CHOICE HOTELS INTERNATIONAL INC /DE
Form 10-Q
May 07, 2007
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 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** | **52-1209792** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**10750 COLUMBIA PIKE**

**SILVER SPRING, MD. 20901**

**(Address of principal executive offices)**

**(Zip Code)**

**(301) 592-5000**

**(Registrant s telephone number, including area code)**

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

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes x 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 x Accelerated filer ¨ Non-accelerated filer ¨

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

| **CLASS** | **SHARES OUTSTANDING AT MARCH 31, 2007** |
|---|---|
| Common Stock, Par Value $0.01 per share | 66,122,531 |

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

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

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

**CONSOLIDATED STATEMENTS OF INCOME**

**(UNAUDITED, IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)**

| | Three Months Ended March 31, 2007 | Three Months Ended March 31, 2006 |
|---|---|---|
| **REVENUES:** | | |
| Royalty fees | **$ 43,328** | $ 39,864 |
| Initial franchise and relicensing fees | **4,931** | 5,643 |
| Brand solutions | **2,986** | 2,782 |
| Marketing and reservation | **62,041** | 57,976 |
| Hotel operations | **1,096** | 980 |
| Other | **1,801** | 2,173 |
| **Total revenues** | **116,183** | 109,418 |
| **OPERATING EXPENSES:** | | |
| Selling, general and administrative | **23,900** | 18,275 |
| Depreciation and amortization | **2,115** | 2,349 |
| Marketing and reservation | **62,041** | 57,976 |
| Hotel operations | **741** | 745 |
| **Total operating expenses** | **88,797** | 79,345 |
| **Operating income** | **27,386** | 30,073 |
| **OTHER INCOME AND EXPENSES, NET:** | | |
| Interest expense | **2,997** | 4,040 |
| Interest and other investment income | **(601)** | (704) |
| Equity in net income of affiliates | **(194)** | (258) |
| **Total other income and expenses, net** | **2,202** | 3,078 |
| **Income before income taxes** | **25,184** | 26,995 |
| **Income taxes** | **8,869** | 9,330 |
| **Net income** | **$ 16,315** | $ 17,665 |
| **Weighted average shares outstanding-basic** | **65,782** | 64,781 |
| **Weighted average shares outstanding-diluted** | **67,048** | 66,728 |
| **Basic earnings per share** | **$ 0.25** | $ 0.27 |
| **Diluted earnings per share** | **$ 0.24** | $ 0.26 |

| | | |
|---|---|---|
| **Cash dividends declared per share** | **$ 0.15** | $ 0.13 |

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

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

**CONSOLIDATED BALANCE SHEETS**

**(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)**

| | March 31, 2007 (Unaudited) | December 31, 2006 |
|---|---|---|
| **ASSETS** | | |
| Current assets | | |
| Cash and cash equivalents | **$ 35,380** | $ 35,841 |
| Receivables (net of allowance for doubtful accounts of $3,070 and $3,937, respectively) | **37,406** | 41,694 |
| Deferred income taxes | **3,060** | 1,790 |
| Other current assets | **6,930** | 7,757 |
| **Total current assets** | **82,776** | 87,082 |
| Property and equipment, at cost, net | **43,356** | 42,802 |
| Goodwill | **65,813** | 65,813 |
| Franchise rights and other identifiable intangibles, net | **34,601** | 35,509 |
| Receivable marketing fees | **12,172** | 6,662 |
| Investments, employee benefit plans, at fair value | **35,415** | 31,529 |
| Deferred income taxes | **20,418** | 22,451 |
| Other assets | **10,719** | 11,461 |
| **Total assets** | **$ 305,270** | $ 303,309 |
| **LIABILITIES AND SHAREHOLDERS DEFICIT** | | |
| Current liabilities | | |
| Current portion of long-term debt | **$ 146** | $ 146 |
| Accounts payable | **40,776** | 41,816 |
| Accrued expenses and other | **34,642** | 45,306 |
| Deferred revenue | **49,753** | 47,167 |
| Deferred compensation and retirement plan obligations | **3,411** | |
| Income taxes payable | **9,270** | 5,356 |
| **Total current liabilities** | **137,998** | 139,791 |
| **Long-term debt** | **184,370** | 172,390 |
| **Deferred compensation and retirement plan obligations** | **39,687** | 40,101 |
| **Other liabilities** | **13,704** | 13,407 |
| **Total liabilities** | **375,759** | 365,689 |
| Commitments and contingencies | | |
| **SHAREHOLDERS DEFICIT** | | |
| Common stock, $0.01 par value | **661** | 664 |
| Additional paid-in-capital | **79,656** | 81,689 |
| Accumulated other comprehensive income (loss) | **61** | (772) |
| Treasury stock, at cost | **(640,595)** | (627,311) |
| Retained earnings | **489,728** | 483,350 |

| | | |
|---|---|---|
| **Total shareholders deficit** | **(70,489)** | (62,380) |
| **Total liabilities and shareholders deficit** | **$ 305,270** | $ 303,309 |

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

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(UNAUDITED, IN THOUSANDS)**

| | Three Months Ended March 31, | |
|---|---|---|
| | **2007** | **2006** |
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Net income | **$ 16,315** | $ 17,665 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | **2,115** | 2,349 |
| Provision for bad debts | **(570)** | (409) |
| Non-cash stock compensation and other charges | **4,698** | 3,369 |
| Non-cash interest and other income | **(319)** | (505) |
| Dividends received from equity method investees | **295** | 169 |
| Equity in net income of affiliates | **(194)** | (258) |
| Changes in assets and liabilities, net of acquisitions: | | |
| Receivables | **4,995** | 3,231 |
| Receivable marketing and reservation fees, net | **(7,131)** | (8,319) |
| Accounts payable | **(1,046)** | 5,785 |
| Accrued expenses and other | **(11,502)** | (8,665) |
| Income taxes payable | **3,914** | 708 |
| Deferred income taxes | **299** | 1,799 |
| Deferred revenue | **2,586** | 2,450 |
| Other assets | **897** | 808 |
| Other liabilities | **5,101** | 4,275 |
| **Net cash provided by operating activities** | **20,453** | 24,452 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Investment in property and equipment | **(3,020)** | (1,193) |
| Acquisitions, net of cash acquired | **(343)** | |
| Issuance of notes receivable | **(131)** | (649) |
| Collections of notes receivable | **306** | 190 |
| Purchases of investments | **(4,496)** | (4,353) |
| Proceeds from sale of investments | **961** | 859 |
| Other items, net | **(300)** | (228) |
| **Net cash used in investing activities** | **(7,023)** | (5,374) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | |
| Principal payments of long-term debt | **(36)** | (37) |
| Net (repayments) borrowings pursuant to revolving credit facilities | **12,000** | (14,800) |
| Purchase of treasury stock | **(19,001)** | (1,277) |
| Excess tax benefits from stock-based compensation | **1,362** | 5,050 |
| Dividends paid | **(9,895)** | (8,436) |
| Proceeds from exercise of stock options | **1,679** | 3,437 |
| **Net cash used in financing activities** | **(13,891)** | (16,063) |
| **Net change in cash and cash equivalents** | **(461)** | 3,015 |
| **Cash and cash equivalents at beginning of period** | **35,841** | 16,921 |

| | | |
|---|---|---|
| **Cash and cash equivalents at end of period** | **$ 35,380** | $ 19,936 |
| | | |
| **Supplemental disclosure of cash flow information:** | | |
| **Cash payments during the period for:** | | |
| Income taxes, net of refunds | **$ 3,112** | $ 1,796 |
| Interest | **$ 1,049** | $ 2,283 |
| **Non-cash financing activities:** | | |
| Declaration of dividends | **$ 9,850** | $ 8,496 |
| Issuance of treasury stock to employee stock purchase plan | **$ 229** | |
| Issuance of restricted shares of common stock | **$ 4,695** | $ 5,749 |

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

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

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

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

The accompanying unaudited consolidated financial statements of Choice Hotels International, Inc. and subsidiaries (together the Company ) have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. 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 first quarter of 2006 related to dividends received from equity method investees. During the first three 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 March 31, 2007 and December 31, 2006, $8.3 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.

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

The marketing fees receivable at March 31, 2007 and December 31, 2006 was $12.2 million and $6.7 million, respectively. As of March 31, 2007 and December 31, 2006, cumulative reservation fees collected exceeded expenses by $4.8 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 $2.0 million and $1.9 million for the three months ended March 31, 2007 and 2006, respectively. Interest expense attributable to reservation activities was $0.1 million and $0.2 million for the three months ended March 31, 2007 and 2006, respectively.

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**3. Income Taxes**

The effective income tax rates for the three months ended March 31, 2007 and 2006 were approximately 35.2% and 34.6%, respectively, and 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, the Company had $8.2 million of total unrecognized tax benefits of which approximately $4.9 million would affect the effective tax rate if recognized. There have been no significant changes to these amounts during the quarter ended March 31, 2007. 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 $1.3 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 $0.1 million for the three months ended March 31, 2007. Accrued interest and penalties were $1.2 million as of March 31, 2007.

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:

| | **Three Months Ended March 31,** | |
|---|---|---|
| **(In thousands)** | **2007** | **2006** |
| Net income | **$ 16,315** | $ 17,665 |
| Other comprehensive income, net of tax: | | |
| Amortization of pension related costs, net of tax | | |
| Prior service costs | **7** | |
| Loss | **13** | |
| Curtailment and remeasurement, net of tax | **758** | |
| Foreign currency translation adjustment, net | **72** | (30) |
| Amortization of deferred gain on hedge, net | **(17)** | (17) |
| Other comprehensive income (loss) | **833** | (47) |
| Comprehensive income | **$ 17,148** | $ 17,618 |

**5. Capital Stock**

*Stock Options*

The Company granted approximately 0.2 million options to certain officers of the Company during the three months ended March 31, 2007 and 2006 at a fair value of approximately $2.1 million and $2.8 million,

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respectively. The stock options granted by the Company had an exercise price equal to the market price of the Company s common stock on the date of grant. The fair value of the options granted was estimated on the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | 2007 Grants | 2006 Grants |
|---|---|---|
| Risk-free interest rate | 4.88% | 4.69% |
| Expected volatility | 32.41% | 32.09% |
| Expected life of stock option | 4.5 years | 4.3 years |
| Dividend yield | 1.47% | 1.07% |
| Requisite service period | 4 years | 4 years |
| Contractual life | 7 years | 7 years |
| Weighted average fair value of options granted | $ 12.39 | $ 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.

