

CHOICE HOTELS INTERNATIONAL INC /DE

Form 10-Q

November 09, 2011

Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

---

FORM 10-Q

---

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2011

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)

10750 COLUMBIA PIKE

SILVER SPRING, MD. 20901

(Address of principal executive offices)

(Zip Code)

(301) 592-5000

(Registrant's telephone number, including area code)

52-1209792

(I.R.S. Employer  
Identification No.)

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

---

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

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

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

CLASS

Common Stock, Par Value \$0.01 per share

SHARES OUSTANDING AT SEPTEMBER 30, 2011

59,166,765



Table of Contents

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
INDEX

|   | PAGE NO.  |
|---|-----------|
| <u>PART I. FINANCIAL INFORMATION:</u>   |           |
| <u>Item 1—Financial Statements (Unaudited)</u>  | <u>3</u>  |
| <u>Consolidated Statements of Income -- For the three and nine months ended September 30, 2011 and September 30, 2010</u> | <u>3</u>  |
| <u>Consolidated Balance Sheets—As of September 30, 2011 and December 31, 2010</u>   | <u>4</u>  |
| <u>Consolidated Statements of Cash Flows—For the nine months ended September 30, 2011 and 2010</u>                        | <u>5</u>  |
| <u>Notes to Consolidated Financial Statements</u>   | <u>6</u>  |
| <u>Item 2—Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>                       | <u>31</u> |
| <u>Item 3—Quantitative and Qualitative Disclosures About Market Risk</u>  | <u>53</u> |
| <u>Item 4—Controls and Procedures</u>   | <u>53</u> |
| <u>PART II. OTHER INFORMATION:</u>  |           |
| <u>Item 1—Legal Proceedings</u>   | <u>54</u> |
| <u>Item 1A—Risk Factors</u>   | <u>54</u> |
| <u>Item 2—Unregistered Sales of Equity Securities and Use of Proceeds</u>   | <u>54</u> |
| <u>Item 3—Defaults Upon Senior Securities</u>   | <u>54</u> |
| <u>Item 4—(Removed and Reserved)</u>  | <u>54</u> |
| <u>Item 5—Other Information</u>   | <u>54</u> |
| <u>Item 6—Exhibits</u>  | <u>55</u> |
| <u>SIGNATURES</u>   | <u>56</u> |

Table of Contents

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(UNAUDITED, IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

|   | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|----------|------------------------------------|-----------|
|   | 2011                                | 2010     | 2011                               | 2010      |
| <b>REVENUES:</b>                          |                                     |          |                                    |           |
| Royalty fees                              | \$77,355                            | \$72,565 | \$183,896                          | \$171,029 |
| Initial franchise and relicensing fees    | 3,469                               | 1,970    | 8,668                              | 6,537     |
| Procurement services                      | 3,984                               | 3,756    | 13,706                             | 13,612    |
| Marketing and reservation                 | 104,393                             | 102,867  | 258,192                            | 242,096   |
| Hotel operations                          | 1,236                               | 1,068    | 3,173                              | 3,044     |
| Other                                     | 1,884                               | 1,575    | 5,268                              | 4,752     |
| Total revenues                            | 192,321                             | 183,801  | 472,903                            | 441,070   |
| <b>OPERATING EXPENSES:</b>                |                                     |          |                                    |           |
| Selling, general and administrative       | 22,555                              | 23,156   | 72,941                             | 67,796    |
| Depreciation and amortization             | 2,073                               | 2,078    | 5,976                              | 6,470     |
| Marketing and reservation                 | 104,393                             | 102,867  | 258,192                            | 242,096   |
| Hotel operations                          | 900                                 | 823      | 2,593                              | 2,387     |
| Total operating expenses                  | 129,921                             | 128,924  | 339,702                            | 318,749   |
| Operating income                          | 62,400                              | 54,877   | 133,201                            | 122,321   |
| <b>OTHER INCOME AND EXPENSES, NET:</b>    |                                     |          |                                    |           |
| Interest expense                          | 3,228                               | 1,864    | 9,719                              | 3,160     |
| Interest income                           | (506)                               | (161)    | (937)                              | (356)     |
| Other (gains) and losses                  | 2,673                               | (1,510)  | 3,678                              | (1,289)   |
| Equity in net (income) loss of affiliates | 39                                  | (342)    | (262)                              | (890)     |
| Total other income and expenses, net      | 5,434                               | (149)    | 12,198                             | 625       |
| Income before income taxes                | 56,966                              | 55,026   | 121,003                            | 121,696   |
| Income taxes                              | 14,664                              | 14,532   | 35,393                             | 38,398    |
| Net income                                | \$42,302                            | \$40,494 | \$85,610                           | \$83,298  |
| Basic earnings per share                  | \$0.71                              | \$0.68   | \$1.43                             | \$1.40    |
| Diluted earnings per share                | \$0.71                              | \$0.68   | \$1.43                             | \$1.40    |
| Cash dividends declared per share         | \$0.185                             | \$0.185  | \$0.555                            | \$0.555   |

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

Table of Contents

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(UNAUDITED, IN THOUSANDS, EXCEPT SHARE AMOUNTS)

|  | September 30,<br>2011 | December 31,<br>2010 |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |
| Current assets   |                       |                      |
| Cash and cash equivalents  | \$124,734             | \$91,259             |
| Receivables (net of allowance for doubtful accounts of \$8,546 and \$9,159, respectively)  | 62,009                | 47,638               |
| Deferred income taxes  | 429                   | 429                  |
| Other current assets   | 22,585                | 24,256               |
| Total current assets   | 209,757               | 163,582              |
| