

CHOICE HOTELS INTERNATIONAL INC /DE

Form 10-Q

August 09, 2007

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

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

| | SHARES OUTSTANDING |
|--|---------------------------|
| CLASS | AT JUNE 30, 2007 |
| Common Stock, Par Value \$0.01 per share | 65,701,820 |

Table of Contents

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

INDEX

| | PAGE NO. |
|---|-----------------|
| <u>PART I. FINANCIAL INFORMATION:</u> | |
| <u>Item 1 Financial Statements</u> | 3 |
| <u>Consolidated Statements of Income For the three and six months ended June 30, 2007 (Unaudited) and June 30, 2006 (Unaudited)</u> | 3 |
| <u>Consolidated Balance Sheets As of June 30, 2007 (Unaudited) and December 31, 2006</u> | 4 |
| <u>Consolidated Statements of Cash Flows For the six months ended June 30, 2007 (Unaudited) and June 30, 2006 (Unaudited)</u> | 5 |
| <u>Notes to Consolidated Financial Statements (Unaudited)</u> | 6 |
| <u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 21 |
| <u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u> | 33 |
| <u>Item 4 Controls and Procedures</u> | 33 |
| <u>PART II. OTHER INFORMATION:</u> | |
| <u>Item 1 Legal Proceedings</u> | 33 |
| <u>Item 1A Risk Factors</u> | 34 |
| <u>Item 2 Unregistered Sales of Equity Securities, Use of Proceeds and Issuer Purchases of Equity Securities</u> | 34 |
| <u>Item 3 Defaults Upon Senior Securities</u> | 34 |
| <u>Item 4 Submission of Matters to a Vote of Security Holders</u> | 34 |
| <u>Item 5 Other Information</u> | 34 |
| <u>Item 6 Exhibits</u> | 35 |
| <u>SIGNATURE</u> | 37 |

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(UNAUDITED, IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|------------------|------------------------------|------------------|
| | 2007 | 2006 | 2007 | 2006 |
| REVENUES: | | | | |
| Royalty fees | \$ 59,176 | \$ 53,146 | \$ 102,504 | \$ 93,010 |
| Initial franchise and relicensing fees | 7,649 | 6,723 | 12,580 | 12,366 |
| Brand solutions | 5,995 | 4,900 | 8,981 | 7,682 |
| Marketing and reservation | 81,810 | 72,742 | 143,851 | 130,718 |
| Hotel operations | 1,193 | 1,180 | 2,289 | 2,160 |
| Other | 1,886 | 1,849 | 3,687 | 4,022 |
| Total revenues | 157,709 | 140,540 | 273,892 | 249,958 |
| OPERATING EXPENSES: | | | | |
| Selling, general and administrative | 25,605 | 22,242 | 49,505 | 40,517 |
| Depreciation and amortization | 2,137 | 2,642 | 4,252 | 4,991 |
| Marketing and reservation | 81,810 | 72,742 | 143,851 | 130,718 |
| Hotel operations | 794 | 800 | 1,535 | 1,545 |
| Total operating expenses | 110,346 | 98,426 | 199,143 | 177,771 |
| Operating income | 47,363 | 42,114 | 74,749 | 72,187 |
| OTHER INCOME AND EXPENSES, NET: | | | | |
| Interest expense | 3,217 | 4,044 | 6,214 | 8,084 |
| Interest and other investment (income) loss | (1,721) | 174 | (2,322) | (530) |
| Equity in net income of affiliates | (181) | (130) | (375) | (388) |
| Loss on extinguishment of debt | | 342 | | 342 |
| Total other income and expenses, net | 1,315 | 4,430 | 3,517 | 7,508 |
| Income before income taxes | 46,048 | 37,684 | 71,232 | 64,679 |
| Income taxes | 17,403 | 13,548 | 26,272 | 22,878 |
| Net income | \$ 28,645 | \$ 24,136 | \$ 44,960 | \$ 41,801 |
| Weighted average shares outstanding-basic | 65,475 | 65,356 | 65,627 | 65,070 |
| Weighted average shares outstanding-diluted | 66,599 | 67,105 | 66,823 | 66,925 |
| Basic earnings per share | \$ 0.44 | \$ 0.37 | \$ 0.69 | \$ 0.64 |

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

| | | | | |
|--|----------------|---------|----------------|---------|
| Diluted earnings per share | \$ 0.43 | \$ 0.36 | \$ 0.67 | \$ 0.62 |
| Cash dividends declared per share | \$ 0.15 | \$ 0.13 | \$ 0.30 | \$ 0.26 |

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

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

| | June 30, 2007 (Unaudited) | December 31, 2006 |
|---|---------------------------------|----------------------|
| Current assets | | |
| Cash and cash equivalents | \$ 47,330 | \$ 35,841 |
| Receivables (net of allowance for doubtful accounts of \$3,629 and \$3,937, respectively) | 45,995 | 41,694 |
| Deferred income taxes | 3,061 | 1,790 |
| Investments, employee benefit plans, at fair value | 3,343 | |
| Other current assets | 11,745 | 7,757 |
| Total current assets | 111,474 | 87,082 |
| Property and equipment, at cost, net | 43,674 | 42,802 |
| Goodwill | 65,813 | 65,813 |
| Franchise rights and other identifiable intangibles, net | 33,677 | 35,509 |
| Receivable marketing fees | 7,139 | 6,662 |
| Investments, employee benefit plans, at fair value | 34,083 | 31,529 |
| Deferred income taxes | 25,387 | 22,451 |
| Other assets | 10,797 | 11,461 |
| Total assets | \$ 332,044 | \$ 303,309 |
| LIABILITIES AND SHAREHOLDERS DEFICIT | | |
| Current liabilities | | |
| Current portion of long-term debt | \$ | \$ 146 |
| Accounts payable | 41,545 | 41,816 |
| Accrued expenses and other | 33,071 | 45,306 |
| Deferred revenue | 48,984 | 47,167 |
| Income taxes payable | 17,936 | 5,356 |
| Deferred compensation and retirement plan obligations | 3,343 | |
| Total current liabilities | 144,879 | 139,791 |
| Long-term debt | 199,146 | 172,390 |
| Deferred compensation and retirement plan obligations | 41,543 | 40,101 |
| Other liabilities | 18,329 | 13,407 |
| Total liabilities | 403,897 | 365,689 |
| Commitments and contingencies | | |
| SHAREHOLDERS DEFICIT | | |
| Common stock, \$0.01 par value | 657 | 664 |
| Additional paid-in-capital | 80,732 | 81,689 |
| Accumulated other comprehensive income (loss) | 378 | (772) |
| Treasury stock, at cost | (662,192) | (627,311) |
| Retained earnings | 508,572 | 483,350 |

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

| | | |
|---|-------------------|-------------------|
| Total shareholders deficit | (71,853) | (62,380) |
| Total liabilities and shareholders deficit | \$ 332,044 | \$ 303,309 |

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, | |
|---|--------------------------------------|-----------------|
| | 2007 | 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 44,960 | \$ 41,801 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,252 | 4,991 |
| Provision for bad debts | (528) | (127) |
| Non-cash stock compensation and other charges | 6,891 | 5,550 |
| Non-cash interest and other income | (1,598) | (107) |
| Loss on extinguishment of debt | | 342 |
| Dividends received from equity method investees | 295 | 169 |
| Equity in net income of affiliates | (375) | (388) |
| Changes in assets and liabilities, net of acquisitions: | | |
| Receivables | (3,654) | (3,414) |
| Receivable - marketing and reservation fees, net | 1,731 | 670 |
| Accounts payable | (277) | 8,404 |
| Accrued expenses and other | (12,678) | (7,549) |
| Income taxes payable | 12,580 | 4,815 |
| Deferred income taxes | (4,680) | (1,912) |
| Deferred revenue | 1,817 | 3,603 |
| Other assets | (1,278) | (420) |
| Other liabilities | 9,688 | 6,200 |
| Net cash provided by operating activities | 57,146 | 62,628 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Investment in property and equipment | (5,786) | (4,045) |
| Acquisitions, net of cash acquired | (343) | |
| Issuance of notes receivable | (3,255) | (1,277) |
| Collections of notes receivable | 469 | 359 |
| Purchases of investments, employee benefit plans | (5,701) | (5,784) |
| Proceeds from sale of investments, employee benefit plans | 1,551 | 1,387 |
| Other items, net | (359) | (296) |
| Net cash used in investing activities | (13,424) | (9,656) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Principal payments of long-term debt | (422) | (73) |
| Net borrowings (repayments) pursuant to revolving credit facility | 27,000 | (49,600) |
| Purchase of treasury stock | (47,341) | (1,132) |
| Excess tax benefits from stock-based compensation | 3,765 | 11,983 |
| Debt issuance costs | | (472) |
| Dividends paid | (19,751) | (16,925) |
| Proceeds from exercise of stock options | 4,516 | 7,984 |
| Net cash used in financing activities | (32,233) | (48,235) |

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

| | | |
|--|------------------|-----------|
| Net change in cash and cash equivalents | 11,489 | 4,737 |
| Cash and cash equivalents at beginning of period | 35,841 | 16,921 |
| Cash and cash equivalents at end of period | \$ 47,330 | \$ 21,658 |
| Supplemental disclosure of cash flow information: | | |
| Cash payments during the period for: | | |
| Income taxes, net of refunds | \$ 13,506 | \$ 7,734 |
| Interest | \$ 6,155 | \$ 8,115 |
| Non-cash financing activities: | | |
| Declaration of dividends | \$ 19,651 | \$ 17,059 |
| Issuance of restricted shares of common stock | \$ 5,935 | \$ 6,549 |
| Issuance of treasury stock to employee stock purchase plan | \$ 396 | |

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. 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 condensed 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, 2006 and notes thereto included in the Company's Form 10-K, filed with the Securities and Exchange Commission on March 1, 2007 (the 10-K). Interim results are not necessarily indicative of the entire year results because of seasonal variations. All intercompany transactions and balances between Choice Hotels International, Inc. and its subsidiaries have been eliminated in consolidation.

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

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

The Company revised its presentation of cash flows for the six months ended June 30, 2006 related to dividends received from equity method investees. During the first six months of 2006, the Company had presented these cash flows as investing activities on its consolidated statement of cash flows. Statement of Financial Accounting Standards (SFAS) No. 95, Statement of Cash Flows requires these dividends, which represent a return on investments, to be classified as operating cash flows. There was no effect on any other previously reported income statement or balance sheet amounts.

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, 2007 and December 31, 2006, \$6.6 million and \$7.8 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.

Land held for sale

During the three months ended June 30, 2007, the Company acquired for resale 2.1 acres of undeveloped land in San Antonio, Texas at a cost of approximately \$1.0 million. The Company concluded that the land qualified as land held for sale and therefore has recorded the land at its fair value as of June 30, 2007 in other current assets on the accompanying consolidated balance sheet.

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

The marketing fees receivable at June 30, 2007 and December 31, 2006 was \$7.1 million and \$6.7 million, respectively. As of June 30, 2007 and December 31, 2006, cumulative reservation fees collected exceeded expenses by \$6.7 million and \$8.4 million, respectively, and the excess has been reflected as a long-term liability in the accompanying consolidated balance sheets. Depreciation and amortization expense attributable to marketing and reservation activities was \$1.9 million and \$2.0 million for the three months ended June 30, 2007 and 2006, respectively, and \$3.9 million for both the six months ended June 30, 2007 and 2006. Interest expense attributable to reservation activities was \$0.1 million and \$0.2 million for the three months ended June 30, 2007 and 2006, respectively, and \$0.3 million and \$0.4 million for the six months ended June 30, 2007 and 2006, respectively.

3. Income Taxes

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

The effective income tax rates for the 2007 and 2006 six-month periods ended June 30, of approximately 36.9% and 35.4%, respectively, differ from the statutory rate due to foreign income earned, which is taxed at lower rates than statutory federal income tax rates; state income taxes; and certain federal and state income tax credits.

Effective January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes . FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This pronouncement also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. As a result of the implementation of FIN 48, the Company increased its existing reserves for uncertain tax positions by \$3.2 million with a corresponding net reduction to opening additional paid-in-capital and retained earnings.

As of January 1, 2007 and June 30, 2007, the Company had \$8.2 million and \$9.0 million, respectively of total unrecognized tax benefits of which approximately \$5.1 million and \$5.5 million, respectively would affect the effective tax rate if recognized. These unrecognized tax benefits relate principally to state tax filing positions and previously deducted expenses. The Company believes it is reasonably possible it will recognize tax benefits of up to \$2.0 million within the next twelve months. This is related to the anticipated expiration of statutes of limitations of previously deducted expenses.

In many cases, 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 2002. Substantially all material state and local and foreign income tax matters have been concluded for years through 2002. U.S. federal income tax returns for 2003 through 2006 are currently open for examination.

Table of Contents

Estimated interest and penalties related to the underpayment of income taxes are classified as a component of income tax expense in the consolidated statements of income and totaled \$0.2 million and \$0.3 million for the three months and six months ended June 30, 2007, respectively. Accrued interest and penalties were \$1.1 million and \$1.4 million as of January 1, 2007 and June 30, 2007, respectively.

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

4. Comprehensive Income

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

| (In thousands) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-----------|
| | 2007 | 2006 | 2007 | 2006 |
| Net income | \$ 28,645 | \$ 24,136 | \$ 44,960 | \$ 41,801 |
| Other comprehensive income, net of tax: | | | | |
| Amortization of pension related costs, net of tax | | | | |
| Prior service costs | 7 | | 14 | |
| Actuarial loss | 7 | | 20 | |
| Curtailement and remeasurement, net of tax | | | 758 | |
| Foreign currency translation adjustment, net | 319 | 101 | 391 | 71 |
| Amortization of deferred gain on hedge, net | (16) | (16) | (33) | (33) |
| Other comprehensive income | 317 | 85 | 1,150 | 38 |
| Comprehensive income | \$ 28,962 | \$ 24,221 | \$ 46,110 | \$ 41,839 |

5. Capital Stock*Stock Options*

The Company granted 0.2 million options to officers of the Company during both the six months ended June 30, 2007 and 2006 at a fair value of approximately \$2.6 million and \$2.8 million during the six months ended June 30, 2007 and 2006, respectively. The Company granted 45,000 options to officers of the Company at a fair value of approximately \$0.5 million during the three months ended June 30, 2007. No options were granted during the three months ended June 30, 2006. 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:

| | 2007 Grants | 2006 Grants |
|--|-------------|-------------|
| Risk-free interest rate | 4.84% | 4.69% |
| Expected volatility | 32.31% | 32.09% |
| Expected life of stock option | 4.5 years | 4.3 years |
| Dividend yield | 1.49% | 1.07% |
| Requisite service period | 4 years | 4 years |
| Contractual life | 7 years | 7 years |
| Weighted average fair value of options granted | \$ 12.15 | \$ 14.82 |

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. 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.

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

The aggregate intrinsic value of the stock options outstanding and exercisable at June 30, 2007 was \$60.0 million and \$52.0 million, respectively. The total intrinsic value of options exercised during the three months ended June 30, 2007 and 2006 was \$8.0 million and \$25.3 million, respectively, and \$12.7 million and \$40.5 million during the six months ended June 30, 2007 and 2006, respectively.

The Company received \$2.8 million and \$4.5 million in proceeds from the exercise of 0.3 million and 0.4 million employee stock options during the three and six months ended June 30, 2007, respectively. During the three and six months ended June 30, 2006, the Company received \$4.5 million and \$8.0 million in proceeds from the exercise of 0.6 million and 1.0 million employee stock options, respectively.

Table of Contents*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, | |
|--|--------------------------------|----------|------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| Restricted share grants | 32,544 | 15,191 | 146,967 | 133,207 |
| Weighted Average Grant Date Fair Value Per Share | \$ 38.12 | \$ 52.64 | \$ 40.39 | \$ 49.16 |
| Aggregate Grant Date Fair Value (\$000) | \$ 1,241 | \$ 800 | \$ 5,935 | \$ 6,549 |
| Restricted Shares Forfeited | 7,693 | 13,513 | 25,790 | 18,487 |
| Vesting Service Period of Shares Granted | 4 years | 4 years | 4 years | 4 years |
| Fair Value of Shares Vested (\$000) | \$ 463 | \$ 914 | \$ 5,437 | \$ 8,027 |

Compensation expense related to the fair value of these awards is recognized straight-line over the requisite service period on those restricted stock grants that ultimately vest. The fair value is measured by the average of the high and low market price of the Company's common stock on the date of grant. Restricted stock awards in 2007 and 2006 vest ratably at 25 percent per year beginning with the first anniversary of the grant date.

Performance Vested Restricted Stock Units

During the first quarter of 2007, the Company granted performance vested restricted stock units (PVRSU) to certain officers. The vesting of these stock awards is contingent upon the Company achieving specified earnings per share targets at the end of 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 50% and 200% of the initial target. Under SFAS No. 123 (Revised), Share-Based Payment (SFAS No. 123R), compensation expense related to these awards will be recognized over the requisite period regardless of whether the performance targets have been met based on the Company's estimate of the achievement of the performance target. The Company has currently estimated that 100% and 130% of the 2007 and 2006 awards targets will be achieved, respectively. The fair value is measured by the average of the high and low market price of the Company's common stock on the date of grant. Compensation expense is recognized ratably over the requisite service period based on those PVRSU's that ultimately vest. There were no grants of PVRSU's during the three months ended June 30, 2007 and 2006.

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

| | Six Months Ended June 30, | |
|---|------------------------------|----------|
| | 2007 | 2006 |
| Performance Vested Restricted Stock Units Granted | 21,141 | 29,780 |
| Weighted Average Grant Date Fair Value Per Share | \$ 40.75 | \$ 48.72 |
| Aggregate Grant Date Fair Value (\$000) | \$ 862 | \$ 1,451 |
| Requisite Service Period | 3 years | 3 years |

A summary of stock-based award activity as of June 30, 2007, and changes during the six months ended are presented below:

| | Six Months Ended June 30, 2007 | | | | |
|--------------------------------|--------------------------------|---|--|--|--|
| | Shares | Stock Options Weighted Average Exercise Price | Weighted Average Contractual Term | Restricted Stock Weighted Average Grant Date Fair Value | Performance Vested Restricted Stock Units Weighted Average Grant Date Fair Value |
| Outstanding at January 1, 2007 | 2,860,159 | \$ 14.30 | | \$ 29.81 | \$ 46.22 |
| Granted | 210,957 | 40.21 | | 40.39 | 40.75 |
| | | | 570,134 | | 49,780 |

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

| | | | | | | | | |
|--------------------------------------|-----------|----------|-----------|-----------|----------|--------|----------|--|
| Exercised/Vested | (446,960) | 10.10 | | (132,632) | 28.84 | | | |
| Forfeited/Expired | (38,661) | 19.87 | | (25,790) | 30.58 | | | |
| Outstanding at June 30, 2007 | 2,585,495 | \$ 17.06 | 4.6 years | 558,679 | \$ 32.78 | 70,921 | \$ 44.59 | |
| Options exercisable at June 30, 2007 | 1,824,490 | \$ 11.28 | 3.8 years | | | | | |

Table of Contents

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:

| (in millions) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|--------|------------------------------|--------|
| | 2007 | 2006 | 2007 | 2006 |
| Stock options | \$ 0.5 | \$ 0.8 | \$ 2.1 | \$ 2.4 |
| Restricted stock | 1.5 | 1.3 | 3.0 | 2.5 |
| Performance vested restricted stock units | 0.1 | 0.1 | 0.5 | 0.6 |
| Total | \$ 2.1 | \$ 2.2 | \$ 5.6 | \$ 5.5 |
| Income tax benefits | \$ 0.8 | \$ 0.8 | \$ 2.1 | \$ 2.1 |

Stock-based compensation expense on stock option and performance vested restricted stock grants made to a retirement eligible executive officer during the six months ended June 30, 2007 and 2006 was recognized upon issuance of the grants rather than over the awards' vesting periods since the terms of these grants provide that the awards will vest upon retirement of the employee. Compensation costs for stock options and performance vested restricted stock related to vesting upon retirement eligibility totaled \$1.2 million and \$1.3 million for the six month periods ended June 30, 2007 and 2006, respectively.

Dividends

On May 1, 2007, the Company declared a cash dividend of \$0.15 per share (or approximately \$9.8 million in the aggregate), which was paid on July 20, 2007 to shareholders of record on July 6, 2007. On February 12, 2007, the Company declared a cash dividend of \$0.15 per share (or approximately \$9.9 million in the aggregate), which was paid on April 20, 2007 to shareholders of record on April 5, 2007.

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

Stock Repurchase Program

During the three and six months ended June 30, 2007, the Company purchased 0.7 million and 1.2 million shares of common stock under the share repurchase program at a total cost of \$28.3 million and \$46.1 million, respectively. The Company did not purchase any common stock during the three and six months ended June 30, 2006 under the share repurchase program.

During the three and six months ended June 30, 2007, the Company purchased 2,160 and 31,139 shares of common stock at a total cost of \$0.1 million and \$1.3 million, respectively, from employees to satisfy statutory minimum tax-withholding requirements from the vesting of restricted stock grants. No shares were repurchased from employees to satisfy tax-withholding requirements during the three months ended June 30, 2006. During the six months ended June 30, 2006, the Company purchased 26,794 shares of common stock at a total cost of \$1.1 million to satisfy statutory minimum tax-withholding requirements from the vesting of restricted stock grants. These purchases were outside the share repurchase program initiated in June 1998.

6. Earnings Per Share

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

| (In thousands, except per share amounts) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------------|------|------------------------------|------|
| | 2007 | 2006 | 2007 | 2006 |

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

| | | | | |
|---|------------------|-----------|------------------|-----------|
| Computation of Basic Earnings Per Share: | | | | |
| Net Income | \$ 28,645 | \$ 24,136 | \$ 44,960 | \$ 41,801 |
| Weighted average shares outstanding-basic | 65,475 | 65,356 | 65,627 | 65,070 |
| Basic earnings per share | \$ 0.44 | \$ 0.37 | \$ 0.69 | \$ 0.64 |
| Computation of Diluted Earnings Per Share: | | | | |
| Net income for diluted earnings per share | \$ 28,645 | \$ 24,136 | \$ 44,960 | \$ 41,801 |
| Weighted average shares outstanding-basic | 65,475 | 65,356 | 65,627 | 65,070 |
| Effect of Dilutive Securities: | | | | |
| Employee stock option and restricted stock plan | 1,124 | 1,749 | 1,196 | 1,855 |
| Weighted average shares outstanding-diluted | 66,599 | 67,105 | 66,823 | 66,925 |
| Diluted earnings per share | \$ 0.43 | \$ 0.36 | \$ 0.67 | \$ 0.62 |

Basic earnings per share exclude dilution and are computed by dividing net income by the weighted-average number of common shares outstanding. Diluted earnings per share assumes dilution and is computed based on the weighted-average number of common shares outstanding after consideration of the dilutive effect of stock options and unvested restricted stock. The effect of dilutive securities is computed using the treasury stock method and average market prices during the period. However, at June 30, 2007 and 2006, PVRsUs totaling 70,921 and 29,780 were excluded from the computation since the performance conditions had not been met at the reporting date. In addition, at June 30, 2007, the Company excluded 0.4 million anti-dilutive options from the computation of diluted earnings per share for the three and six months ended June 30, 2007. There were no anti-dilutive options at June 30, 2006.

Table of Contents**7. Pension Plans**

The Company sponsors an unfunded non-qualified defined benefit plan (SERP) for certain senior executives. No assets are held with respect to the plan; therefore benefits are funded as paid to participants. Effective December 31, 2006, the Company began accounting for the SERP in accordance with SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS No. 158). For the three and six months ended June 30, 2007, the Company recorded \$0.2 million and \$0.8 million, respectively for the expenses related to the SERP which is included in selling, general and administrative expense in the accompanying consolidated statements of income. For the three and six months ended June 30, 2006, the Company recorded \$0.3 million and \$0.6 million, respectively for the expenses related to the SERP. Based on the plan retirement age of 65 years old, no benefit payments are anticipated over the current year.

The following table presents the components of net periodic benefit costs for the three and six months ended June 30, 2007 and 2006:

| (In thousands) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|--------|------------------------------|--------|
| | 2007 | 2006 | 2007 | 2006 |
| Components of net periodic pension cost: | | | | |
| Service cost | \$ 128 | \$ 170 | \$ 268 | \$ 339 |
| Interest cost | 94 | 87 | 191 | 175 |
| Amortization: | | | | |
| Prior service cost | 10 | 14 | 22 | 28 |
| Loss | 13 | 19 | 33 | 38 |
| | 245 | 290 | 514 | 580 |
| Curtailement | | | 248 | |
| Net periodic pension cost | \$ 245 | \$ 290 | \$ 762 | \$ 580 |

Curtailement

During the first quarter of 2007, the Company recognized a curtailement loss due to the termination of certain senior executive officers from the Company. The Company recognized a curtailement loss equal to the unrecognized prior service costs attributed to these employees' expected aggregate future services which totaled approximately \$248,000. In addition, the monthly net periodic pension costs declined from approximately \$106,000 to \$82,000. The components of projected pension costs for the year ended December 31, 2007 are as follows:

| | (In thousands) |
|---------------------------|----------------|
| Service cost | \$ 523 |
| Interest cost | 379 |
| Amortization | |
| Prior service cost | 43 |
| Loss | 58 |
| | 1,003 |
| Curtailement loss | 248 |
| Net periodic pension cost | \$ 1,251 |

The following is a reconciliation of the changes in the projected benefit obligation for the six months ended June 30, 2007:

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

| | (In thousands) |
|---|-----------------------|
| Projected benefit obligation, January 1, 2007 | \$ 7,223 |
| Service cost | 268 |
| Interest cost | 191 |
| Remeasurement | (962) |
| Projected benefit obligation, June 30, 2007 | \$ 6,720 |

The amounts in accumulated other comprehensive income that have not yet been recognized as components of net periodic benefit costs at June 30, 2007 are as follows:

| | (In thousands) |
|-------------------------------|-----------------------|
| Transition asset (obligation) | \$ |
| Prior service cost | (615) |
| Accumulated loss | (1,119) |
| Total | \$ (1,734) |

Table of Contents

8. Debt

On June 16, 2006, the Company entered into a new \$350 million senior unsecured revolving credit agreement (the Revolver), with a syndicate of lenders. The proceeds from the Revolver were used to refinance and terminate a previous revolving credit facility. The Revolver allows the Company to borrow, repay and reborrow revolving loans up to \$350 million (which includes swingline loans for up to \$20 million and standby letters of credit up to \$30 million) until the scheduled maturity date of June 16, 2011. The Company has the ability to request an increase in available borrowings under the Revolver by an additional amount of up to \$150 million by obtaining the agreement of the existing lenders to increase their lending commitments or by adding additional lenders. The rate of interest generally applicable for revolving loans under the Revolver are, at the Company's option, equal to either (i) the greater of the prime rate or the federal funds effective rate plus 50 basis points, or (ii) an adjusted LIBOR rate plus a margin between 22 and 70 basis points based on the Company's credit rating. The Revolver requires the company to pay a quarterly facility fee, based upon the credit rating of the Company, at a rate between 8 and 17 1/2 basis points, on the full amount of the commitment (regardless of usage). The Revolver also requires the payment of a quarterly usage fee, based upon the credit rating of the Company, at a rate between 10 and 12 1/2 basis points, on the amount outstanding under the commitment, at all times when the amount borrowed under the Revolver exceeds 50% of the total commitment. The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. The Revolver also restricts the Company's ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions. As of June 30, 2007, the Company had \$99.2 million of revolving loans outstanding pursuant to the Revolver. As of June 30, 2007, the Company was in compliance with all covenants under the Revolver.

In 1998, the Company completed a \$100 million senior unsecured note offering (the Senior Notes) at a discount of \$0.6 million, bearing a coupon rate of 7.13% with an effective rate of 7.22%. The Senior Notes will mature on May 1, 2008, with interest on the Senior Notes paid semi-annually. The Senior Notes have been classified as a long-term liability at June 30, 2007, since the Company's intention is to repay the Senior Notes upon maturity by utilizing the available capacity of the Revolver.

As of June 30, 2007, in addition to the Revolver and Senior Notes, the Company had a line of credit with a bank providing an aggregate of \$10 million of borrowings, which is due upon demand. The line of credit ranks pari-pasu (or equally) with the Company's Revolver and includes customary financial and other covenants that require the maintenance of certain ratios identical to those included in the Company's Revolver. Borrowings under the line of credit bear interest rates established at the time of borrowing based on prime rate minus 175 basis points. As of June 30, 2007, the Company had no amounts outstanding pursuant to this line of credit.

In the second quarter of 2007, the Company repaid an outstanding note with a balance of \$0.4 million by utilizing proceeds from the Revolver. The note had an original maturity date of January 1, 2009. The loan bore interest based on seventy percent of prime and required monthly principal and interest payments.

As of June 30, 2007, total debt outstanding for the Company was \$199.1 million.

9. Condensed Consolidating Financial Statements

Effective July 14, 2006, the Company's Senior Notes are guaranteed jointly, severally, fully and unconditionally by 7 wholly-owned domestic subsidiaries. There are no legal or regulatory restrictions on the payment of dividends to Choice Hotels International, Inc. from subsidiaries that do not guarantee the Senior Notes. As a result of these guarantee arrangements, the following condensed consolidating financial statements are presented. Investments in subsidiaries are accounted for under the equity method of accounting.

Table of Contents

Choice Hotels International, Inc.

Condensed Consolidating Statement of Income

For the Three Months Ended June 30, 2007

(Unaudited, In Thousands)

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|--------------------------------------|---------------------------|-------------------------------|-------------------|------------------|
| REVENUES: | | | | | |
| Royalty fees | \$ 53,716 | \$ 26,707 | \$ 5,516 | \$ (26,763) | \$ 59,176 |
| Initial franchise and relicensing fees | 7,649 | | | | 7,649 |
| Brand solutions | 5,995 | | | | 5,995 |
| Marketing and reservation | 71,311 | 68,297 | 3,653 | (61,451) | 81,810 |
| Other items, net | 1,886 | 1,193 | | | 3,079 |
| Total revenues | 140,557 | 96,197 | 9,169 | (88,214) | 157,709 |
| OPERATING EXPENSES: | | | | | |
| Selling, general and administrative | 25,335 | 24,060 | 2,973 | (26,763) | 25,605 |
| Marketing and reservation | 75,120 | 64,980 | 3,161 | (61,451) | 81,810 |
| Other items, net | 794 | 1,865 | 272 | | 2,931 |
| Total operating expenses | 101,249 | 90,905 | 6,406 | (88,214) | 110,346 |
| Operating income | 39,308 | 5,292 | 2,763 | | 47,363 |
| OTHER INCOME AND EXPENSES, NET: | | | | | |
| Interest expense | 3,383 | (134) | (32) | | 3,217 |
| Other items, net | (107) | (1,395) | (400) | | (1,902) |
| Equity in earnings of consolidated subsidiaries | (5,558) | | | 5,558 | |
| Total other income and expenses, net | (2,282) | (1,529) | (432) | 5,558 | 1,315 |
| Income before income taxes | 41,590 | 6,821 | 3,195 | (5,558) | 46,048 |
| Income taxes | 12,945 | 3,846 | 612 | | 17,403 |
| Net income | \$ 28,645 | \$ 2,975 | \$ 2,583 | \$ (5,558) | \$ 28,645 |

Table of Contents

Choice Hotels International, Inc.

Condensed Consolidating Statement of Income

For the Three Months Ended June 30, 2006

(Unaudited, In Thousands)

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|--------------------------------------|---------------------------|-------------------------------|-------------------|------------------|
| REVENUES: | | | | | |
| Royalty fees | \$ 49,347 | \$ 23,983 | \$ 3,630 | \$ (23,814) | \$ 53,146 |
| Initial franchise and relicensing fees | 6,723 | | | | 6,723 |
| Brand solutions | 4,900 | | | | 4,900 |
| Marketing and reservation | 63,203 | 60,362 | 2,395 | (53,218) | 72,742 |
| Other items, net | 1,849 | 1,180 | | | 3,029 |
| Total revenues | 126,022 | 85,525 | 6,025 | (77,032) | 140,540 |
| OPERATING EXPENSES: | | | | | |
| Selling, general and administrative | 23,949 | 21,766 | 761 | (24,234) | 22,242 |
| Marketing and reservation | 66,156 | 57,524 | 1,860 | (52,798) | 72,742 |
| Other items, net | 798 | 2,456 | 188 | | 3,442 |
| Total operating expenses | 90,903 | 81,746 | 2,809 | (77,032) | 98,426 |
| Operating income | 35,119 | 3,779 | 3,216 | | 42,114 |
| OTHER INCOME AND EXPENSES, NET: | | | | | |
| Interest expense | 4,236 | (201) | 9 | | 4,044 |
| Other items, net | 282 | 301 | (197) | | 386 |
| Equity in earnings of consolidated subsidiaries | (5,438) | | | 5,438 | |
| Total other income and expenses, net | (920) | 100 | (188) | 5,438 | 4,430 |
| Income before income taxes | 36,039 | 3,679 | 3,404 | (5,438) | 37,684 |
| Income taxes | 11,903 | 1,377 | 268 | | 13,548 |
| Net income | \$ 24,136 | \$ 2,302 | \$ 3,136 | \$ (5,438) | \$ 24,136 |

Table of Contents

Choice Hotels International, Inc.

Condensed Consolidating Statement of Income

For the Six Months Ended June 30, 2007

(Unaudited, In Thousands)

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|--------------------------------------|---------------------------|-------------------------------|--------------|--------------|
| REVENUES: | | | | | |
| Royalty fees | \$ 92,415 | \$ 54,033 | \$ 10,155 | \$ (54,099) | \$ 102,504 |
| Initial franchise and relicensing fees | 12,580 | | | | 12,580 |
| Brand solutions | 8,981 | | | | 8,981 |
| Marketing and reservation | 123,130 | 133,579 | 6,925 | (119,783) | 143,851 |
| Other items, net | 3,687 | 2,289 | | | 5,976 |
| Total revenues | 240,793 | 189,901 | 17,080 | (173,882) | 273,892 |
| OPERATING EXPENSES: | | | | | |
| Selling, general and administrative | 49,087 | 49,319 | 5,198 | (54,099) | 49,505 |
| Marketing and reservation | 129,856 | 127,554 | 6,224 | (119,783) | 143,851 |
| Other items, net | 1,600 | 3,643 | 544 | | 5,787 |
| Total operating expenses | 180,543 | 180,516 | 11,966 | (173,882) | 199,143 |
| Operating income | 60,250 | 9,385 | 5,114 | | 74,749 |
| OTHER INCOME AND EXPENSES, NET: | | | | | |
| Interest expense | 6,505 | (259) | (32) | | 6,214 |
| Other items, net | (167) | (1,747) | (783) | | (2,697) |
| Equity in earnings of consolidated subsidiaries | (11,108) | | | 11,108 | |
| Total other income and expenses, net | (4,770) | (2,006) | (815) | 11,108 | 3,517 |
| Income before income taxes | 65,020 | 11,391 | 5,929 | (11,108) | 71,232 |
| Income taxes | 20,060 | 5,420 | 792 | | 26,272 |
| Net income | \$ 44,960 | \$ 5,971 | \$ 5,137 | \$ (11,108) | \$ 44,960 |

Table of Contents

Choice Hotels International, Inc.

Condensed Consolidating Statement of Income

For the Six Months Ended June 30, 2006

(Unaudited, In Thousands)

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|--------------------------------------|---------------------------|-------------------------------|--------------------|------------------|
| REVENUES: | | | | | |
| Royalty fees | \$ 85,905 | \$ 46,223 | \$ 7,132 | \$ (46,250) | \$ 93,010 |
| Initial franchise and relicensing fees | 12,366 | | | | 12,366 |
| Brand solutions | 7,682 | | | | 7,682 |
| Marketing and reservation | 111,122 | 124,134 | 4,299 | (108,837) | 130,718 |
| Other items, net | 4,022 | 2,160 | | | 6,182 |
| Total revenues | 221,097 | 172,517 | 11,431 | (155,087) | 249,958 |
| OPERATING EXPENSES: | | | | | |
| Selling, general and administrative | 43,725 | 41,840 | 1,577 | (46,625) | 40,517 |
| Marketing and reservation | 117,241 | 118,458 | 3,481 | (108,462) | 130,718 |
| Other items, net | 1,594 | 4,567 | 375 | | 6,536 |
| Total operating expenses | 162,560 | 164,865 | 5,433 | (155,087) | 177,771 |
| Operating income | 58,537 | 7,652 | 5,998 | | 72,187 |
| OTHER INCOME AND EXPENSES, NET: | | | | | |
| Interest expense | 8,453 | (388) | 19 | | 8,084 |
| Other items, net | 232 | (311) | (497) | | (576) |
| Equity in earnings of consolidated subsidiaries | (10,035) | | | 10,035 | |
| Total other income and expenses, net | (1,350) | (699) | (478) | 10,035 | 7,508 |
| Income before income taxes | 59,887 | 8,351 | 6,476 | (10,035) | 64,679 |
| Income taxes | 18,086 | 4,232 | 560 | | 22,878 |
| Net income | \$ 41,801 | \$ 4,119 | \$ 5,916 | \$ (10,035) | \$ 41,801 |

Table of Contents

Choice Hotels International, Inc.

Condensed Consolidating Balance Sheet

As of June 30, 2007

(Unaudited, In thousands)

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|--------------------------------------|---------------------------|-------------------------------|---------------------|-------------------|
| ASSETS | | | | | |
| Cash and cash equivalents | \$ 9,595 | \$ 546 | \$ 37,189 | \$ | \$ 47,330 |
| Receivables | 40,734 | 760 | 4,501 | | 45,995 |
| Other current assets | 7,927 | 8,935 | 1,287 | | 18,149 |
| Total current assets | 58,256 | 10,241 | 42,977 | | 111,474 |
| Property and equipment, at cost, net | 16,504 | 26,437 | 733 | | 43,674 |
| Goodwill | 60,620 | 5,193 | | | 65,813 |
| Franchise rights and other identifiable intangibles, net | 22,469 | 6,118 | 5,090 | | 33,677 |
| Investments, employee benefit plans, at fair value | | 34,083 | | | 34,083 |
| Investment in and advances to affiliates | 211,018 | 123,252 | 48,553 | (382,823) | |
| Receivable, marketing fees | 7,449 | | | (310) | 7,139 |
| Deferred income taxes | | 37,807 | 731 | (13,151) | 25,387 |
| Other assets | 1,233 | 9,410 | 434 | (280) | 10,797 |
| Total assets | \$ 377,549 | \$ 252,541 | \$ 98,518 | \$ (396,564) | \$ 332,044 |
| LIABILITIES AND SHAREHOLDERS' DEFICIT | | | | | |
| Accounts payable | \$ 8,890 | \$ 28,627 | \$ 4,028 | | \$ 41,545 |
| Accrued expenses and other | 14,556 | 17,049 | 1,466 | | 33,071 |
| Deferred revenue | 7,214 | 41,770 | | | 48,984 |
| Deferred compensation & retirement plan obligations | | 3,343 | | | 3,343 |
| Income taxes payable | 8,810 | 7,476 | 1,650 | | 17,936 |
| Total current liabilities | 39,470 | 98,265 | 7,144 | | 144,879 |
| Long-term debt | 199,146 | | | | 199,146 |
| Deferred compensation & retirement plan obligations | | 41,541 | 2 | | 41,543 |
| Advances from affiliates | 180,610 | 6,011 | 49,261 | (235,882) | |
| Payable, marketing fees | | 310 | | (310) | |
| Deferred income taxes | 13,151 | | | (13,151) | |
| Other liabilities | 17,025 | 839 | 745 | (280) | 18,329 |
| Total liabilities | 449,402 | 146,966 | 57,152 | (249,623) | 403,897 |
| Total shareholders' deficit | (71,853) | 105,575 | 41,366 | (146,941) | (71,853) |
| Total liabilities and shareholders' deficit | \$ 377,549 | \$ 252,541 | \$ 98,518 | \$ (396,564) | \$ 332,044 |

Table of Contents

Choice Hotels International, Inc.

Condensed Consolidating Balance Sheet

As of December 31, 2006

(In thousands)

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|--------------------------------------|---------------------------|-------------------------------|---------------------|-------------------|
| ASSETS | | | | | |
| Cash and cash equivalents | \$ 10,072 | \$ 213 | \$ 25,556 | \$ | \$ 35,841 |
| Receivables | 35,885 | 358 | 5,451 | | 41,694 |
| Other current assets | 9,317 | 7,489 | 645 | (7,904) | 9,547 |
| Total current assets | 55,274 | 8,060 | 31,652 | (7,904) | 87,082 |
| Property and equipment, at cost, net | 17,270 | 24,793 | 739 | | 42,802 |
| Goodwill | 60,620 | 5,193 | | | 65,813 |
| Franchise rights and other identifiable intangibles, net | 23,885 | 6,427 | 5,197 | | 35,509 |
| Investments, employee benefit plans, at fair value | | 31,529 | | | 31,529 |
| Investment in and advances to affiliates | 184,223 | 129,728 | 47,947 | (361,898) | |
| Receivable, marketing fees | 6,972 | | | (310) | 6,662 |
| Deferred income taxes | | 33,842 | 728 | (12,119) | 22,451 |
| Other assets | 1,055 | 10,170 | 236 | | 11,461 |
| Total assets | \$ 349,299 | \$ 249,742 | \$ 86,499 | \$ (382,231) | \$ 303,309 |
| LIABILITIES AND SHAREHOLDERS DEFICIT | | | | | |
| Current portion of long-term debt | \$ 146 | \$ | \$ | \$ | \$ 146 |
| Accounts payable | 9,503 | 28,735 | 3,578 | | 41,816 |
| Accrued expenses and other | 14,988 | 28,617 | 1,701 | | 45,306 |
| Deferred revenue | 7,485 | 39,622 | 60 | | 47,167 |
| Income taxes payable | | 11,587 | 1,673 | (7,904) | 5,356 |
| Total current liabilities | 32,122 | 108,561 | 7,012 | (7,904) | 139,791 |
| Long-term debt | 172,390 | | | | 172,390 |
| Deferred compensation & retirement plan obligations | | 40,099 | 2 | | 40,101 |
| Advances from affiliates | 182,114 | 5,609 | 41,032 | (228,755) | |
| Payable, marketing fees | | 310 | | (310) | |
| Deferred income taxes | 12,119 | | | (12,119) | |
| Other liabilities | 12,934 | | 473 | | 13,407 |
| Total liabilities | 411,679 | 154,579 | 48,519 | (249,088) | 365,689 |
| Total shareholders deficit | (62,380) | 95,163 | 37,980 | (133,143) | (62,380) |
| Total liabilities and shareholders deficit | \$ 349,299 | \$ 249,742 | \$ 86,499 | \$ (382,231) | \$ 303,309 |

Table of Contents

Choice Hotels International, Inc.

Condensed Consolidating Statement of Cash Flows

For the Six Months Ended June 30, 2007

(Unaudited, In thousands)

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|--------------------------------------|---------------------------|-------------------------------|--------------|--------------|
| Net Cash Provided from Operating Activities | \$ 40,352 | \$ 4,831 | \$ 11,963 | | \$ 57,146 |
| Cash Flows From Investing Activities | | | | | |
| Investment in property and equipment | (1,689) | (3,973) | (124) | | (5,786) |
| Acquisitions, net of cash acquired | | | (343) | | (343) |
| Issuance of notes receivable | (3,038) | (217) | | | (3,255) |
| Collection of notes receivable | 75 | 394 | | | 469 |
| Purchases of investments, employee benefit plans | | (5,701) | | | (5,701) |
| Proceeds from the sales of investments, employee benefit plans | | 1,551 | | | 1,551 |
| Other items, net | (225) | (271) | 137 | | (359) |
| Net Cash Used in Investing Activities | (4,877) | (8,217) | (330) | | (13,424) |
| Cash Flows from Financing Activities | | | | | |
| Principal payments of long-term debt | (422) | | | | (422) |
| Net borrowings pursuant to revolving credit facility | 27,000 | | | | 27,000 |
| Purchase of treasury stock | (47,341) | | | | (47,341) |
| Excess tax benefits from stock-based compensation | 46 | 3,719 | | | 3,765 |
| Dividends paid | (19,751) | | | | (19,751) |
| Proceeds from exercise of stock options | 4,516 | | | | 4,516 |
| Net Cash Provided (Used) from Financing Activities | (35,952) | 3,719 | | | (32,233) |
| Net change in cash and cash equivalents | (477) | 333 | 11,633 | | 11,489 |
| Cash and cash equivalents at beginning of period | 10,072 | 213 | 25,556 | | 35,841 |
| Cash and Cash Equivalents at End of Period | \$ 9,595 | \$ 546 | \$ 37,189 | | \$ 47,330 |

Table of Contents**Choice Hotels International, Inc.****Condensed Consolidating Statement of Cash Flows****For the Six Months Ended June 30, 2006****(Unaudited, In thousands)**

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|--|-----------------------------------|---------------------------------------|---------------------|---------------------|
| Net Cash Provided (Used) from Operating Activities | \$ 58,192 | \$ (2,387) | \$ 6,823 | | \$ 62,628 |
| Cash Flows From Investing Activities | | | | | |
| Investment in property and equipment | (2,633) | (1,361) | (51) | | (4,045) |
| Issuance of notes receivable | | (1,277) | | | (1,277) |
| Collections of notes receivable | | 359 | | | 359 |
| Purchases of investments, employee benefit plans | | (5,784) | | | (5,784) |
| Proceeds from the sale of investments, employee benefit plans | | 1,387 | | | 1,387 |
| Other items, net | (132) | (591) | 427 | | (296) |
| Net Cash Provided (Used) from Investing Activities | (2,765) | (7,267) | 376 | | (9,656) |
| Cash Flows from Financing Activities | | | | | |
| Principal payment of long-term debt | (73) | | | | (73) |
| Net repayments pursuant to revolving credit facilities | (49,600) | | | | (49,600) |
| Purchase of treasury stock | (1,132) | | | | (1,132) |
| Excess tax benefits from stock-based compensation | 3,965 | 8,018 | | | 11,983 |
| Debt issuance costs | (472) | | | | (472) |
| Dividends paid | (16,925) | | | | (16,925) |
| Proceeds from exercise of stock options | 7,984 | | | | 7,984 |
| Net Cash Provided (Used) in Financing Activities | (56,253) | 8,018 | | | (48,235) |
| Net change in cash and cash equivalents | (826) | (1,636) | 7,199 | | 4,737 |
| Cash and cash equivalents at beginning of period | 5,848 | 2,052 | 9,021 | | 16,921 |
| Cash and Cash Equivalents at End of Period | \$ 5,022 | \$ 416 | \$ 16,220 | | \$ 21,658 |

10. 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, brand solutions revenue and other revenue. The Company is obligated under its franchise agreements to provide marketing and reservation services appropriate for the successful operation of its systems. These services do not represent separate reportable segments as their operations are directly related to the Company's franchising business. The revenues received from franchisees that are used to pay for part of the Company's central ongoing operations are included in franchising revenues and are offset by the related expenses paid for marketing and reservation activities to calculate franchising operating income. Corporate and other revenue consists of hotel operations. Except as described in Note 2, 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, 2007 | | | Three Months Ended June 30, 2006 | | |
|--------------------------------|----------------------------------|-------------------|--------------|----------------------------------|-------------------|--------------|
| | Franchising | Corporate & Other | Consolidated | Franchising | Corporate & Other | Consolidated |
| Revenues | \$ 156,516 | \$ 1,193 | \$ 157,709 | \$ 139,360 | \$ 1,180 | \$ 140,540 |
| Operating income (loss) | \$ 58,400 | \$ (11,037) | \$ 47,363 | \$ 54,665 | \$ (12,551) | \$ 42,114 |

| (In thousands) | Six Months Ended June 30, 2007 | | | Six Months Ended June 30, 2006 | | |
|--------------------------------|--------------------------------|-------------------|--------------|--------------------------------|-------------------|--------------|
| | Franchising | Corporate & Other | Consolidated | Franchising | Corporate & Other | Consolidated |
| Revenues | \$ 271,603 | \$ 2,289 | \$ 273,892 | \$ 247,798 | \$ 2,160 | \$ 249,958 |
| Operating income (loss) | \$ 97,971 | \$ (23,222) | \$ 74,749 | \$ 95,031 | \$ (22,844) | \$ 72,187 |

11. Commitments and Contingencies

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

In April 2007, two punitive federal securities law class actions were filed in the United States District Court for the District of Colorado on behalf of persons who purchased the Company's stock between April 25, 2006, and July 26, 2006. These substantially-similar lawsuits assert claims pursuant to Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, against the Company, its current Vice Chairman and Chief Executive Officer, and its former Executive Vice President and Chief Financial Officer. These claims are related to the Company's July 25, 2006 announcement of its results of operations for the second quarter of 2006.

Table of Contents

Since the initial filings, the Company has filed a motion to transfer the litigation from Colorado to the United States District Court for the District of Maryland. Additionally, one plaintiff has petitioned the Court to be named lead plaintiff in the dispute. At this time, the Company has not responded to the complaints filed and is not required to do so until after a lead plaintiff is appointed and a consolidated complaint is filed. The Company believes that the allegations contained within these class action lawsuits are without merit and intends to vigorously defend the litigation.

The Company's management does not expect that the outcome of any of its currently ongoing legal proceedings individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

In March 2006, the Company guaranteed \$1 million of a bank loan funding a franchisee's construction of a Cambria Suites in Green Bay, Wisconsin. The guaranty was scheduled to expire in June 2010. In the second quarter of 2007, the Company was released from its obligations under the March 2006 guaranty, and subsequently, on May 3, 2007, issued a new \$1 million guaranty for a bank loan funding the construction for the same franchisee's Cambria Suites in Green Bay, Wisconsin. The guaranty expires in August 2010. The Company has received personal guarantees from several of the franchisee's principal owners related to the repayment of any amounts paid by the Company under this guaranty.

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

12. Termination Charges

During the first quarter of 2007, the Company recorded a \$3.7 million charge for employee termination benefits relating to the termination of certain executive officers. Termination benefits include salary continuation of approximately \$2.5 million, SERP curtailment expenses of \$0.2 million and \$1.0 million of accelerated share based compensation. Termination benefits payable to the executives were accounted for under SFAS No. 112 Employer's Accounting for Post-employment Benefits. At June 30, 2007, approximately \$3.1 million of termination benefits remained of which \$2.9 million is included in current liabilities and \$0.2 million in other long-term liabilities in the Company's consolidated financial statements.

13. Recently Issued Accounting Standards

In September 2006, FASB issued SFAS No. 157, Fair Value Measurements which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the impact, if any, the adoption of this statement will have on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159) which provides reporting entities an option to report certain financial instruments and other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective as of the beginning of a reporting entity's first fiscal year beginning after November 15, 2007. We are currently evaluating the impact, if any, the adoption of this statement will have on our consolidated financial statements.

14. Subsequent Event

Subsequent to June 30, 2007 through August 9, 2007, the Company repurchased an additional 1.3 million shares of its common stock at a total cost of \$50.5 million.

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

During 2005, the Company acquired 100% of the stock of Suburban Franchise Holding Company, Inc. (Suburban) and its wholly owned subsidiary, Suburban Franchise Systems, Inc. Beginning on the third anniversary of the closing, the merger provided for contingent cash payments of up to \$5.0 million to be made upon the satisfaction of certain criteria. At June 30, 2007, no liabilities had been recorded related to the contingent cash payments. Subsequent to June 30, 2007, the Company has determined that the performance conditions can no longer be satisfied and therefore the contingent consideration will not be earned.

Table of Contents

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

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

Overview

We are a hotel franchisor with franchise agreements representing 5,474 hotels open and 943 hotels under development as of June 30, 2007, with 445,826 rooms and 75,747 rooms, respectively, in 49 states, the District of Columbia and 38 countries and territories outside the United States. Our brand names include Comfort Inn®, Comfort Suites®, Quality®, Clarion®, Sleep Inn®, Econo Lodge®, Rodeway Inn®, MainStay Suites®, Suburban Extended Stay Hotel®, Cambria Suites and Flag Hotels®.

The Company conducts its international franchise operations through a combination of direct franchising and master franchising arrangements (which 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 Company's brands under master franchising relationships. As a result of our use of master franchising relationships and international market conditions, total revenues from international operations comprised only 7% of our total revenues for the six months ended June 30, 2007 while representing approximately 21% of hotels open at June 30, 2007.

During 2006, the Company acquired 100% of the stock of Choice Hotels Franchise GmbH (CHG). CHG was a wholly owned subsidiary of one of the Company's master franchisees, The Real Hotel Company PLC (RHC), formerly known as CHE Hotel Group PLC. Under the master franchise agreement with RHC, CHG franchised hotels under the Company's brands in Austria, Germany, Italy, Czech Republic and portions of Switzerland. As a result of this acquisition, the master franchise agreement between the Company and RHC covering these countries terminated. The results of CHG have been consolidated with the Company since October 30, 2006.

During 2006, the Company acquired RHC's assets, including franchise contracts, related to its franchising of hotels under the Company's brands in France, Belgium, Portugal, Spain and portions of Switzerland. As a result of the acquisition, the master franchise agreement between the Company and RHC covering these countries terminated and the Company commenced direct franchising operations in these countries on November 30, 2006.

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

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 properties and effective royalty rates of our franchise contracts resulting in increased initial fee revenue; ongoing royalty fees and brand solutions revenues. In addition, our operating results can also be improved through our company wide efforts related to improving property level performance. In addition to these revenues, we also collect marketing and reservation fees to support centralized marketing and reservation activities for the franchise system. As a lodging franchisor, the Company has relatively low capital expenditure requirements.

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

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

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

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

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

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

Maximizing Financial Returns and Creating Value for Shareholders. Our capital allocation decisions, including capital structure and uses of capital, are intended to maximize our return on invested capital and create value for our shareholders. We believe our strong and predictable cash flows create a strong financial position that provides us a competitive advantage. Our business does not require significant capital to operate and grow, therefore, we can maintain a capital structure that generates high financial returns and use our excess cash flow to increase returns to our shareholders. We have returned value to our shareholders in two primary ways: share repurchases and dividends. In 1998, we instituted a share repurchase program which has generated substantial value for our shareholders. Through June 30, 2007, we

Table of Contents

have repurchased 34.8 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 \$758 million since the program's inception. Considering the effect of the two-for-one stock split, the Company has repurchased 67.8 million shares at an average price of \$11.17 per share through June 30, 2007. At June 30, 2007, the Company had 3.9 million shares remaining under our current board of directors' authorization. The Company expects to continue to return value to its shareholders through a combination of dividends and share repurchases, subject to market and other conditions and upon completion of the current authorization we will evaluate the propriety of additional share repurchases with our board of directors. During the three and six months ended June 30, 2007, we paid cash dividends totaling approximately \$9.9 million and \$19.8 million, respectively and we presently expect to continue to pay dividends in the future. On May 1, 2007, our board of directors declared a cash dividend of \$0.15 on outstanding common shares payable on July 20, 2007 to shareholders of record on July 6, 2007. Based on our present dividend rate and outstanding share count, aggregate annual dividends would be approximately \$39.3 million.