The aggregate intrinsic value of the stock options outstanding and exercisable at March 31, 2007 was $58.7 million and $51.7 million, respectively. The total intrinsic value of options exercised during the three months ended March 31, 2007 and 2006 was $4.8 million and $15.2 million, respectively.

The Company received $1.7 million and $3.4 million in proceeds from the exercise of 0.2 million and 0.4 million employee stock options during the three months ended March 31, 2007 and 2006, respectively.

*Restricted Stock*

The following table is a summary of activity related to restricted stock grants to key employees for the three months ended March 31:

| | 2007 | 2006 |
|---|---|---|
| Restricted Shares Granted | **114,423** | 118,016 |
| Weighted Average Grant Date Fair Value Per Share | **$ 41.03** | $ 48.72 |
| Aggregate Grant Date Fair Value ($000) | **$ 4,695** | $ 5,749 |
| Restricted Shares Forfeited | **18,097** | 4,974 |
| Vesting Service Period of Shares Granted | **4 years** | 4 years |
| Fair Value of Shares Vested ($000) | **$ 4,974** | $ 7,113 |

Compensation expense related to the fair value of these awards is recognized straight-line over the requisite service period based on those restricted stock grants that ultimately vest. The fair value is measured by the average of the high and low market price of the Company s common stock on the date of the 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 three months ended March 31, 2007 and 2006, 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

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SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123R ), compensation expense related to these awards will be recognized over the requisite service period regardless of whether the performance targets have been met based on the Company s estimate of the achievement of the performance target. The Company has currently estimated that 100% and 130% of the 2007 and 2006 award 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.

The following table is a summary of activity related to PVRSU grants during the three months ending March 31, 2007 and 2006:

| | Three Months Ended March 31, 2007 | Three Months Ended March 31, 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 March 31, 2007, and changes during the three months ended are presented below:

| | Three Months Ended March 31, 2007 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Stock Options | | | Restricted Stock | | Performance Vested Restricted Stock Units | |
| | Shares | Weighted Average Exercise Price | Weighted Average Contractual Term | Shares | Weighted Average Grant Date Fair Value | Shares | Weighted Average Grant Date Fair Value |
| Outstanding at January 1, 2007 | 2,860,159 | $ 14.30 | | 570,134 | $ 29.81 | 49,780 | $ 46.22 |
| Granted | 165,957 | 40.74 | | 114,423 | 41.03 | 21,141 | 40.75 |
| Exercised/Vested | (165,247) | 10.17 | | (120,450) | 27.98 | | |
| Forfeited/Expired | (15,661) | 17.75 | | (18,097) | 33.43 | | |
| Outstanding at March 31, 2007 | 2,845,208 | $ 16.06 | 4.9 years | 546,010 | $ 32.44 | 70,921 | $ 44.59 |
| Options exercisable at March 31, 2007 | 2,094,535 | $ 11.11 | 4.0 years | | | | |

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

| (in millions) | Three Months Ended March 31, 2007 | 2006 |
|---|---|---|
| Stock options | $ 1.6 | $ 1.6 |
| Restricted stock | 1.5 | 1.2 |
| Performance vested restricted stock units | 0.4 | 0.5 |
| Total | $ 3.5 | $ 3.3 |

| | | |
|---|---|---|
| Income tax benefits | $ 1.3 | $ 1.2 |

Stock-based compensation expense on stock option and performance vested restricted stock grants made to a retirement eligible executive officer during the three months ended March 31, 2007 and 2006 was recognized upon issuance of the grants rather than over the awards vesting period since the terms of the grant provide that the awards will vest upon retirement of the employee. Compensation costs recognized during the three months ended March 31, 2007 and 2006 related to vesting upon retirement eligibility totaled $1.2 million and $1.3 million, respectively.

*Dividends*

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 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 months ended March 31, 2007, the Company purchased 0.5 million shares of common stock under the share repurchase program at a total cost of $17.8 million. The Company did not purchase any common stock during the three months ended March 31, 2006 under the share repurchase program.

During the three months ended March 31, 2007 and 2006, the Company purchased 28,979 and 26,794 shares of common stock at a total cost of $1.2 million and $1.3 million, respectively, from employees to satisfy statutory minimum tax-withholding requirements from the vesting of restricted stock grants. These purchases were outside the share repurchase program initiated in June 1998.

**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 March 31, 2007** | **2006** |
|---|---|---|
| Computation of Basic Earnings Per Share: | | |
| Net Income | **$ 16,315** | $ 17,665 |
| Weighted average shares outstanding-basic | **65,782** | 64,781 |
| Basic earnings per share | **$ 0.25** | $ 0.27 |
| Computation of Diluted Earnings Per Share: | | |
| Net income for diluted earnings per share | **$ 16,315** | $ 17,665 |
| Weighted average shares outstanding-basic | **65,782** | 64,781 |
| Effect of Dilutive Securities: | | |
| Employee stock option and restricted stock plan | **1,266** | 1,947 |
| Weighted average shares outstanding-diluted | **67,048** | 66,728 |
| Diluted earnings per share | **$ 0.24** | $ 0.26 |

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. At March 31, 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 March 31, 2007 and 2006, the Company excluded 356,505 and 190,548 anti-dilutive options from the computation of diluted earnings per share.

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**7. Pension Plans**

*Net periodic pension costs*

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 months ended March 31, 2007 and 2006, the Company recorded $0.5 million and $0.3 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. 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 months ended March 31, 2007 and 2006.

| | **Three Months Ended March 31,** | |
|---|---|---|
| **(In thousands)** | **2007** | **2006** |
| Components of net periodic pension cost: | | |
| Service cost | **$ 140** | $ 169 |
| Interest cost | **97** | 88 |
| Amortization: | | |
| Prior service cost | **12** | 14 |
| (Gain)/Loss | **20** | 19 |
| | **269** | 290 |
| Curtailment | 248 | |
| Net periodic pension cost | **$ 517** | $ 290 |

*Curtailment*

During the first quarter of 2007, the Company recognized a curtailment loss due to the termination of certain senior executive officers from the Company. The Company recognized a curtailment 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 |
| (Gain)/Loss | 58 |
| | 1,003 |
| Curtailment loss | 248 |
| Net periodic pension cost | $ 1,251 |

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The following is a reconciliation of the changes in the projected benefit obligation for the three months ended March 31, 2007:

| | (In thousands) |
|---|---|
| Projected benefit obligation, January 1, 2007 | $ 7,223 |
| Service cost | 140 |
| Interest cost | 97 |
| Remeasurement | (962) |
| Projected benefit obligation, March 31, 2007 | $ 6,498 |

The amounts in accumulated other comprehensive income that have not yet been recognized as components of net periodic benefit costs at March 31, 2007 are as follows:

| | (In thousands) |
|---|---|
| Transition asset (obligation) | $ |
| Prior service cost | (625) |
| Accumulated loss | (1,132) |
| Total | $ (1,757) |

**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 swing line 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 March 31, 2007, the Company had $84.2 million of revolving loans outstanding pursuant to the Revolver. At March 31, 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 to be paid semi-annually.

As of March 31, 2007, in addition to the Revolver and Senior Notes, the Company had a line of credit with a bank providing up to an aggregate of $10 million of borrowings, which is due upon demand. The line of credit ranks pari-pasu (or equally) with the Company s Revolver and includes customary financial and other covenants that require the maintenance of certain ratios identical to those included in the Company s Revolver. Borrowings under the line of credit bear interest at rates established at the time of borrowing based on prime rate minus 175 basis points. As of March 31, 2007, the Company had no amounts outstanding pursuant to this line of credit.

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The Company also has a note with an outstanding balance at March 31, 2007 of $0.4 million and a maturity date of January 1, 2009. This loan bears interest based on seventy percent of prime and requires monthly principal and interest payments. Subsequent to March 31, 2007, the Company repaid this loan in full utilizing proceeds from the Revolver.

As of March 31, 2007, total debt outstanding for the Company was $184.5 million, of which $0.1 million was scheduled to mature in the twelve months ending March 31, 2008.

**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.

**Choice Hotels International, Inc.**

**Condensed Consolidating Statement of Income**

**For the Three Months Ended March 31, 2007**

**(Unaudited, In Thousands)**

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **REVENUES:** | | | | | |
| Royalty fees | $ 38,699 | $ 27,326 | $ 7,911 | $ (30,608) | **$ 43,328** |
| Initial franchise and relicensing fees | 4,931 | | | | **4,931** |
| Brand solutions | 2,986 | | | | **2,986** |
| Marketing and reservation | 51,819 | 65,282 | 3,359 | (58,419) | **62,041** |
| Other items, net | 1,801 | 1,096 | | | **2,897** |
| Total revenues | 100,236 | 93,704 | 11,270 | (89,027) | **116,183** |
| **OPERATING EXPENSES:** | | | | | |
| Selling, general and administrative | 23,752 | 25,259 | 5,497 | (30,608) | **23,900** |
| Marketing and reservation | 54,736 | 62,574 | 3,150 | (58,419) | **62,041** |
| Other items, net | 806 | 1,778 | 272 | | **2,856** |
| Total operating expenses | 79,294 | 89,611 | 8,919 | (89,027) | **88,797** |
| **Operating income** | 20,942 | 4,093 | 2,351 | | **27,386** |
| **OTHER INCOME AND EXPENSES, NET:** | | | | | |
| Interest expense (income) | 3,122 | (125) | | | **2,997** |
| Interest and other investment income | (60) | (352) | (383) | | **(795)** |
| Equity in earnings of consolidated subsidiaries | (5,550) | | | 5,550 | |
| Total other income and expenses, net | (2,488) | (477) | (383) | 5,550 | **2,202** |
| **Income before income taxes** | 23,430 | 4,570 | 2,734 | (5,550) | **25,184** |
| **Income taxes** | 7,115 | 1,574 | 180 | | **8,869** |
| **Net income** | $ 16,315 | $ 2,996 | $ 2,554 | $ (5,550) | **$ 16,315** |

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**Choice Hotels International, Inc.**

**Condensed Consolidating Statement of Income**

**For the Three Months Ended March 31, 2006**

**(Unaudited, In Thousands)**

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **REVENUES:** | | | | | |
| Royalty fees | $ 36,558 | $ 22,240 | $ 3,502 | $ (22,436) | **$ 39,864** |
| Initial franchise and relicensing fees | 5,643 | | | | **5,643** |
| Brand solutions | 2,782 | | | | **2,782** |
| Marketing and reservation | 47,919 | 63,772 | 1,904 | (55,619) | **57,976** |
| Other items, net | 2,173 | 980 | | | **3,153** |
| Total revenues | 95,075 | 86,992 | 5,406 | (78,055) | **109,418** |
| **OPERATING EXPENSES:** | | | | | |
| Selling, general and administrative | 19,776 | 20,074 | 816 | (22,391) | **18,275** |
| Marketing and reservation | 51,085 | 60,934 | 1,621 | (55,664) | **57,976** |
| Other items, net | 796 | 2,111 | 187 | | **3,094** |
| Total operating expenses | 71,657 | 83,119 | 2,624 | (78,055) | **79,345** |
| **Operating income** | 23,418 | 3,873 | 2,782 | | **30,073** |
| **OTHER INCOME AND EXPENSES, NET:** | | | | | |
| Interest expense (income) | 4,217 | (187) | 10 | | **4,040** |
| Interest and other investment income | (50) | (612) | (300) | | **(962)** |
| Equity in earnings of consolidated subsidiaries | (4,597) | | | 4,597 | |
| Total other income and expenses, net | (430) | (799) | (290) | 4,597 | **3,078** |
| **Income before income taxes** | 23,848 | 4,672 | 3,072 | (4,597) | **26,995** |
| **Income taxes** | 6,183 | 2,855 | 292 | | **9,330** |
| **Net income** | $ 17,665 | $ 1,817 | $ 2,780 | $ (4,597) | **$ 17,665** |

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**Choice Hotels International, Inc.**

**Condensed Consolidating Balance Sheet**

**As of March 31, 2007**

**(Unaudited, In thousands)**

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| Cash and cash equivalents | $ 5,172 | $ 342 | $ 29,866 | $ | **$ 35,380** |
| Receivables | 32,050 | 574 | 4,782 | | **37,406** |
| Other current assets | 3,045 | 6,924 | 21 | | **9,990** |
| Total current assets | 40,267 | 7,840 | 34,669 | | **82,776** |
| Property and equipment, at cost, net | 16,310 | 26,339 | 707 | | **43,356** |
| Goodwill | 60,620 | 5,193 | | | **65,813** |
| Franchise rights and other identifiable intangibles, net | 23,223 | 6,272 | 5,106 | | **34,601** |
| Investments, employee benefit plans, at fair value | | 35,415 | | | **35,415** |
| Investment in and advances to affiliates | 198,018 | 117,184 | 49,533 | (364,735) | |
| Receivable, marketing fees | 12,482 | | | (310) | **12,172** |
| Deferred income taxes | | 34,122 | 730 | (14,434) | **20,418** |
| Other assets | 1,034 | 9,574 | 231 | (120) | **10,719** |
| **Total assets** | $ 351,954 | $ 241,939 | $ 90,976 | $ (379,599) | **$ 305,270** |
| **LIABILITIES AND SHAREHOLDERS DEFICIT** | | | | | |
| Current portion of long-term debt | $ 146 | $ | $ | $ | **$ 146** |
| Accounts payable | 6,158 | 31,102 | 3,516 | | **40,776** |
| Accrued expenses and other | 16,694 | 16,724 | 1,224 | | **34,642** |
| Deferred revenue | 8,707 | 41,046 | | | **49,753** |
| Deferred compensation & retirement plan obligations | | 3,411 | | | **3,411** |
| Income taxes payable | 5,536 | 2,566 | 1,168 | | **9,270** |
| Total current liabilities | 37,241 | 94,849 | 5,908 | | **137,998** |
| Long-term debt | 184,370 | | | | **184,370** |
| Deferred compensation & retirement plan obligations | | 39,686 | 1 | | **39,687** |
| Advances from affiliates | 174,138 | 5,893 | 43,449 | (223,480) | |
| Payable, marketing fees | | 310 | | (310) | |
| Deferred income taxes | 14,434 | | | (14,434) | |
| Other liabilities | 12,260 | 979 | 585 | (120) | **13,704** |
| Total liabilities | 422,443 | 141,717 | 49,943 | (238,344) | **375,759** |
| Total shareholders deficit | (70,489) | 100,222 | 41,033 | (141,255) | **(70,489)** |
| **Total liabilities and shareholders deficit** | $ 351,954 | $ 241,939 | $ 90,976 | $ (379,599) | **$ 305,270** |

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**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** |

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**Choice Hotels International, Inc.**

**Condensed Consolidating Statement of Cash Flows**

**For the Three Months Ended March 31, 2007**

**(Unaudited, In thousands)**

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Net Cash Provided from Operating Activities** | $ 10,852 | $ 4,814 | $ 4,787 | | **$ 20,453** |
| **Cash Flows From Investing Activities** | | | | | |
| Investment in property and equipment | (292) | (2,686) | (42) | | **(3,020)** |
| Purchases of investments | | (4,496) | | | **(4,496)** |
| Proceeds from the sales of investments | | 961 | | | **961** |
| Issuance of notes receivable | (100) | (31) | | | **(131)** |
| Other items, net | (107) | 205 | (435) | | **(337)** |
| **Net Cash Used in Investing Activities** | (499) | (6,047) | (477) | | **(7,023)** |
| **Cash Flows from Financing Activities** | | | | | |
| Principal payments of long-term debt | (36) | | | | **(36)** |
| Net borrowings pursuant to revolving credit facilities | 12,000 | | | | **12,000** |
| Purchase of treasury stock | (19,001) | | | | **(19,001)** |
| Excess tax benefits from stock-based compensation | | 1,362 | | | **1,362** |
| Dividends paid | (9,895) | | | | **(9,895)** |
| Proceeds from exercise of stock options | 1,679 | | | | **1,679** |
| **Net Cash Provided (Used) from Financing Activities** | (15,253) | 1,362 | | | **(13,891)** |
| Net change in cash and cash equivalents | (4,900) | 129 | 4,310 | | **(461)** |
| Cash and cash equivalents at beginning of period | 10,072 | 213 | 25,556 | | **35,841** |
| **Cash and Cash Equivalents at End of Period** | $ 5,172 | $ 342 | $ 29,866 | | **$ 35,380** |

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**Choice Hotels International, Inc.**

**Condensed Consolidating Statement of Cash Flows**

**For the Three Months Ended March 31, 2006**

**(Unaudited, In thousands)**

| | Choice Hotels International, Inc. | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Net Cash Provided (Used) from Operating Activities** | $ 20,657 | $ (606) | $ 4,401 | | **$ 24,452** |
| **Cash Flows From Investing Activities** | | | | | |
| Investment in property and equipment | (553) | (609) | (31) | | **(1,193)** |
| Issuance of notes receivable | | (649) | | | **(649)** |
| Purchases of investments | | (4,353) | | | **(4,353)** |
| Proceeds from sales of investments | | 859 | | | **859** |
| Other items, net | (61) | (289) | 312 | | **(38)** |
| **Net Cash Provided (Used) from Investing Activities** | (614) | (5,041) | 281 | | **(5,374)** |
| **Cash Flows from Financing Activities** | | | | | |
| Principal payment of long-term debt | (37) | | | | **(37)** |
| Net repayments pursuant to revolving credit facilities | (14,800) | | | | **(14,800)** |
| Purchase of treasury stock | (1,277) | | | | **(1,277)** |
| Excess tax benefits from stock-based compensation | 1,087 | 3,963 | | | **5,050** |
| Dividends paid | (8,436) | | | | **(8,436)** |
| Proceeds from exercise of stock options | 3,437 | | | | **3,437** |
| **Net Cash Provided (Used) in Financing Activities** | (20,026) | 3,963 | | | **(16,063)** |
| Net change in cash and cash equivalents | 17 | (1,684) | 4,682 | | **3,015** |
| Cash and cash equivalents at beginning of period | 5,848 | 2,052 | 9,021 | | **16,921** |
| **Cash and Cash Equivalents at End of Period** | $ 5,865 | $ 368 | $ 13,703 | | **$ 19,936** |

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**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.

| | Three Months Ended March 31, 2007 | | | Three Months Ended March 31, 2006 | | |
|---|---|---|---|---|---|---|
| **(In thousands)** | **Franchising** | **Corporate & Other** | **Consolidated** | **Franchising** | **Corporate & Other** | **Consolidated** |
| **Revenues** | **$ 115,087** | **$ 1,096** | **$ 116,183** | $ 108,438 | $ 980 | $ 109,418 |
| **Operating income (loss)** | **$ 39,571** | **$ (12,185)** | **$ 27,386** | $ 40,366 | $ (10,293) | $ 30,073 |

**11. 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 March 31, 2007, approximately $3.5 million of termination benefits remained of which $3.0 million is included in current liabilities and $0.5 million in other long-term liabilities in the Company s consolidated financial statements.

**12. Commitments and Contingencies**

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

In March 2006, the Company guaranteed $1 million of a bank loan funding a franchisee s construction of a Cambria Suites in Green Bay, Wisconsin. The guaranty was scheduled to expire in June 2010. However, during the first quarter of 2007, the Company was released from its guaranty of the bank loan.

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

**13. Subsequent Events**

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. Potential plaintiffs have until June 11, 2007, to move the court for appointment as lead plaintiff. At this time the Company has not responded to the complaints 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.

On May 1, 2007, the Company s Board of Directors declared a quarterly cash dividend of $0.15 per share of common stock. The dividend is payable on July 20, 2007 to shareholders of record as of July 6, 2007. Based on the Company s present share count, the total dividends to be paid is approximately $9.9 million.

Subsequent to March 31, 2007 through May 7, 2007, the Company repurchased an additional 0.1 million shares of its common stock at a total cost of $4.4 million.

**14. Impact of 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. Earlier application is encouraged provided that the reporting entity has not yet issued financial statements for that fiscal year including financial statements for an interim period within that fiscal year. We are currently evaluating the potential impact of this statement, if any.

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. Early adoption is permitted as of the beginning of the previous fiscal year provided the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of SFAS No. 157. We are currently evaluating the impact, if any, the adoption of this statement will have on our consolidated financial statements.

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

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

**Overview**

We are a hotel franchisor with franchise agreements representing 5,406 hotels open and 903 hotels under development as of March 31, 2007, with 441,256 rooms and 70,541 rooms, respectively, in 49 states, the District of Columbia and 39 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 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 three months ended March 31, 2007 while representing approximately 21% of hotels open at March 31, 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, CHE Hotel Group PLC ( CHE ). Under the master franchise agreement with CHE, CHG franchised hotels under the Company s brands in Austria, Germany, Italy, Czech Republic and potions of Switzerland. As a result of this acquisition, the master franchise agreement between the Company and CHE covering these countries terminated. The results of CHG have been consolidated with the Company since October 30, 2006.

During 2006, the Company acquired CHE 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 CHE 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, Choice 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.

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 March 31, 2007, we have repurchased 34.1 million shares (including 33.0 million prior to the two-for-one stock split effected in October 2005) of common stock at a total cost of $729.7 million since the program s inception. Considering the effect of the two-for-one stock split, the Company has repurchased 67.1 million shares at an average price of $10.87 per share through March 31, 2007. At March 31, 2007, the Company had 4.6 million shares remaining under our current board of directors

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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. For the three months ended March 31, 2007, we paid cash dividends totaling approximately $9.9 million and we presently expect to continue to pay dividends in the future. 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. Based on our present dividend rate and outstanding share count, aggregate annual dividends would be approximately $39.5 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 March 31, 2007, royalty fees revenue totaled $43.3 million, a 9% increase from the same period in 2006. Operating income totaled $27.4 million for the three months ended March 31, 2007, a $2.7 million or 9% decrease from the same period in 2006. Net income for the three months ended March 31, 2007 decreased $1.4 million to $16.3 million, an 8% decline from the first quarter of 2006. Diluted earnings per share for the first quarter of 2007 were $0.24 compared to $0.26 for the first quarter of 2006. Operating income, net income and EPS for the three months ended March 31, 2007 include termination benefits related to the termination of certain executive officers totaling $3.7 million, $2.3 million and $0.03, respectively. 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 three months ended March 31, 2007 and 2006, net cash provided by operating activities was $20.5 million and $24.5 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.

**Operations Review**

**Comparison of Operating Results for the Three-Month Periods Ended March 31, 2007 and March 31, 2006**

The Company recorded net income of $16.3 million for the three months ended March 31, 2007, a decrease of $1.4 million, or 8% from $17.7 million for the quarter ended March 31, 2006. The decline in net income for the three months ended March 31, 2007 is primarily attributable to a $2.7 million decline in operating income and a 60 basis point increase in the effective income tax rate to 35.2% offset by a $1.0 million reduction in interest expense. Operating income decreased as a result of a $5.6 million, or 31% increase in selling, general and administrative expenses partially offset by a $2.5 million increase in franchising revenues (total revenues excluding marketing and reservation revenues and hotel operations). The increase in selling, general and administration expenses was due primarily 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.

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Summarized financial results for the three months ended March 31, 2007 and 2006 are as follows:

| (in thousands, except per share amounts) | 2007 | 2006 |
|---|---|---|
| **REVENUES:** | | |
| Royalty fees | **$ 43,328** | $ 39,864 |
| Initial franchise and relicensing fees | **4,931** | 5,643 |
| Brand solutions | **2,986** | 2,782 |
| Marketing and reservation | **62,041** | 57,976 |
| Hotel operations | **1,096** | 980 |
| Other | **1,801** | 2,173 |
| **Total revenues** | **116,183** | 109,418 |
| **OPERATING EXPENSES:** | | |
| Selling, general and administrative | **23,900** | 18,275 |
| Depreciation and amortization | **2,115** | 2,349 |
| Marketing and reservation | **62,041** | 57,976 |
| Hotel operations | **741** | 745 |
| **Total operating expenses** | **88,797** | 79,345 |
| **Operating income** | **27,386** | 30,073 |
| **OTHER INCOME AND EXPENSES, NET:** | | |
| Interest expense | **2,997** | 4,040 |
| Interest and other investment income | **(601)** | (704) |
| Equity in net income of affiliates | **(194)** | (258) |
| **Total other income and expenses, net** | **2,202** | 3,078 |
| **Income before income taxes** | **25,184** | 26,995 |
| **Income taxes** | **8,869** | 9,330 |
| **Net income** | **$ 16,315** | $ 17,665 |
| **Weighted average shares outstanding diluted** | **67,048** | 66,728 |
| **Diluted earnings per share** | **$ 0.24** | $ 0.26 |

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 $53.0 million for the three months ended March 31, 2007 compared to $50.5 million for the three months ended March 31, 2006. The growth in franchising revenues is primarily due to a 9% increase in royalty revenues offset by a 13% and 17% decline in initial franchise and relicensing fees and other income.

Domestic royalty fees increased $2.1 million to $38.9 million from $36.8 million in the three months ended March 31, 2007, an increase of 5.7%. The increase in royalties is attributable to a combination of factors including a 3.9% increase in the number of domestic franchised hotel rooms, a 1.4% increase in RevPAR and an increase in the effective royalty rate of the domestic hotel system from 4.07% to 4.14%. System-wide RevPAR increases resulted primarily from average daily rate ( ADR ) increases of 3.6% over the prior year offset by a 110 basis point decline in occupancy rates.

