial fee per agreement and a higher proportion of economy brand executed agreements which typically carry a lower initial franchise fee.

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

A summary of executed domestic franchise agreements by brand for the three months ended March 31, 2010 and 2009 is as follows:

	For the Three Months Ended March 31, 2010			For the Three Months Ended March 31, 2009			% Change		
	New			New			New		
	Construction	Conversion	Total	Construction	Conversion	Total	Construction	Conversion	Total
<b>Comfort Inn</b>	1	8	9		7	7	NM	14%	29%
<b>Comfort Suites</b>	2		2	1	1	2	100%	(100%)	0%
<b>Sleep</b>	2		2	2		2	0%	NM	0%
<b>Midscale without Food &amp; Beverage</b>	5	8	13	3	8	11	67%	0%	18%
<b>Quality</b>	1	11	12	1	23	24	0%	(52%)	(50%)
<b>Clarion</b>		3	3		6	6	NM	(50%)	(50%)
<b>Midscale with Food &amp; Beverage</b>	1	14	15	1	29	30	0%	(52%)	(50%)
<b>Econo Lodge</b>		10	10		9	9	NM	11%	11%
<b>Rodeway</b>	1	11	12	1	7	8	0%	57%	50%
<b>Economy</b>	1	21	22	1	16	17	0%	31%	29%
<b>MainStay</b>	2		2		1	1	NM	(100%)	100%
<b>Suburban</b>	1		1				NM	NM	NM
<b>Extended Stay</b>	3		3		1	1	NM	(100%)	200%
<b>Ascend Collection</b>		2	2				NM	NM	NM
<b>Cambria Suites</b>				1		1	(100%)	NM	(100%)

<b>Total Domestic System</b>	<b>10</b>	<b>45</b>	<b>55</b>	<b>6</b>	<b>54</b>	<b>60</b>	<b>67%</b>	<b>(17%)</b>	<b>(8%)</b>
------------------------------	-----------	-----------	-----------	----------	-----------	-----------	------------	--------------	-------------

---

**Table of Contents**

Relicensing fees include fees charged to the new owners of a franchised property whenever an ownership change occurs and the property remains in the franchise system as well as fees required to renew expiring franchise contracts. Relicensing and renewal contracts declined 53% from 38 in the first quarter of 2009 to 18 for the three months ended March 31, 2010. As a result of the decline in contracts, relicensing revenues declined \$0.3 million from \$0.9 million for the three months ended March 31, 2009 to \$0.6 million for the three months ended March 31, 2010. The Company's relicensing activity in 2010 and beyond is dependent on the availability and cost of capital as well as the presence of an active real estate market for hotel transactions.

*Selling, General and Administrative Expenses:* The cost to operate the franchising business is reflected in SG&A on the consolidated statements of income. SG&A expenses were \$21.8 million for the three months ended March 31, 2010, a \$0.4 million or 2% increase from the three months ended March 31, 2009. Adjusted SG&A costs, which exclude certain items described above, for the three months ended March 31, 2010 totaled \$21.5 million compared to adjusted SG&A of \$21.1 million for the same period of the prior year.

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

Total marketing and reservation revenues were \$58.8 million and \$62.0 million for the three months ended March 31, 2010 and 2009, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$2.7 million and \$2.4 million for the three months ended March 31, 2010 and 2009, respectively. Interest expense attributable to reservation activities was approximately \$0.1 million for both the three month periods ended March 31, 2010 and 2009. As of March 31, 2010 and December 31, 2009, the Company's balance sheet includes a receivable of \$25.2 million and \$19.2 million, respectively from cumulative marketing expenses incurred in excess of cumulative marketing fee revenues earned. As of March 31, 2010 and December 31, 2009, the Company's balance sheet includes a receivable from cumulative reservation expenses incurred in excess of cumulative reservation fee revenues earned totaling \$22.3 million and \$14.7 million, respectively. These receivables are recorded as an asset in the financial statements as the Company has the contractual authority to require that the franchisees in the system at any given point repay the Company for any deficits related to marketing and reservation activities. The Company's current franchisees are legally obligated to pay any assessment the Company imposes on its franchisees to obtain reimbursement of such deficit regardless of whether those constituents continue to generate gross room revenue. The Company has no present intention to accelerate repayment of the deficit from current franchisees. Conversely, cumulative reservation and marketing fees not expended are recorded as a payable in the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

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

*Other Income and Expenses, Net:* Other income and expenses, net, increased \$3.0 million to income of \$0.8 million for the three months ended March 31, 2010 compared to an expense of \$2.2 million in the same period of the prior year. Interest expense decreased from \$1.5 million for the three months ended March 31, 2009 to \$0.6 million for the same period of 2010. Interest expense decreased due to a decline in the Company's weighted average interest rate from 1.6% as of March 31, 2009 to 0.6% as of March 31, 2010, as well as lower outstanding borrowings. The decline in the weighted average interest rate is due to lower variable borrowing costs on the Company's \$350 million senior unsecured revolving credit agreement.