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

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, 2007, royalty fees revenue totaled \$59.2 million, an 11% increase from the same period in 2006. Operating income totaled \$47.4 million for the three months ended June 30, 2007, a \$5.2 million or 12% increase from the same period in 2006. Net income for the three months ended June 30, 2007 increased \$4.5 million to \$28.6 million, a 19% increase from the second quarter of 2006. Diluted earnings per share for the second quarter of 2007 were \$0.43 compared to \$0.36 for the second quarter of 2006, a 19% improvement resulting primarily from increased net income. These measurements will continue to be a key management focus in 2007 and beyond.

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

Liquidity and Capital Resources: The Company generates significant cash flows from operations. In the six months ended June 30, 2007 and 2006, net cash provided by operating activities was \$57.1 million and \$62.6 million, respectively. Since our business does not require significant reinvestment of capital, we utilize cash in ways that management believes provide the greatest returns to our shareholders, which include share repurchases and dividends. We believe the Company's cash flow from operations and available financing capacity are sufficient to meet the expected future operating, investing and financing needs of the business.

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

Table of Contents**Operations Review****Comparison of Operating Results for the Three-Month Periods Ended June 30, 2007 and June 30, 2006**

The Company recorded net income of \$28.6 million for the three months ended June 30, 2007, an increase of \$4.5 million, or 19% from \$24.1 million for the quarter ended June 30, 2006. The increase in net income for the three months ended June 30, 2007 is primarily attributable to a \$5.2 million increase in operating income, a \$0.8 million decline in interest expense, a \$1.9 million increase in interest and other investment income, offset by an increase in the effective income tax rate to 37.8% from 36.0%. The effective income tax rate increased primarily due to a decline in the proportion of foreign income earned over the prior year period, which is taxed at lower rates than statutory U.S. income tax rates. Operating income increased as a result of an \$8.1 million, or 12% increase in franchising revenues (total revenues excluding marketing and reservation revenues and hotel operations) partially offset by a \$3.4 million increase in selling, general and administrative expenses. The increase in selling, general and administration expenses was partially due to the commencement of direct franchising operations in continental Europe. The \$3.1 million decline in net other income and expenses was primarily related to investment gains on assets held in the Company's non-qualified employee benefit plans and an \$0.8 million decline in interest expense due to lower average debt balances.

Summarized financial results for the three months ended June 30, 2007 and 2006 are as follows:

| (in thousands, except per share amounts) | 2007 | 2006 |
|--|------------------|----------------|
| REVENUES: | | |
| Royalty fees | \$ 59,176 | \$ 53,146 |
| Initial franchise and relicensing fees | 7,649 | 6,723 |
| Brand solutions | 5,995 | 4,900 |
| Marketing and reservation | 81,810 | 72,742 |
| Hotel operations | 1,193 | 1,180 |
| Other | 1,886 | 1,849 |
| Total revenues | 157,709 | 140,540 |
| OPERATING EXPENSES: | | |
| Selling, general and administrative | 25,605 | 22,242 |
| Depreciation and amortization | 2,137 | 2,642 |
| Marketing and reservation | 81,810 | 72,742 |
| Hotel operations | 794 | 800 |
| Total operating expenses | 110,346 | 98,426 |
| Operating income | 47,363 | 42,114 |
| OTHER INCOME AND EXPENSES, NET: | | |
| Interest expense | 3,217 | 4,044 |
| Interest and other investment (income) loss | (1,721) | 174 |
| Equity in net income of affiliates | (181) | (130) |
| Loss on extinguishment of debt | | 342 |
| Total other income and expenses, net | 1,315 | 4,430 |
| Income before income taxes | 46,048 | 37,684 |
| Income taxes | 17,403 | 13,548 |
| Net income | \$ 28,645 | 24,136 |
| Weighted average shares outstanding diluted | 66,599 | 67,105 |

Diluted earnings per share \$ 0.43 \$ 0.36

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

Franchising Revenues: Franchising revenues were \$74.7 million for the three months ended June 30, 2007 compared to \$66.6 million for the three months ended June 30, 2006. The growth in franchising revenues is primarily due to an 11% increase in royalty revenues, a 14% increase in initial franchise and relicensing fees and a 22% increase in brand solutions revenues.

Domestic royalty fees increased \$4.3 million to \$53.9 million from \$49.6 million in the three months ended June 30, 2007, an increase of 8.7%. The increase in royalties is attributable to a combination of factors including a 4.2% increase in the number of domestic franchised hotel rooms, a 3.3% increase in RevPAR and an increase in the effective royalty rate of the domestic hotel system from 4.10% to 4.14%. System-wide RevPAR increases resulted primarily from average daily rate (ADR) increases of 4.4% over the prior year offset by a 60 basis point decline in occupancy rates.

Table of Contents

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

| | For the Three Months Ended | | | For the Three Months Ended | | | Change | | |
|---|----------------------------|--------------|-----------------|----------------------------|-----------|----------|--------------------|-----------|--------|
| | June 30, 2007 | | | June 30, 2006 | | | | | |
| | Average Daily Rate | Occupancy | RevPAR | Average Daily Rate | Occupancy | RevPAR | Average Daily Rate | Occupancy | RevPAR |
| Comfort Inn | \$ 75.62 | 63.9% | \$ 48.29 | \$ 71.84 | 64.0% | \$ 45.97 | 5.3% | -10bps | 5.0% |
| Comfort Suites | 87.54 | 67.8% | 59.36 | 83.04 | 69.5% | 57.72 | 5.4% | -170bps | 2.8% |
| Sleep | 69.74 | 65.4% | 45.63 | 66.69 | 65.2% | 43.47 | 4.6% | 20bps | 5.0% |
| Midscale without Food & Beverage | 77.32 | 64.9% | 50.18 | 73.42 | 65.2% | 47.90 | 5.3% | -30bps | 4.8% |
| Quality | 68.96 | 55.4% | 38.19 | 66.18 | 56.5% | 37.36 | 4.2% | -110bps | 2.2% |
| Clarion | 80.13 | 53.1% | 42.51 | 77.77 | 53.5% | 41.63 | 3.0% | -40bps | 2.1% |
| Midscale with Food & Beverage | 71.58 | 54.8% | 39.24 | 69.01 | 55.7% | 38.44 | 3.7% | -90bps | 2.1% |
| Econo Lodge | 52.85 | 48.4% | 25.55 | 52.09 | 47.5% | 24.75 | 1.5% | 90bps | 3.2% |
| Rodeway | 51.47 | 46.1% | 23.71 | 49.98 | 44.5% | 22.23 | 3.0% | 160bps | 6.7% |
| Economy | 52.56 | 47.8% | 25.14 | 51.72 | 47.0% | 24.29 | 1.6% | 80bps | 3.5% |
| MainStay | 69.53 | 69.7% | 48.43 | 67.43 | 70.3% | 47.39 | 3.1% | -60bps | 2.2% |
| Suburban | 40.39 | 70.7% | 28.56 | 38.95 | 76.8% | 29.91 | 3.7% | -610bps | -4.5% |
| Extended Stay | 46.65 | 70.5% | 32.88 | 44.05 | 75.5% | 33.27 | 5.9% | -500bps | -1.2% |
| Total | \$ 70.98 | 59.1% | \$ 41.92 | \$ 67.98 | 59.7% | \$ 40.58 | 4.4% | -60bps | 3.3% |

The number of domestic rooms on-line increased to 346,712 as of June 30, 2007 from 332,656 as of June 30, 2006, an increase of 4.2%. The total number of domestic hotels on-line grew 5.1% to 4,326 as of June 30, 2007 from 4,116 as of June 30, 2006. A summary of the domestic hotels and rooms on-line at June 30, 2007 and 2006 by brand is as follows:

| | June 30, 2007 | | June 30, 2006 | | Variance | | | |
|---|---------------|----------------|---------------|---------|----------|-------|-------|-------|
| | Hotels | Rooms | Hotels | Rooms | Hotels | Rooms | % | % |
| Comfort Inn | 1,424 | 111,230 | 1,411 | 110,440 | 13 | 790 | 0.9% | 0.7% |
| Comfort Suites | 453 | 35,494 | 417 | 32,786 | 36 | 2,708 | 8.6% | 8.3% |
| Sleep | 340 | 25,338 | 320 | 24,133 | 20 | 1,205 | 6.3% | 5.0% |
| Midscale without Food & Beverage | 2,217 | 172,062 | 2,148 | 167,359 | 69 | 4,703 | 3.2% | 2.8% |
| Quality | 783 | 75,840 | 692 | 68,407 | 91 | 7,433 | 13.2% | 10.9% |
| Clarion | 161 | 23,378 | 157 | 23,262 | 4 | 116 | 2.5% | 0.5% |
| Midscale with Food & Beverage | 944 | 99,218 | 849 | 91,669 | 95 | 7,549 | 11.2% | 8.2% |

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

| | | | | | | | | |
|----------------------------------|--------------|----------------|-------|---------|-----|--------|-------|-------|
| Econo Lodge | 819 | 49,882 | 825 | 50,673 | (6) | (791) | -0.7% | -1.6% |
| Rodeway | 256 | 15,412 | 203 | 12,469 | 53 | 2,943 | 26.1% | 23.6% |
| Economy | 1,075 | 65,294 | 1,028 | 63,142 | 47 | 2,152 | 4.6% | 3.4% |
| MainStay | 29 | 2,166 | 27 | 2,047 | 2 | 119 | 7.4% | 5.8% |
| Suburban | 60 | 7,853 | 64 | 8,439 | (4) | (586) | -6.3% | -6.9% |
| Extended Stay | 89 | 10,019 | 91 | 10,486 | (2) | (467) | -2.2% | -4.5% |
| Cambria Suites | 1 | 119 | | | 1 | 119 | NM | NM |
| Total Domestic Franchises | 4,326 | 346,712 | 4,116 | 332,656 | 210 | 14,056 | 5.1% | 4.2% |

International rooms on-line increased to 99,114 as of June 30, 2007 from 98,818 as of June 30, 2006. The total number of international hotels on-line decreased from 1,168 as of June 30, 2006 to 1,148 as of June 30, 2007.

As of June 30, 2007, the Company had 858 franchised domestic hotels with 67,740 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 687 hotels and 53,765 rooms at June 30, 2006. The number of new construction franchised hotels in the Company's domestic pipeline increased 24% to 611 at June 30, 2007 from 494 at June 30, 2006. The Company had an additional 85 franchised hotels with 8,007 rooms under development in its international system as of June 30, 2007 compared to 65 hotels and 5,993 rooms at June 30, 2006. While the Company's hotel pipeline provides a strong platform for growth, a hotel in the pipeline does not always result in an open and operating hotel due to various factors.

Table of Contents

A summary of the domestic franchised hotels under construction, awaiting conversion or approved for development at June 30, 2007 and 2006 by brand is as follows:

| | June 30, 2007 | | | June 30, 2006 | | | Variance | | | | | |
|---|---------------|--------------|-------|---------------|--------------|-------|------------|-------|------------------|------|-------|------|
| | Units New | | Total | Units New | | Total | Conversion | | New Construction | | Total | |
| | Conversion | Construction | | Conversion | Construction | | Units | % | Units | % | Units | % |
| Comfort Inn | 42 | 121 | 163 | 40 | 101 | 141 | 2 | 5% | 20 | 20% | 22 | 16% |
| Comfort Suites | 3 | 240 | 243 | 4 | 202 | 206 | (1) | (25)% | 38 | 19% | 37 | 18% |
| Sleep Inn | | 108 | 108 | | 85 | 85 | | NM | 23 | 27% | 23 | 27% |
| Midscale without Food & Beverage | 45 | 469 | 514 | 44 | 388 | 432 | 1 | 2% | 81 | 21% | 82 | 19% |
| Quality | 68 | 11 | 79 | 55 | 14 | 69 | 13 | 24% | (3) | -21% | 10 | 14% |
| Clarion | 23 | 7 | 30 | 18 | 4 | 22 | 5 | 28% | 3 | 75% | 8 | 36% |
| Midscale with Food & Beverage | 91 | 18 | 109 | 73 | 18 | 91 | 18 | 25% | | 0% | 18 | 20% |
| Econo Lodge | 44 | 4 | 48 | 24 | 6 | 30 | 20 | 83% | (2) | -33% | 18 | 60% |
| Rodeway | 61 | 1 | 62 | 50 | 1 | 51 | 11 | 22% | | 0% | 11 | 22% |
| Economy | 105 | 5 | 110 | 74 | 7 | 81 | 31 | 42% | (2) | -29% | 29 | 36% |
| MainStay | 1 | 33 | 34 | 1 | 35 | 36 | | 0% | (2) | -6% | (2) | -6% |
| Suburban | 5 | 30 | 35 | 1 | 18 | 19 | 4 | 400% | 12 | 67% | 16 | 84% |
| Extended Stay | 6 | 63 | 69 | 2 | 53 | 55 | 4 | 200% | 10 | 19% | 14 | 25% |
| Cambria Suites | | 56 | 56 | | 28 | 28 | | NM | 28 | 100% | 28 | 100% |
| | 247 | 611 | 858 | 193 | 494 | 687 | 54 | 28% | 117 | 24% | 171 | 25% |

There were 72 net domestic franchise additions during the three months ended June 30, 2007 compared to 46 net franchise additions during the three months ended June 30, 2006. Gross domestic franchise additions increased from 114 for the three months ended June 30, 2006 to 122 for the same period of 2007. Net franchise terminations decreased to 50 from 68 for the three months ended June 30, 2007. The Company continues 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 hotels and utilizing the domestic hotels under development as a strong platform for continued system growth.

International royalties increased \$1.7 million or 47% from \$3.6 million in the second quarter of 2006 to \$5.3 million for the same period of 2007 primarily due to the commencement of direct franchising operations in continental Europe which contributed \$1.1 million of additional royalties.