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

| | For the Three Months Ended March 31, 2007 | | | For the Three Months Ended March 31, 2006 | | | Change | | |
|---|---|---|---|---|---|---|---|---|---|
| | Average Daily Rate | Occupancy | RevPAR | Average Daily Rate | Occupancy | RevPAR | Average Daily Rate | Occupancy | RevPAR |
| **Comfort Inn** | **$ 70.59** | **51.2%** | **$ 36.11** | $ 67.12 | 51.7% | $ 34.70 | 5.2% | -50bps | 4.1% |
| **Comfort Suites** | **83.28** | **56.8%** | **47.29** | 79.18 | 58.8% | 46.58 | 5.2% | -200bps | 1.5% |
| **Sleep** | **64.17** | **51.9%** | **33.28** | 62.00 | 51.8% | 32.14 | 3.5% | 10bps | 3.5% |
| **Midscale without Food & Beverage** | **72.46** | **52.4%** | **37.98** | 68.98 | 53.1% | 36.63 | 5.0% | -70bps | 3.7% |
| **Quality** | **63.45** | **43.4%** | **27.54** | 61.79 | 44.9% | 27.77 | 2.7% | -150bps | -0.8% |
| **Clarion** | **73.84** | **41.3%** | **30.48** | 76.25 | 42.5% | 32.44 | -3.2% | -120bps | -6.0% |
| **Midscale with Food & Beverage** | **65.95** | **42.9%** | **28.27** | 65.29 | 44.3% | 28.95 | 1.0% | -140bps | -2.3% |
| **Econo Lodge** | **49.42** | **39.2%** | **19.36** | 48.54 | 39.0% | 18.92 | 1.8% | 20bps | 2.3% |
| **Rodeway** | **47.67** | **38.5%** | **18.37** | 46.80 | 39.0% | 18.23 | 1.9% | -50bps | 0.8% |
| **Economy** | **49.06** | **39.0%** | **19.15** | 48.23 | 39.0% | 18.80 | 1.7% | 0bps | 1.9% |
| **MainStay** | **65.90** | **58.2%** | **38.35** | 65.31 | 57.0% | 37.23 | 0.9% | 120bps | 3.0% |
| **Suburban** | **38.67** | **63.6%** | **24.59** | 36.97 | 69.3% | 25.63 | 4.6% | -570bps | -4.1% |
| **Extended Stay** | **44.11** | **62.4%** | **27.54** | 41.64 | 66.9% | 27.88 | 5.9% | -450bps | -1.2% |
| **Total Domestic System** | **$ 66.18** | **47.6%** | **$ 31.52** | $ 63.85 | 48.7% | $ 31.08 | 3.6% | -110bps | 1.4% |

The number of domestic rooms on-line increased to 342,775 as of March 31, 2007 from 329,934 as of March 31, 2006, an increase of 3.9%. The total number of domestic hotels on-line grew 4.5% to 4,254 as of March 31, 2007 from 4,070 as of March 31, 2006. A summary of the domestic hotels and rooms on-line at March 31, 2007 and March 31, 2006 by brand is as follows:

| | March 31, 2007 | | March 31, 2006 | | Variance | | | |
|---|---|---|---|---|---|---|---|---|
| | Hotels | Rooms | Hotels | Rooms | Hotels | Rooms | % | % |
| **Comfort Inn** | 1,421 | 110,980 | 1,418 | 111,032 | 3 | (52) | 0.2% | |
| **Comfort Suites** | 442 | 34,649 | 415 | 32,666 | 27 | 1,983 | 6.5% | 6.1% |
| **Sleep** | 330 | 24,772 | 322 | 24,384 | 8 | 388 | 2.5% | 1.6% |
| **Midscale without Food & Beverage** | 2,193 | 170,401 | 2,155 | 168,082 | 38 | 2,319 | 1.8% | 1.4% |
| **Quality** | 757 | 74,036 | 670 | 66,657 | 87 | 7,379 | 13.0% | 11.1% |
| **Clarion** | 161 | 23,881 | 151 | 23,157 | 10 | 724 | 6.6% | 3.1% |
| **Midscale with Food & Beverage** | 918 | 97,917 | 821 | 89,814 | 97 | 8,103 | 11.8% | 9.0% |
| **Econo Lodge** | 812 | 49,202 | 818 | 50,144 | (6) | (942) | -0.7% | -1.9% |
| **Rodeway** | 240 | 14,930 | 185 | 11,387 | 55 | 3,543 | 29.7% | 31.1% |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Economy** | 1,052 | 64,132 | 1,003 | 61,531 | 49 | 2,601 | 4.9% | 4.2% |
| **MainStay** | 30 | 2,237 | 27 | 2,047 | 3 | 190 | 11.1% | 9.3% |
| **Suburban** | 61 | 8,088 | 64 | 8,460 | (3) | (372) | -4.7% | -4.4% |
| **Extended Stay** | 91 | 10,325 | 91 | 10,507 | | (182) | | -1.7% |
| **Total Domestic Franchises** | 4,254 | 342,775 | 4,070 | 329,934 | 184 | 12,841 | 4.5% | 3.9% |

International rooms on-line increased to 98,481 as of March 31, 2007 from 98,456 as of March 31, 2006. The total number of international hotels on-line decreased from 1,168 as of March 31, 2006 to 1,152 as of March 31, 2007.

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As of March 31, 2007, the Company had 833 franchised domestic hotels with 64,078 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 653 hotels and 51,157 rooms at March 31, 2006. The number of new construction franchised hotels in the Company s domestic pipeline increased 33% to 601 at March 31, 2007 from 452 at March 31, 2006. The Company had an additional 70 franchised hotels with 6,463 rooms under development in its international system as of March 31, 2007 compared to 69 hotels and 6,223 rooms at March 31, 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. A summary of the domestic franchised hotels under construction, awaiting conversion or approved for development at March 31, 2007 and March 31, 2006 by brand is as follows:

| | March 31, 2007 | | | March 31, 2006 | | Variance |
|---|---|---|---|---|---|---|
| | Conversion | New Construction | Total | Conversion | New Construction | |