

CHOICE HOTELS INTERNATIONAL INC /DE

Form 10-Q

August 09, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2010

OR

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

COMMISSION FILE NO. 001-13393

CHOICE HOTELS INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
 (State or other jurisdiction of
 incorporation or organization)

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

10750 COLUMBIA PIKE

SILVER SPRING, MD. 20901

(Address of principal executive offices)

(Zip Code)

(301) 592-5000

(Registrant's telephone number, including area code)

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

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

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

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

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

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

CLASS
 Common Stock, Par Value \$0.01 per share

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED, IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

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

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Diluted earnings per share	\$ 0.45	\$ 0.42	\$ 0.72	\$ 0.69
Cash dividends declared per share	\$ 0.185	\$ 0.185	\$ 0.37	\$ 0.37

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

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

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

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

Retained earnings	685,300	664,431
Total shareholders deficit	(97,035)	(114,212)
Total liabilities and shareholders deficit	\$ 390,208	\$ 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)**

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

Cash and cash equivalents at end of period **\$ 70,926** \$ 61,810

Supplemental disclosure of cash flow information:

Cash payments during the period for:

Income taxes, net of refunds **\$ 11,921** \$ 1,485

Interest **\$ 1,341** \$ 3,258

Non-cash financing activities:

Declaration of dividends **\$ 21,934** \$ 22,207

Issuance of restricted shares of common stock **\$ 9,083** \$ 6,931

Issuance of performance vested restricted stock units **\$ 256** \$ 461

Issuance of treasury stock to employee stock purchase plan **\$ 314** \$ 301

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Company Information and Significant Accounting Policies

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

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

Cash and Cash Equivalents

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

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

Recently Adopted Accounting Guidance

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

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

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

Other current assets consist of the following:

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

3. Notes Receivable

	June 30, 2010	December 31, 2009
(In thousands)		
Forgivable notes receivable	\$ 7,080	\$ 7,432
Mezzanine and other notes receivables	19,766	12,345
	26,846	19,777
Loan reserves	(9,733)	(9,531)
Total	\$ 17,113	\$ 10,246
Current portion, net	\$ 8,874	\$ 2,378
Long-term portion, net	8,239	7,868
Total	\$ 17,113	\$ 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 typically range from 3 to 10 years, bearing market interest rates, and are forgiven and amortized over that time period if the franchisee remains in the system in good standing. As of June 30, 2010 and December 31, 2009, the unamortized balance of these notes totaled \$7.1 million and \$7.4 million, respectively. The Company recorded an allowance for credit losses on these forgivable notes receivable of \$0.7 million at both June 30, 2010 and December 31, 2009. Amortization expense included in the accompanying consolidated statements of income related to the notes was \$0.5 million and \$1.0 million for the three and six months ended June 30, 2010, respectively. Amortization expense for the three and six months ended June 30, 2009 relating to the notes was \$0.5 million and \$1.0 million, respectively. At

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

Mezzanine and Other Notes Receivable

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

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

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

5. Deferred Revenue

Deferred revenue consists of the following:

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

6. Debt

On June 16, 2006, the Company entered into a \$350 million senior unsecured revolving credit agreement (the "Revolver"), with a syndicate of lenders. The Revolver allows the Company to borrow, repay and reborrow revolving loans up to \$350 million (which includes swingline loans for up to \$20 million and standby letters of credit of up to \$30 million) until the scheduled maturity date of June 16, 2011. The Company has the ability to request an increase in available borrowings under the Revolver by an additional amount of up to \$150 million by obtaining the agreement of the existing lenders to increase their lending commitments or by adding additional lenders. The rate of interest generally applicable for revolving loans under the Revolver is, at the Company's option, equal to either (i) the greater of the prime rate or the federal funds effective rate plus 50 basis points, or (ii) an adjusted LIBOR rate plus a margin between 22 and 70 basis points based on the Company's credit rating. The Revolver requires the Company to pay a quarterly facility fee, based upon the credit rating of the Company, at a rate between 8 and 17^{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 June 30, 2010, the Company had \$291.1 million of revolving loans outstanding pursuant to the Revolver and the Company was in compliance with all covenants.

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

pursuant to this line of credit.

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

7. Acquisition of Choice Hospitality (India) Ltd.

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

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

8. Pension Plan

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

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

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

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

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

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

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

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

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

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

9. Non-Qualified Retirement, Savings and Investment Plans

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

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

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

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

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

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

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

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

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

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

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

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

11. Income Taxes

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

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

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

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

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

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

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

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

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

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

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

Restricted Stock

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

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

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

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

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

Performance Vested Restricted Stock Units

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

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

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

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

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

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

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

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

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

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

Dividends

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

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

Stock Repurchase Program

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

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

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

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

13. Comprehensive Income

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

(In thousands)	Three Months Ended		Six Months Ended	
	June 30, 2010	2009	June 30, 2010	2009
Net income	\$ 27,011	\$ 25,503	\$ 42,804	\$ 41,811
Other comprehensive income (loss), net of tax:				
Amortization of pension related costs, net of tax				
Prior service costs		36		72
Foreign currency translation adjustment, net	(1,189)	1,586	(1,183)	1,327
Other comprehensive income (loss), net of tax	(1,189)	1,622	(1,183)	1,399
Comprehensive income	\$ 25,822	\$ 27,125	\$ 41,621	\$ 43,210

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

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

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

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

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

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

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

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

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

15. Reportable Segment Information

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

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

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

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

16. Commitments and Contingencies

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

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

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

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

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

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

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

17. Termination Charges

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

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

18. Future Adoption of Accounting Standards

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

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

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

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

19. Subsequent Events

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

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

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

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

Overview

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

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

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

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

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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

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

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

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

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

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

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

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

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

other conditions.

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

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

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

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

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

Operations Review

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

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

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

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

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

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

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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**

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

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

Calculation of Adjusted Operating Income

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

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

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

Calculation of Adjusted Net Income and Adjusted Diluted EPS

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

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

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

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

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

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