New domestic franchise agreements executed in the three months ended June 30, 2007 totaled 176 representing 14,493 rooms compared to 155 agreements representing 12,956 rooms executed in the second quarter of 2006. During the second quarter of 2007, 68 of the executed agreements were for new construction hotel franchises, representing 5,570 rooms, compared to 58 contracts, representing 4,320 rooms for the same period a year ago. Conversion hotel franchise executed contracts totaled 108 representing 8,923 rooms for three months ended June 30, 2007 compared to 97 agreements representing 8,636 rooms from 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 increased 30% to \$4.8 million for the three months ended June 30, 2007 from \$3.7 million for the three months ended June 30, 2006. Higher revenues than the prior year resulted primarily from 21 additional executed agreements.

Table of Contents

A summary of executed domestic franchise agreements by brand for the three months ended June 30, 2007 and 2006 is as follows:

| | For the Three Months Ended | | | | | | | | |
|---|---|------------|------------|---------------------|------------|------------|---------------------|------------|------------|
| | For the Three Months Ended June 30, 2007 | | | June 30, 2006 | | | % Change | | |
| | New Construction | Conversion | Total | New Construction | Conversion | Total | New Construction | Conversion | Total |
| Comfort Inn | 11 | 17 | 28 | 9 | 5 | 14 | 22% | 240% | 100% |
| Comfort Suites | 26 | 2 | 28 | 29 | 2 | 31 | -10% | 0% | -10% |
| Sleep | 8 | 1 | 9 | 7 | | 7 | 14% | NM | 29% |
| Midscale without Food & Beverage | 45 | 20 | 65 | 45 | 7 | 52 | 0% | 186% | 25% |
| Quality | 4 | 28 | 32 | 3 | 32 | 35 | 33% | -13% | -9% |
| Clarion | 2 | 15 | 17 | | 9 | 9 | NM | 67% | 89% |
| Midscale with Food & Beverage | 6 | 43 | 49 | 3 | 41 | 44 | 100% | 5% | 11% |
| Econo Lodge | 1 | 15 | 16 | | 14 | 14 | NM | 7% | 14% |
| Rodeway | | 28 | 28 | 1 | 33 | 34 | -100% | -15% | -18% |
| Economy | 1 | 43 | 44 | 1 | 47 | 48 | 0% | -9% | -8% |
| MainStay | 4 | 1 | 5 | 1 | | 1 | 300% | NM | 400% |
| Suburban | 3 | 1 | 4 | 3 | 2 | 5 | 0% | -50% | -20% |
| Extended Stay | 7 | 2 | 9 | 4 | 2 | 6 | 75% | 0% | 50% |
| Cambria Suites | 9 | | 9 | 5 | | 5 | 80% | NM | 80% |
| Total Domestic System | 68 | 108 | 176 | 58 | 97 | 155 | 17% | 11% | 14% |

Relicensing fees are charged to the new property owner of a franchised property whenever an ownership change occurs and the property remains in the franchise system. During the three months ended June 30, 2007, relicensings increased 5% to 96 for the three months ended June 30, 2007 from 91 in the second quarter of 2006. Despite the increase in relicensing contracts, fees declined 3% to \$2.9 million for the three months ended June 30, 2007 from \$3.0 million for the three months ended June 30, 2006 primarily due to lower average fees earned per contract.

Brand solutions revenue increased \$1.1 million or 22% to \$6.0 million resulting primarily from increased vendor sponsorships of our annual franchisee convention.

Franchise Expenses: The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative (SG&A) expenses were \$25.6 million for the three months ended June 30, 2007, an increase of \$3.4 million from the three months ended June 30, 2006. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 34.3% for the three months ended June 30, 2007 compared to 33.4% for the three months ended June 30, 2006. Expenses as a percentage of franchise revenues increased primarily due to an additional \$0.7 million in expenses related to the commencement of direct franchising operations in continental Europe.

Depreciation and Amortization: Expenses declined \$0.5 million to \$2.1 million for the three months ended June 30, 2007 due to the acceleration of depreciation in the prior year period resulting from the renovation and replacement of furniture, fixtures and equipment at two of the Company-owned MainStay Suites.

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

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

Total marketing and reservations revenues were \$81.8 million and \$72.7 million for the three months ended June 30, 2007 and 2006, respectively. Depreciation and amortization attributable to marketing and reservation activities were \$1.9 and \$2.0 million for the three months ended June 30, 2007 and 2006, respectively. Interest expense attributable to reservation activities was \$0.1 million and \$0.2 million for the three months ended June 30, 2007 and 2006, respectively. Marketing and reservations activities generated \$1.7 million and \$0.7 million of positive operating cash flow for the six months ended June 30, 2007 and 2006, respectively. As of June 30, 2007 and December 31, 2006, the Company's balance sheet includes a receivable of \$7.1 million and \$6.7 million, respectively resulting from the cumulative marketing expenses incurred in excess of accumulated marketing fees earned. These receivables are recorded as assets 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. A payable has been recorded in the Company's balance sheet within other long-term liabilities related to cumulative reservation fee revenues received in excess of reservation fee expenses incurred totaling \$6.7 million and \$8.4 million at June 30, 2007 and December 31, 2006, respectively. Cumulative reservation and marketing fees not expended are recorded as a payable on the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

Other Income and Expenses, Net: Other income and expenses, net, decreased \$3.1 million to an expense of \$1.3 million for the three months ended June 30, 2007 from \$4.4 million for the same period in 2006. This decline resulted primarily from a \$1.4 million increase in the fair value of investments held in non-qualified employee benefit plans versus a \$0.3 million decline in the value of these investments in the prior year period. In addition, interest expense declined \$0.8 million from \$4.0 million to \$3.2 million for the three months ended June 30, 2007. Interest expense declined due to lower outstanding borrowings on the Company's variable rate debt partially offset by higher average interest rates. The Company's weighted average interest rate as of June 30, 2007 was 6.42% compared to 6.34% as of June 30, 2006.

Income Taxes: The Company's effective income tax provision rate was 37.8% for the three months ended June 30, 2007, an increase of 180 bps from the effective income tax provision rate of 36.0% for the three months ended June 30, 2006. The effective income tax rate increased primarily due to a decline in the proportion of foreign income earned over the prior year period, which is taxed at lower rates than statutory federal income tax rates. Depending upon the outcome of certain income

Table of Contents

tax contingencies during 2007 up to \$2.0 million of additional income tax benefits may be reflected in our 2007 results of operations from the resolution of tax contingency reserves.

Net income for the three months ended June 30, 2007 increased by 19% to \$28.6 million, and diluted earnings per share increased 19% to \$0.43 for the three months ended June 30, 2007 from \$0.36 reported for the three months ended June 30, 2006.

Comparison of Operating Results for the Six-Month Periods Ended June 30, 2007 and June 30, 2006

The Company recorded net income of \$45.0 million for the six months ended June 30, 2007, an increase of \$3.2 million, or 8% from \$41.8 million for the six months ended June 30, 2006. The increase in net income for the six months ended June 30, 2007 is primarily attributable to a \$2.6 million increase in operating income, a \$1.9 million decline in interest expense and a \$1.8 million increase in interest and other investment income. Operating income increased as a result of a \$10.7 million, or 9% increase in franchising revenues (total revenues excluding marketing and reservation revenues and hotel operations) partially offset by a \$9.0 million increase in selling, general and administrative expenses. The increase in selling, general and administration expenses was primarily due to executive termination benefits of \$3.7 million incurred during the first quarter of 2007 as well as the commencement of direct franchising operations in continental Europe. The \$4.0 million decline in net other income and expenses was primarily related to investment gains on assets held in the Company's non-qualified employee benefit plans and a decline in interest expense due to lower average debt outstanding.

Summarized financial results for the six months ended June 30, 2007 and 2006 are as follows:

| (in thousands, except per share amounts) | 2007 | 2006 |
|---|------------------|-----------|
| REVENUES: | | |
| Royalty fees | \$ 102,504 | \$ 93,010 |
| Initial franchise and relicensing fees | 12,580 | 12,366 |
| Brand solutions | 8,981 | 7,682 |
| Marketing and reservation | 143,851 | 130,718 |
| Hotel operations | 2,289 | 2,160 |
| Other | 3,687 | 4,022 |
| Total revenues | 273,892 | 249,958 |
| OPERATING EXPENSES: | | |
| Selling, general and administrative | 49,505 | 40,517 |
| Depreciation and amortization | 4,252 | 4,991 |
| Marketing and reservation | 143,851 | 130,718 |
| Hotel operations | 1,535 | 1,545 |
| Total operating expenses | 199,143 | 177,771 |
| Operating income | 74,749 | 72,187 |
| OTHER INCOME AND EXPENSES, NET: | | |
| Interest expense | 6,214 | 8,084 |
| Interest and other investment income | (2,322) | (530) |
| Equity in net income of affiliates | (375) | (388) |
| Loss on the extinguishment of debt | | 342 |
| Total other income and expenses, net | 3,517 | 7,508 |
| Income before income taxes | 71,232 | 64,679 |
| Income taxes | 26,272 | 22,878 |
| Net income | \$ 44,960 | \$ 41,801 |

| | | | |
|--|----------------|----------------|---------|
| Weighted average shares outstanding | diluted | 66,823 | 66,925 |
| Diluted earnings per share | | \$ 0.67 | \$ 0.62 |

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

Franchising Revenues: Franchising revenues were \$127.8 million for the six months ended June 30, 2007 compared to \$117.1 million for the six months ended June 30, 2006. The growth in franchising revenues is primarily due to a 10% and 17% increase in royalty and brand solutions revenues, respectively.

Domestic royalty fees increased \$6.4 million to \$92.8 million from \$86.4 million in the six months ended June 30, 2007, an increase of 7.4%. The increase in royalties is attributable to a combination of factors including a 4.2% increase in the number of domestic franchised hotel rooms, a 2.6% increase in RevPAR and an increase in the effective royalty rate of the domestic hotel system from 4.09% to 4.14%. System-wide RevPAR increases resulted primarily from average daily rate increases of 4.1% over the prior year offset by an 80 basis point decline in occupancy rates.

Table of Contents

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

| | For the Six Months Ended | | | For the Six Months Ended | | | Change | | |
|---|--------------------------|-----------|----------|--------------------------|-----------|----------|--------------------|-----------|--------|
| | June 30, 2007 | | | June 30, 2006 | | | | | |
| | Average Daily Rate | Occupancy | RevPAR | Average Daily Rate | Occupancy | RevPAR | Average Daily Rate | Occupancy | RevPAR |
| Comfort Inn | \$ 73.42 | 57.6% | \$ 42.29 | \$ 69.76 | 57.9% | \$ 40.40 | 5.2% | -30bps | 4.7% |
| Comfort Suites | 85.64 | 62.4% | 53.45 | 81.30 | 64.3% | 52.24 | 5.3% | -190bps | 2.3% |
| Sleep | 67.32 | 58.7% | 39.55 | 64.64 | 58.6% | 37.87 | 4.1% | 10bps | 4.4% |
| Midscale without Food & Beverage | 75.19 | 58.8% | 44.18 | 71.46 | 59.2% | 42.34 | 5.2% | -40bps | 4.3% |
| Quality | 66.62 | 49.6% | 33.03 | 64.26 | 50.8% | 32.63 | 3.7% | -120bps | 1.2% |
| Clarion | 77.42 | 47.2% | 36.57 | 77.11 | 48.1% | 37.11 | 0.4% | -90bps | -1.5% |
| Midscale with Food & Beverage | 69.18 | 49.0% | 33.90 | 67.39 | 50.1% | 33.77 | 2.7% | -110bps | 0.4% |
| Econo Lodge | 51.36 | 43.9% | 22.52 | 50.52 | 43.3% | 21.89 | 1.7% | 60bps | 2.9% |
| Rodeway | 49.87 | 42.6% | 21.23 | 48.57 | 41.9% | 20.33 | 2.7% | 70bps | 4.4% |
| Economy | 51.04 | 43.6% | 22.24 | 50.18 | 43.1% | 21.61 | 1.7% | 50bps | 2.9% |
| MainStay | 67.91 | 64.0% | 43.47 | 66.48 | 63.7% | 42.33 | 2.2% | 30bps | 2.7% |
| Suburban | 39.58 | 67.2% | 26.59 | 38.02 | 73.1% | 27.79 | 4.1% | -590bps | -4.3% |
| Extended Stay | 45.47 | 66.5% | 30.23 | 42.93 | 71.3% | 30.60 | 5.9% | -480bps | -1.2% |
| Total | \$ 68.89 | 53.5% | \$ 36.83 | \$ 66.16 | 54.3% | \$ 35.90 | 4.1% | -80bps | 2.6% |

Net domestic franchise additions during the six months ended June 30, 2007 were 115 compared with 68 for the same period a year ago. Gross domestic franchise additions increased from 186 for the six months ended June 30, 2006 to 215 for the same period of 2007. Net franchise terminations declined from 118 to 100 for the six months ended June 30, 2007. The Company continues 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 hotels and utilizing the domestic hotels under development as a strong platform for continued system growth.

International royalties increased \$3.1 million or 47% from \$6.6 million for the six months ended June 30, 2006 to \$9.7 million for the same period of 2007 primarily due to the commencement of direct franchising operations in continental Europe which contributed \$1.8 million of additional royalties.

New domestic franchise agreements executed in the first six months of 2007 totaled 287 representing 23,593 rooms compared to 275 agreements representing 23,648 rooms executed in the same period in 2006. During the first six months of 2007, 109 of the executed agreements were for new construction hotel franchises, representing 8,890 rooms, compared to 106 contracts, representing 8,337 rooms for the same period a year ago. Conversion hotel franchise executed contracts totaled 178 representing 14,703 rooms for six months ended June 30, 2007 compared to 169 agreements representing 15,311 rooms. Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise agreements increased 10% to \$7.5 million for the six months ended June 30, 2007 from \$6.8 million for the six months ended June 30, 2006.