Interest and other investment income increased \$1.9 million primarily due to the appreciation in the fair value of investments held in the Company's non-qualified employee benefit plans compared to decline in the fair value of these investments in the prior year. As discussed in the accompanying critical accounting policies, the Company sponsors two non-qualified retirement and savings plans: the Non-Qualified Plan and the EDCP plan. The fair value of the Non-Qualified Plan investments increased \$0.3 million during the three months ended March 31, 2010 compared to a \$0.2 million decline in fair value during the three months ended March 31, 2009. The fair value of the Company's investments held in the EDCP plan appreciated \$0.5 million during the three months ended March 31, 2010 compared to a decline in fair value of \$0.7 million during the same period of the prior year.

The Company accounts for the Non-Qualified Plan in accordance with accounting for deferred compensation arrangements when investments are held in a rabbi trust and invested. As a result, the Company also recognizes compensation expense in SG&A related to changes in the fair value of investments held in the Non-Qualified Plan, excluding investments in the Company's stock. Therefore, during the three months ended March 31, 2010, the Company recognized additional SG&A expense totaling \$0.4 million. During the three months ended March 31, 2009, the

Company's SG&A expense was reduced by \$0.3 million due to the decline in fair value of these investments.

---

**Table of Contents**

*Income Taxes:* The Company's effective income tax rate was 35.9% for the three months ended March 31, 2010, compared to an effective income tax rate of 36.3% for the three months ended March 31, 2009. The effective income tax rate for the three months ended March 31, 2010, declined from the same period of the prior year primarily due to a decline in the Company's foreign income tax liability. Depending upon the outcome of certain income tax contingencies, up to an additional \$2.1 million of additional tax benefits may be reflected in our 2010 results of operations from the resolution of tax contingency reserves.

*Net income:* Net income for the three months ended March 31, 2010 decreased by 3% to \$15.8 million from \$16.3 million in the same period of the prior year. Adjusted net income, as adjusted for certain items described above, declined \$0.5 million or 3% to \$16.0 million for the three months ended March 31, 2010 from \$16.5 million for the same period of the prior year.

*Diluted EPS:* Diluted EPS declined \$0.01 per share from \$0.27 for the three months ended March 31, 2009 to \$0.26 for 2010. Adjusted diluted EPS, which excludes certain items described above, totaled \$0.27 for the three months ended March 31, 2010 compared to \$0.27 for the same period of the prior year.

**Liquidity and Capital Resources**

Net cash provided by operating activities declined \$3.5 million to \$7.0 million for the three months ended March 31, 2010 from \$10.5 million for the same period of 2009. The decline in cash flows from operating activities primarily reflects the decline in operating income as well as the timing of working capital items.

Net cash advanced for marketing and reservations activities totaled \$10.9 million and \$10.4 million during the three months ended March 31, 2010 and 2009, respectively. Cash advances during the three months ended March 31, 2010 related primarily to planned increases in advertising and promotional cost spending versus fees collected, investments in information technology initiatives as well as the seasonality of the business. Based on the current economic conditions, the Company expects marketing and reservation activities to be a net use of cash ranging between \$15 million and \$20 million in 2010.

Cash utilized for investing activities totaled \$6.3 million and \$3.9 million for the three months ended March 31, 2010 and 2009, respectively. The increase in cash utilized for investing activities was primarily due to an increase in capital expenditures. During the three months ended March 31, 2010 and 2009, capital expenditures totaled \$4.6 million and \$2.1 million, respectively. Capital expenditures for 2010 primarily include upgrades of system-wide property and yield management systems, improvements to Company facilities and information systems infrastructure and the purchase of computer software and equipment.

The Company occasionally provides financing to franchisees for property improvements, hotel development efforts and other purposes. During the three months ended March 31, 2010 and 2009, the Company advanced \$0.5 million and \$0.9 million, respectively for these purposes. At March 31, 2010, the Company had commitments to extend an additional \$5.5 million for these purposes provided certain conditions are met by its franchisees, of which \$1.8 million is expected to be advanced in the next twelve months.