Table of Contents

A summary of executed domestic franchise agreements by brand for the six months ended June 30, 2007 and 2006 is as follows:

| | For the Six Months Ended | | | For the Six Months Ended | | | % Change | | |
|---|--------------------------|------------|------------|--------------------------|------------|------------|---------------------|------------|-----------|
| | June 30, 2007 | | | June 30, 2006 | | | | | |
| | New Construction | Conversion | Total | New Construction | Conversion | Total | New Construction | Conversion | Total |
| Comfort Inn | 16 | 20 | 36 | 24 | 18 | 42 | -33% | 11% | -14% |
| Comfort Suites | 40 | 3 | 43 | 41 | 2 | 43 | -2% | 50% | 0% |
| Sleep | 16 | 1 | 17 | 10 | | 10 | 60% | NM | 70% |
| Midscale without Food & Beverage | 72 | 24 | 96 | 75 | 20 | 95 | -4% | 20% | 1% |
| Quality | 5 | 63 | 68 | 5 | 57 | 62 | 0% | 11% | 10% |
| Clarion | 4 | 21 | 25 | 1 | 18 | 19 | 300% | 17% | 32% |
| Midscale with Food & Beverage | 9 | 84 | 93 | 6 | 75 | 81 | 50% | 12% | 15% |
| Econo Lodge | 2 | 28 | 30 | | 23 | 23 | NM | 22% | 30% |
| Rodeway | | 39 | 39 | 1 | 48 | 49 | -100% | -19% | -20% |
| Economy | 2 | 67 | 69 | 1 | 71 | 72 | 100% | -6% | -4% |
| MainStay | 4 | 1 | 5 | 3 | 1 | 4 | 33% | 0% | 25% |
| Suburban | 7 | 2 | 9 | 6 | 2 | 8 | 17% | 0% | 13% |
| Extended Stay | 11 | 3 | 14 | 9 | 3 | 12 | 22% | 0% | 17% |
| Cambria Suites | 15 | | 15 | 15 | | 15 | 0% | NM | 0% |
| Total Domestic System | 109 | 178 | 287 | 106 | 169 | 275 | 3% | 5% | 4% |

Relicensing fees declined 11% to \$5.0 million for the six months ended June 30, 2007 from \$5.6 million for the six months ended June 30, 2006. Relicensing fees are charged to the new property owner of a franchised property whenever an ownership change occurs and the property remains in the franchise system. During the six months ended June 30, 2007, relicensings decreased 9% to 158 for the six months ended June 30, 2007 from 173 for the same period of 2006.

Brand solutions revenue increased \$1.3 million or 17% to \$9.0 million resulting primarily from increased vendor sponsorships of our annual franchisee convention.

Other income declined \$0.3 million to \$3.7 million for the six months ended June 30, 2007 primarily due to lower liquidated damage collections related to the early termination of franchise agreements.

Franchise Expenses: The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative (SG&A) expenses were \$49.5 million for the six months ended June 30, 2007, an increase of \$9.0 million from the six months ended June 30, 2006. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 38.8% for the six months ended June 30, 2007 compared to 34.6% for the six months ended June 30, 2006. Expenses increased primarily due to \$3.7 million in termination benefits recorded related to the termination of certain executive officers and an additional \$1.6 million in expenses related to the commencement of direct franchising operations in continental Europe.

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

Depreciation and Amortization: Expenses declined \$0.7 million to \$4.3 million for the six months ended June 30, 2007 due to the acceleration of depreciation in the prior year period resulting from the renovation and replacement of furniture, fixtures and equipment at two of the Company-owned MainStay Suites.

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

Total marketing and reservations revenues were \$143.9 million and \$130.7 million for the six months ended June 30, 2007 and 2006, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$3.9 million for both the six months ended June 30, 2007 and 2006, respectively. Interest expense attributable to reservation activities was \$0.3 million and \$0.4 million for the six months ended June 30, 2007 and 2006, respectively.

Other Income and Expenses, Net: Other income and expenses, net, decreased \$4.0 million to an expense of \$3.5 million for the six months ended June 30, 2007 from \$7.5 million for the same period in 2006. This decline resulted primarily from a \$1.7 million increase in the fair value of investments held in non-qualified employee benefit plans versus a \$0.3 million appreciation in value of these investments in the prior year period. In addition, interest expense declined \$1.9 million from \$8.1 million to \$6.2 million. Interest expense declined due to lower outstanding borrowings on the Company's variable rate debt partially offset by higher average interest rates. The Company's weighted average interest rate as of June 30, 2007 was 6.42% compared to 6.34% as of June 30, 2006.

Income Taxes: The Company's effective income tax provision rate was 36.9% for the six months ended June 30, 2007, an increase of 150 bps from the effective income tax provision rate of 35.4% for the six months ended June 30, 2006. The effective income tax rate increased primarily due to a decline in the proportion of foreign income earned over the prior year period, which is taxed at lower rates than statutory federal income tax rates. Depending upon the outcome of certain income tax contingencies during 2007 up to \$2.0 million of additional income tax benefits may be reflected in our 2007 results of operations from the resolution of tax contingency reserves.

Net income for the six months ended June 30, 2007 increased by 8% to \$45.0 million, and diluted earnings per share increased 8% to \$0.67 for the six months ended

Table of Contents

June 30, 2007 from \$0.62 reported for the six months ended June 30, 2006.

Liquidity and Capital Resources

Net cash provided by operating activities was \$57.1 million and \$62.6 million for the six months ended June 30, 2007 and 2006, respectively. The decline in cash flows from operating activities primarily reflects the timing of working capital items compared to the prior year.

The Company revised its presentation of cash flows for the six month period ended June 30, 2006 related to dividends received from equity method investees. The Company had previously presented these cash flows as investing activities on its consolidated statement of cash flows. SFAS No. 95 Statement of Cash Flows requires the classification of these dividends, which represent a return on investments, as operating cash flows. There was no effect on any other previously reported income statement or balance sheet amounts.

Net cash provided related to marketing and reservations activities totaled \$1.7 million and \$0.7 million during the six months ended June 30, 2007 and 2006, respectively. The increase in cash flows from marketing and reservations relates primarily to the timing of advertising and promotional costs spending versus the prior year offset partially by increased spending on reservation technology initiatives. The Company expects marketing and reservation activities to be a use of cash between \$1.0 million and \$3.0 million in 2007.

Cash used in investing activities for the six months ended June 30, 2007 and 2006 was \$13.4 million and \$9.7 million, respectively. During the six months ended June 30, 2007 and 2006, capital expenditures totaled \$5.8 million and \$4.0 million, respectively. Capital expenditures for 2007 primarily include leasehold improvements to the Company's facilities as well as upgrades of system-wide property and yield management systems and the purchase of computer equipment.

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 up to \$30 million) until the scheduled maturity date of June 16, 2011. The Company has the ability to request an increase in available borrowings under the Revolver by an additional amount of up to \$150 million by obtaining the agreement of the existing lenders to increase their lending commitments or by adding additional lenders. The rate of interest generally applicable for revolving loans under the Revolver are, at the Company's option, equal to either (i) the greater of the prime rate or the federal funds effective rate plus 50 basis points, or (ii) an adjusted LIBOR rate plus a margin between 22 and 70 basis points based on the Company's credit rating. The Revolver requires the Company to pay a quarterly facility fee, based upon the credit rating of the Company, at a rate between 8 and 17 1/2 basis points, on the full amount of the commitment (regardless of usage). The Revolver also requires the payment of a quarterly usage fee, based upon the credit rating of the Company, at a rate between 10 and 12 1/2 basis points, on the amount outstanding under the commitment, at all times when the amount borrowed under the Revolver exceeds 50% of the total commitment. The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. The Revolver also restricts the Company's ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions. As of June 30, 2007, the Company had \$99.2 million of revolving loans outstanding pursuant to the Revolver. At June 30, 2007, 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.

In 1998, the Company completed a \$100 million senior unsecured note offering (the Senior Notes) at a discount of \$0.6 million, bearing a coupon rate of 7.13% with an effective rate of 7.22%. The Senior Notes will mature on May 1, 2008, with interest on the Senior Notes paid semi-annually. The Senior Notes have been classified as a long-term liability at June 30, 2007, since the Company's intention is to repay the Senior Notes upon maturity by utilizing the available capacity of the Revolver.

Effective July 14, 2006, the Company's Senior Notes are guaranteed jointly, severally, fully and unconditionally by 7 wholly-owned subsidiaries. There are no legal or regulatory restrictions on the payment of dividends to Choice Hotels International, Inc. from subsidiaries that do not guarantee the Senior Notes.

The Company has a line of credit with a bank providing up to an aggregate of \$10 million of borrowings which is due upon demand. The line of credit ranks pari-pasu (or equally) with the Revolver. Borrowings under the line of credit bear interest at rates established at the time of the borrowings based on prime minus 175 basis points. As of June 30, 2007, no amounts were outstanding pursuant to this line of credit.

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

In the second quarter of 2007, the Company repaid an outstanding note with a balance of \$0.4 million by utilizing proceeds from the Revolver. The note had an original maturity date of January 1, 2009. The loan bore interest based on seventy percent of prime and required monthly principal and interest payments.

As of June 30, 2007, the total debt outstanding for the Company was \$199.1 million.

For the six months ended June 30, 2007, the Company purchased approximately 1.2 million shares of its common stock at an average price of \$38.33 for a total cost of \$46.1 million under its share repurchase program. As of June 30, 2007, the Company had authorization to purchase up to an additional 3.9 million shares under the share repurchase program. Repurchases will continue to be made in the open market and through privately negotiated transactions subject to market and other conditions. No minimum number of shares has been fixed. Since the Company announced its stock repurchase program on June 25, 1998, the Company has repurchased 34.8 million shares of its common stock for a total cost of \$758 million through June 30, 2007. Considering the effect of a two-for-one stock split in October 2005, the Company has repurchased 67.8 million shares under the share repurchase program at an average price of \$11.17 per share. Subsequent to June 30, 2007 through August 9, 2007, the Company repurchased an additional 1.3 million shares of its common stock at a total cost of \$50.5 million.

On May 1, 2007, the Company declared a cash dividend of \$0.15 per share (or approximately \$9.8 million in the aggregate), which was paid on July 20, 2007 to shareholders of record on July 6, 2007. Dividends paid in the six months ended June 30, 2007 were approximately \$19.8 million and we expect dividends in 2007 to be approximately \$39.3 million.

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

During the six months ended June 30, 2007, certain executive officers separated from the Company. As a result of those separations, the Company will remit to those officers approximately \$2.2 million of cash termination benefits over the next twelve months as well as \$3.3 million of deferred compensation and retirement plan obligations.

As of January 1, 2007 and June 30, 2007, the Company had \$8.2 million and \$9.0 million, respectively of total unrecognized tax benefits of which approximately \$5.1 million and \$5.5 million, respectively would affect the effective tax rate if recognized. These unrecognized tax benefits relate principally to state tax filing positions and

Table of Contents

previously deducted expenses. The Company believes it is reasonably possible it will recognize tax benefits of up to \$2.0 million within the next twelve months. This is related to the anticipated expiration of statutes of limitations of previously deducted expenses.

In April 2007, two punitive federal securities law class actions were filed in the United States District Court for the District of Colorado on behalf of persons who purchased the Company's stock between April 25, 2006, and July 26, 2006. These substantially-similar lawsuits assert claims pursuant to Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, against the Company, its current Vice Chairman and Chief Executive Officer, and its former Executive Vice President and Chief Financial Officer. These claims are related to the Company's July 25, 2006 announcement of its results of operations for the second quarter of 2006.

Since the initial filings, the Company has filed a motion to transfer the litigation from Colorado to the United States District Court for the District of Maryland. Additionally, one plaintiff has petitioned the Court to be named lead plaintiff in the dispute. At this time, the Company has not responded to the complaints filed and is not required to do so until after a lead plaintiff is appointed and a consolidated complaint is filed. The Company believes that the allegations contained within these class action lawsuits are without merit and intends to vigorously defend the litigation.

The Company's management does not expect that the outcome of any of its currently ongoing legal proceedings individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations or cash flow.

During 2005, the Company acquired 100% of the stock of Suburban Franchise Holding Company, Inc. (Suburban) and its wholly owned subsidiary, Suburban Franchise Systems, Inc. Beginning on the third anniversary of the closing, the merger provided for contingent cash payments of up to \$5.0 million to be made upon the satisfaction of certain criteria. At June 30, 2007, no liabilities had been recorded related to the contingent cash payments. Subsequent to June 30, 2007, the Company has determined that the performance conditions can no longer be satisfied and therefore the contingent consideration will not be earned.

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

Critical Accounting Policies

Our accounting policies comply with principles generally accepted in the United States. We have described below those policies that we believe are critical and require the use of complex judgment or significant estimates in their application. Additional discussion of these policies is included in Note 1 to our consolidated financial statements as of and for the year ended December 31, 2006 included in our Annual Report on Form 10-K.

Revenue Recognition.

The Company accounts for initial, relicensing and continuing franchise fees in accordance with SFAS No. 45, Accounting for Franchise Fee Revenue. We recognize continuing franchise fees, including royalty, marketing and reservations fees, when earned and receivable from our franchisees. Franchise fees are typically based on a percentage of gross room revenues of each franchisee. Our estimate of the allowance for uncollectible royalty fees is charged to selling, general and administrative expense.

Initial franchise and relicensing fees are recognized, in most instances, in the period the related franchise agreement is executed because the initial franchise and relicensing fees are non-refundable and the Company has no continuing obligations related to the franchisee. We defer the initial franchise and relicensing fee revenue related to franchise agreements which include incentives until the incentive criteria are met or the agreement is terminated, whichever occurs first.

We account for brand solutions revenues from endorsed vendors in accordance with Staff Accounting Bulletin No. 104, (SAB 104) Revenue Recognition. SAB 104 provides guidance on the recognition, presentation and disclosure of revenue in financial statements. Pursuant to SAB 104, the Company recognizes brand solutions revenues when the services are performed or the product delivered, evidence of an arrangement exists, the fee is fixed and determinable and collectibility is probable. We defer the recognition of brand solutions 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.

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

The Company records marketing and reservation revenues and expenses in accordance with Emerging Issues Task Force (EITF) Issue No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, which requires that these revenues and expenses be recorded gross. In addition, net advances to and repayments from the franchise system for marketing and reservation activities are presented as cash flows from operating activities.

Reservation fees and marketing fees not expended in the current year are carried over to the next fiscal year and expended in accordance with the franchise agreements. Shortfall amounts are similarly recovered in subsequent years. Cumulative excess or shortfall amounts from the operation of these programs are recorded as a marketing or reservation fee payable or receivable. Under the terms of the franchise agreements, the Company may advance capital as necessary for marketing and reservation activities and recover such advances through future fees. Our current assessment is that the credit risk associated with the marketing fee receivable is mitigated due to our contractual right to recover these amounts from a large geographically dispersed group of franchisees.

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

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

Impairment Policy.

We evaluate the fair value of goodwill to assess potential impairments on an annual basis, or during the year if an event or other circumstance indicates that we may not

Table of Contents

be able to recover the carrying amount of the asset. We evaluate impairment of goodwill by comparing the fair value of our net assets with the carrying amount of goodwill. We evaluate the potential impairment of property and equipment and other long-lived assets, including franchise rights on an annual basis or whenever an event or other circumstance indicates that we may not be able to recover the carrying value of the asset. Our evaluation is based upon future cash flow projections. These projections reflect management's best assumptions and estimates. Significant management judgment is involved in developing these projections, and they include inherent uncertainties. If different projections had been used in the current period, the balances for non-current assets could have been materially impacted. Furthermore, if management uses different projections or if different conditions occur in future periods, future-operating results could be materially impacted.

Income Taxes.

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

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

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

Tax assessments and resolution of tax contingencies may arise several years after tax returns have been filed. Predicting the outcome of such tax assessments involves uncertainty; however, we believe that recorded tax liabilities adequately account for our analysis of probable outcomes.

Effective January 1, 2007, the Company adopted the provisions of FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This pronouncement also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. As a result of the implementation of FIN 48, the Company increased its existing reserves for uncertain tax positions by \$3.2 million with a corresponding net reduction to opening additional paid-in-capital and retained earnings.

As of January 1, 2007 and June 30, 2007, the Company had \$8.2 million and \$9.0 million, respectively of total unrecognized tax benefits of which approximately \$5.1 million and \$5.5 million, respectively would affect the effective tax rate if recognized. These unrecognized tax benefits relate principally to state tax filing positions and previously deducted expenses. The Company believes it is reasonably possible it will recognize tax benefits of up to \$2.0 million within the next twelve months. This is related to the anticipated expiration of statutes of limitations of previously deducted expenses.

In many cases, 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 2002. Substantially all material state and local and foreign income tax matters have been concluded for years through 2002. U.S. federal income tax returns for 2003 through 2006 are currently open for examination.

Estimated interest and penalties related to the underpayment of income taxes are classified as a component of income tax expense in the consolidated statements of income and totaled \$0.2 million and \$0.3 million for the three months and six months ended June 30, 2007, respectively. Accrued interest and penalties were \$1.1 million and \$1.4 million as of January 1, 2007 and June 30, 2007, respectively.

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. The Company accounts for these plans in accordance with EITF No. 97-14, *Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested*. Pursuant to EITF 97-14, as of June 30, 2007 and December 31, 2006, the Company had

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

recorded a deferred compensation liability of \$34.3 million and \$32.9 million, respectively. The change in the deferred compensation obligation related to changes in the fair value of the diversified investments held in trust and to earnings credited to participants is recorded in compensation expense. The diversified investments held in the trusts were \$37.4 million and \$31.5 million as of June 30, 2007 and December 31, 2006, respectively, and are recorded at their fair value, based on quoted market prices. The change in the fair value of the diversified assets held in trust is recorded in accordance with SFAS 115 as trading security income (loss) and is included in other income and expenses, net in the accompanying statements of income.

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. Effective December 31, 2006, The Company accounts for the SERP in accordance with SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statements No. 87, 88, 106, and 132(R) . Based on the plan retirement age of 65 years old, no benefit payments are anticipated over the current year.

Stock Compensation

The Company accounts for share based payment transactions in accordance with SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R). SFAS No. 123R requires that the compensation cost relating to share based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued.

Table of Contents

Recently Issued Accounting Standards

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the impact, if any, the adoption of this statement will have on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159) which provides reporting entities an option to report certain financial instruments and other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective as of the beginning of a reporting entity's first fiscal year beginning after November 15, 2007. We are currently evaluating the impact, if any, the adoption of this statement will have on our consolidated financial statements.

FORWARD-LOOKING STATEMENTS

Certain matters discussed in this quarterly report constitute forward-looking statements within the meaning of the federal securities law. Generally, our use of words such as expect, estimate, believe, anticipate, will, forecast, plan, project, assume or similar words of forward-looking statements 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 for the Company's revenue, earnings and other financial and operational measures, Company debt levels, payment of stock dividends, and future operations. 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. 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, 2006, filed with the Securities and Exchange Commission on March 1, 2007. 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. The Company does not foresee any significant changes in exposure in these areas or in how such exposure is managed in the near future.

At June 30, 2007 and December 31, 2006, the Company had \$199.1 million and \$172.5 million of debt outstanding at an effective interest rate of 6.4% and 6.6%, respectively. A hypothetical change of 10% in the Company's effective interest rate from June 30, 2007 levels would increase or decrease annual interest expense by \$0.6 million. Prior to scheduled maturities, the Company expects to refinance its long-term debt obligations.

The Company does not presently have any derivative financial instruments.

ITEM 4. CONTROLS AND PROCEDURES

The Company formed a disclosure review committee whose membership includes the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), among others. The CEO and CFO consider the disclosure review committee's procedures in performing their evaluations of the Company's disclosure controls and procedures and in assessing the accuracy and completeness of the Company's disclosures.

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

An evaluation was performed under the supervision and with the participation of the Company's CEO and CFO of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of June 30, 2007.

There has been no change in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2007 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

In April 2007, two putative federal securities law class actions were filed in the United States District Court for the District of Colorado on behalf of persons who purchased the Company's stock between April 25, 2006, and July 26, 2006. These substantially-similar lawsuits assert claims pursuant to Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, against the Company, its current Vice Chairman and Chief Executive Officer, and its former Executive Vice President and Chief Financial Officer. These claims are related to the Company's July 25, 2006 announcement of its results of operations for the second quarter of 2006.

Since the initial filings, the Company has filed a motion to transfer the litigation from Colorado to the United States District Court for the District of Maryland. Additionally, one plaintiff has petitioned the Court to be named lead plaintiff in the dispute. At this time, the Company has not responded to the complaints filed and is not required to do so until after a lead plaintiff is appointed and a consolidated complaint is filed. The Company believes that the allegations contained within these class action lawsuits are without merit and intends to vigorously defend the litigation.

The Company's management does not expect that the outcome of any of its currently ongoing legal proceedings individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations or cash flow.

Table of Contents**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, 2006, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

The following table sets forth purchases of Choice Hotels International, Inc. common stock made by the Company during the six months ended June 30, 2007.

| Month | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that may yet be Purchased Under the Plans or Programs, End of Period |
|---------------|----------------------------------|------------------------------|--|---|
| January 2007 | 813 | \$ 42.17 | | 5,102,701 |
| February 2007 | 211,534 | 38.84 | 183,368 | 4,919,333 |
| March 2007 | 288,730 | 37.24 | 288,730 | 4,630,603 |
| April 2007 | | | | 4,630,603 |
| May 2007 | 429,586 | 37.90 | 427,808 | 4,202,795 |
| June 2007 | 302,370 | 39.88 | 301,988 | 3,900,807 |
| Total | 1,233,033 | \$ 38.39 | 1,201,894 | 3,900,807 |

During the three and six months ended June 30, 2007, the Company purchased 2,160 and 31,139, shares of common stock from employees to satisfy statutory minimum tax-withholding requirements from the vesting of restricted stock grants. These purchases were outside the share repurchase program initiated in June 1998.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Shareholders of the Company was held on May 1, 2007. At the meeting, William L. Jews, John T. Schwieters and David C. Sullivan were each elected to a three-year term expiring in 2010. The terms of the following directors continued after the meeting:

Stewart Bainum, Jr.

Ervin R. Shames

Gordon A. Smith

Fiona Dias

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

Charles A. Ledsinger, Jr.

The Company's shareholders voted to ratify the appointment of PricewaterhouseCoopers LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2007.

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

| | Votes Cast | | | | Broker Non-Votes |
|---|------------|---------|----------|-------------|------------------|
| | For | Against | Withheld | Abstentions | |
| Election of William L. Jews | 62,720,141 | | 104,464 | | |
| Election of John T. Schwieters | 62,705,234 | | 119,371 | | |
| Election of David C. Sullivan | 62,720,307 | | 104,298 | | |
| Ratification of Appointment of PricewaterhouseCoopers LLP | 62,759,255 | 22,917 | | 42,433 | |

ITEM 5. OTHER INFORMATION

None.

Table of Contents

ITEM 6. EXHIBITS

(a) Exhibits

Exhibit Number and Description

Exhibit

| Number | Description |
|---------------|--|
| 3.01(a) | Restated Certificate of Incorporation of Choice Hotels Franchising, Inc.(renamed Choice Hotels International, Inc.) |
| 3.02(a) | Amended and Restated Bylaws of Choice Hotels International, Inc. |
| 4.01(l) | Senior Unsecured Revolving Credit Facility agreement dated June 16, 2006 among Choice Hotels International, Inc., Wachovia Bank, National Association, as Agent, SunTrust Bank, as Syndication Agent, Bank of America, N.A., as Documentation Agent, Wachovia Capital Markets, LLC, as Lead Arranger and Sole Book Manager, and the additional lenders named in the credit agreement |
| 4.02(f) | Registration Agreement dated April 28, 1998 between Choice Hotels International, Inc. and Salomon Brothers, Inc., Bear Stearns & Co. Inc. and Lehman Brothers Inc. |
| 4.03(f) | Indenture dated as of May 4, 1998, by and among Choice Hotels International, Inc., Quality Hotels Europe, Inc., QH Europe Partnership and Marine Midland Bank, as Trustee, with respect to the 7.125% Senior Notes due 2008 |
| 4.04(f) | Specimen certificate of 7.125% Senior Note due 2008 (Original Note) (Attached as an exhibit to the Indenture set forth as Exhibit 4.03) |
| 4.05(f) | Specimen certificate of 7.125% Senior Note due 2008 (Exchange Note) (Attached as an exhibit to the Indenture set forth as Exhibit 4.03) |
| 4.06(m) | Agreement to furnish certain debt agreements |
| 10.01(n) | Second Amended and Restated Employment Agreement between Choice Hotels International, Inc. and Charles A. Ledsinger, Jr. dated December 20, 2005 |
| 10.02(i) | Amended and Restated Chairman's Service Agreement dated May 4, 2004 by and between Choice Hotels International, Inc. and Stewart Bainum, Jr. |
| 10.03(d) | Amended and Restated Employment Agreement dated April 13, 1999 by and between Choice Hotels International, Inc. and Thomas Mirgon |
| 10.04(e) | Choice Hotels International, Inc. 2006 Long- Term Incentive Plan |
| 10.05(g) | Second Amended and Restated Employment Agreement dated April 13, 1999 between Choice Hotels International, Inc. and Michael J. DeSantis |
| 10.05A(m) | Agreement and Release dated February 15, 2007, between Choice Hotels International, Inc. and Michael J. DeSantis |
| 10.06(h) | Commercial Lease dated May 29, 1998 among Columbia Pike I, LLC and Colesville Road, LLC (each an assignee of Manor Care, Inc.) and Choice Hotels International, Inc. |
| 10.07(j) | Employment Agreement dated June 3, 1999 between Choice Hotels International, Inc. and Joseph M. Squeri |
| 10.07A(m) | Agreement and Release dated February 9, 2007, between Choice Hotels International, Inc. and Joseph M. Squeri. |
| 10.08(k) | Employment Agreement dated May 3, 2000 between Choice Hotels International, Inc. and Daniel Rothfeld |
| 10.09(o) | Agreement and Amendment to Employment Agreement between Choice Hotels International, Inc. and Wayne Wielgus dated September 13, 2006 |
| 10.10(c) | Amended and Restated Supplemental Executive Retirement Plan |
| 10.11(b) | Choice Hotels International, Inc. Executive Deferred Compensation Plan |
| 31.1* | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) |

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

| | |
|-------|--|
| 31.2* | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) |
| 32* | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 |

* Filed herewith

- (a) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Registration Statement on Form S-4, filed August 31, 1998 (Reg. No. 333-62543).
- (b) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002, filed March 31, 2003.
- (c) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2000, filed April 2, 2001.
- (d) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 1999, filed on June 4, 1999.
- (e) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Current Report on form 8-K dated May 1, 2006, filed on May 5, 2006.
- (f) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q filed for the quarterly period ended March 31, 1998, filed on May 15, 1998.
- (g) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q filed for the quarter ended June 30, 1998, filed on August 11, 1998.
- (h) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 1998, filed on March 30, 1999.
- (i) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2004, filed March 16, 2005.
- (j) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1999, filed on August 16, 1999.
- (k) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2000, filed November 14, 2000.

Table of Contents

- (l) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Current Report on Form 8-K dated June 16, 2006, filed June 21, 2006.
 - (m) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2006, filed March 1, 2007.
 - (n) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Current Report on Form 8-K dated December 20, 2005, filed December 22, 2005.
 - (o) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Current Report on Form 8-K dated September 13, 2006, filed September 18, 2006.
- (b) Reports on Form 8-K**

The Company filed a report on Form 8-K, dated April 27, 2007, reporting that on April 25, 2007 a press release had been issued reporting the Company s earnings for the quarter ended March 31, 2007.

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.

Date: August 9, 2007

CHOICE HOTELS INTERNATIONAL, INC.

By: /s/ David L. White
David L. White
Chief Financial Officer