Financing cash flows relate primarily to the Company's borrowings under its credit lines, treasury stock purchases and dividends. On June 16, 2006, the Company entered into a new \$350 million senior unsecured revolving credit agreement (the "Revolver"), with a syndicate of lenders. The Revolver allows the Company to borrow, repay and reborrow revolving loans up to \$350 million (which includes swingline loans for up to \$20 million and standby letters of credit of up to \$30 million) until the scheduled maturity date of June 16, 2011. The Company has the ability to request an increase in available borrowings under the Revolver by an additional amount of up to \$150 million by obtaining the agreement of the existing lenders to increase their lending commitments or by adding additional lenders. The rate of interest generally applicable for revolving loans under the Revolver is, at the Company's option, equal to either (i) the greater of the prime rate or the federal funds effective rate plus 50 basis points, or (ii) an adjusted LIBOR rate plus a margin between 22 and 70 basis points based on the Company's credit rating. The Revolver requires the Company to pay a quarterly facility fee, based upon the credit rating of the Company, at a rate between 8 and 17 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, excluding swingline loans, at all times when the amount borrowed under the Revolver exceeds 50% of the total commitment. As of March 31, 2010, the Company had \$293.9 million of revolving loans outstanding pursuant to the Revolver.

The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. The Revolver also restricts the Company's ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions. The maximum leverage ratio requires the Company to maintain a consolidated indebtedness to consolidated earnings before interest, taxes, depreciation and amortization ("EBITDA") ratio, as defined in the



## **Table of Contents**

Revolver, of less than 3.25x. At March 31 2010, the Company maintained a ratio of approximately 1.8x. Furthermore, the Revolver requires the Company to maintain a consolidated EBITDA to interest expense ratio of at least 3.75x. At March 31, 2010, the Company maintained a ratio of approximately 42.8x. At March 31, 2010, the Company was in compliance with all covenants under the Revolver.

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

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

As of March 31, 2010, total debt outstanding for the Company was \$293.9 million. No outstanding debt amounts at March 31, 2010 were scheduled to mature during the twelve months ending March 31, 2011.

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

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

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

During the three months ended March 31, 2010, the Company repurchased 0.2 million shares of its common stock under the share repurchase program at a total cost of \$6.9 million for an average price of \$31.75 per share. Since the program's inception through March 31, 2010, we have repurchased 43.1 million shares (including 33.0 million prior to the two-for-one stock split effected in October 2005) of common stock at a total cost of \$1.0 billion. Considering the effect of the two-for-one stock split, the Company has repurchased 76.1 million shares at an average price of \$13.33 per share through March 31, 2010. At March 31, 2010 the Company had 3.6 million shares remaining under the current stock repurchase authorization. Upon completion of the current authorization, our board of directors will evaluate the propriety of additional share repurchases.

Our Board has authorized us to enter into programs which permit us to offer investment, financing and guaranty support to qualified franchisees as well as acquire and resell real estate to incent franchise development in top markets for certain brands. We expect to opportunistically deploy this capital over the next several years. The Company previously announced that depending on market and other conditions, our expectation was that our annual investment in these programs would range from \$20 million to \$40 million. Notwithstanding these programs, the Company expects to continue to return value to its shareholders through a combination of share repurchases and dividends, subject to market and other conditions.

During the three months ended March 31, 2010, the Company recorded one-time employee termination charges totaling \$0.8 million in SG&A and marketing and reservation expenses. These charges related to salary and benefits continuation payments for employees separating from service with the Company. At March 31, 2010, the Company had approximately \$0.5 million of these salary and benefits continuation payments remaining to be remitted. In addition, the Company has approximately \$3.8 million of benefits remaining to be paid on termination benefits incurred during prior years. The Company expects to remit \$3.3 million of the remaining \$4.3 million of benefits payable during the next twelve months. In addition, the Company expects to satisfy approximately \$3.1 million of deferred compensation and retirement plan obligations during the next twelve months.

The Company believes that cash flows from operations and available financing capacity are adequate to meet the expected future operating, investing and financing needs of the business. However, events over the past year, including recent failures and near failures of a number of large financial service companies have made the capital markets increasingly volatile. As a result of the dislocation in the credit markets, the availability of reasonably priced credit may be limited and therefore reduce the Company's ability to return value to shareholders through dividends and its share repurchase program.





## **Table of Contents**

### **Critical Accounting Policies**

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

#### *Revenue Recognition.*

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

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

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

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

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

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

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

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

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

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

## **Table of Contents**

We provide Choice Privileges as a marketing program to franchised hotels and collect a percentage of program members' room revenue from franchises to operate the program. Revenues are deferred in an amount equal to the estimated fair value of the future redemption obligation. A third-party actuary estimates the eventual redemption rates and point values using various actuarial methods. These judgmental factors determine the required liability attributable to outstanding points. Upon redemption of points, the Company recognizes the previously deferred revenue as well as the corresponding expense relating to the cost of the awards redeemed. Revenues in excess of the estimated future redemption obligation are recognized when earned to reimburse the Company for costs incurred to operate the program, including administrative costs, marketing, promotion and performing member services. Costs to operate the program, excluding estimated redemption values, are expensed when incurred.

### *Impairment Policy.*

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

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

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

### *Stock Compensation.*

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

### *Income Taxes.*

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

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



## **Table of Contents**

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.

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

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

The Company has established a recognition threshold a tax position is required to meet before being recognized in the financial statements. As of March 3, 2010, the Company had \$4.2 million of total unrecognized tax benefits of which \$2.5 million would affect the consolidated statements of income if recognized. We have reviewed our uncertain income tax positions and the Company believes it is reasonably possible it will recognize tax benefits of up to \$2.1 million within the next twelve months. This is due to the anticipated lapse of applicable statutes of limitations regarding state tax positions and stock-based compensation deductions.

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

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

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

In 2002, the Company adopted the Choice Hotels International, Inc. Executive Deferred Compensation Plan (EDCP) which became effective January 1, 2003. Under the EDCP, certain executive officers may defer a portion of their salary into an irrevocable trust. A participant may elect an investment return of either the annual yield of the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points, or a return based on a selection of available diversified investment options. Effective January 1, 2010, the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points is no longer an investment option for salary deferrals made on compensation earned after December 31, 2009. As of March 31, 2010 and December 31, 2009, the Company recorded a deferred compensation liability of \$16.8 million and \$17.6 million, respectively related to these deferrals and credited investment returns. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. Compensation expense recorded in SG&A for both the three months ended March 31, 2010 and 2009 were \$0.2 million.

The Company has invested the employee salary deferrals in diversified long-term investments which are intended to provide investment returns that partially offset the earnings credited to the participants. The diversified investments held in the trusts totaled \$12.3 million and \$10.9 million as of March 31, 2010 and December 31, 2009, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore, the changes in the fair value of the diversified assets is included in other income and expenses, net in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended March 31, 2010 and 2009 totaling \$0.5 million and (\$0.7 million), respectively.



**Table of Contents**

In 1997, the Company adopted the Choice Hotels International, Inc. Nonqualified Retirement Savings and Investment Plan ( Non-Qualified Plan ). The Non-Qualified Plan allows certain employees who do not participate in the EDCP to defer a portion of their salary and invest these amounts in a selection of available diversified investment options. As of March 31, 2010 and December 31, 2009, the Company had recorded a deferred compensation liability of \$10.9 million and \$11.0 million, respectively related to these deferrals. Compensation expense is recorded in SG&A expense on the Company s consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. The net increase (decrease) in compensation expense recorded in SG&A for the three months ended March 31, 2010 and 2009 was \$0.4 million and (\$0.3) million, respectively.

The diversified investments held in the trusts were \$10.0 million and \$10.1 million as of March 31, 2010 and December 31, 2009, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other income and expenses, net in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended March 31, 2010 and 2009 of \$0.3 million and (\$0.2) million, respectively. In addition, the Non-Qualified Plan held shares of the Company s common stock with a market value of \$0.9 million at both March 31, 2010 and December 31, 2009.

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

**Recently Issued Accounting Standards**

On September 23, 2009, the FASB ratified Emerging Issues Task Force ( EITF ) Issue No. 08-1, Revenue Arrangements with Multiple Deliverables ( EITF 08-1 ). EITF 08-1 updates the current guidance pertaining to multiple-element revenue arrangements included in ASC Subtopic 605-25, which originated primarily from EITF 00-21, also titled Revenue Arrangements with Multiple Deliverables. EITF 08-1 will be effective for annual reporting periods beginning January 1, 2011 for calendar year entities with earlier adoption permitted. The Company is currently evaluating the impact of EITF 08-1 on its financial position, results of operations, cash flows, and disclosures, if any.

**FORWARD-LOOKING STATEMENTS**

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

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

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

The Company is exposed to market risk from changes in interest rates and the impact of fluctuations in foreign currencies on the Company s foreign investments and operations. The Company manages its exposure to these market risks through the monitoring of its available financing alternatives including in certain circumstances the use of derivative financial instruments. We are also subject to risk from changes in debt and equity prices from our non-qualified retirement savings plan investments in debt securities and common stock, which had carrying values of

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

\$22.3 million and \$20.9 million at March 31, 2010 and December 31, 2009, respectively. The Company will continue to monitor the exposure in these areas and make the appropriate adjustments as market conditions dictate.



**Table of Contents**

At March 31, 2010 and December 31, 2009, the Company had \$293.9 million and \$277.7 million of debt outstanding at a weighted average effective interest rate of 0.6% and 0.7%, respectively. A hypothetical change of 10% in the Company's effective interest rate from March 31, 2010 levels would increase or decrease interest expense by \$0.2 million. The Company expects to refinance its long-term debt obligations prior to their scheduled maturities.

The Company does not presently have any derivative financial instruments.

**ITEM 4. CONTROLS AND PROCEDURES**

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

An evaluation was performed under the supervision and with the participation of the Company's CEO and CFO of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of March 31, 2010.

There has been no change in the Company's internal controls over financial reporting that occurred during the quarter ended March 31, 2010, that materially affected, or is reasonably likely to materially affect the Company's internal controls over financial reporting.

**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

None.

**ITEM 1A. RISK FACTORS**

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

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

The following table sets forth purchases and redemptions of Choice Hotels International, Inc. common stock made by the Company during the three months ended March 31, 2010.

Month Ending	Total Number of Shares Purchased or Redeemed	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>(1),(2)</sup>	Maximum Number of Shares that may yet be Purchased Under the Plans or Programs, End of Period
January 31, 2010	57,866	\$ 32.00	45,161	3,795,473

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

February 28, 2010	222,432	31.64	171,400	3,624,073
March 31, 2010	1,396	34.73		3,624,073
Total	281,694	\$ 31.73	216,561	3,624,073

- (1) The Company's share repurchase program was initially approved by the board of directors on June 25, 1998. The program has no fixed dollar amount or expiration date.
- (2) During the three months ended March 31 2010, the Company redeemed 65,133 shares of common stock from employees to satisfy minimum tax-withholding requirements related to the vesting of restricted stock and performance vested restricted stock unit grants. These redemptions were not part of the board repurchase authorization.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. (REMOVED AND RESERVED)**

**Table of Contents****ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS****(a) Exhibits****Exhibit Number and Description****Exhibit**

<b>Number</b>	<b>Description</b>
3.01(a)	Restated Certificate of Incorporation of Choice Hotels Franchising, Inc. (renamed Choice Hotels International, Inc.)
3.02(b)	Amended and Restated Bylaws of Choice Hotels International, Inc.
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 Current Report on Form 8-K dated February 15, 2010, filed February 16, 2010.

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

The Company filed a report on Form 8-K, dated January 5, 2010, reporting that on January 5, 2010, the Company's President and Chief Executive Officer and other members of the Company's senior management team provided an update on the Company's business operations, growth strategies and outlook for 2009 and 2010 via a publicly accessible webcast. The presentation materials contained certain non-GAAP financial measures. A reconciliation of those measures to the most directly related comparable GAAP measures was included in the presentation materials.

The Company filed a report on Form 8-K, dated February 12, 2010, reporting that a press release dated February 11, 2010 had been issued reporting the Company's earnings for the quarter and year ended December 31, 2009.

The Company filed a report on Form 8-K, dated February 16, 2010 reporting that on February 15, 2010, the Board of Directors unanimously approved an amendment and restatement of the Company's Bylaws effective immediately. The changes contained in the Amended and Restated Bylaws are intended to address actual or potential inconsistencies between the Bylaws and other relevant corporate documents or with corporate practice, and reflect updates to Delaware corporate law.

The Company filed a report on Form 8-K, dated March 3, 2010, reporting that on March 3, 2010, the Company posted a presentation to its website, [www.choicehotels.com](http://www.choicehotels.com), which was scheduled to be presented at the 2010 Deutsche Bank Hospitality and Gaming Conference in New York, New York on March 3, 2010. The materials contained certain non-GAAP financial measures. A reconciliation of those measures to the most directly related comparable GAAP measures was included in the presentation materials.

**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: April 30, 2010

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

35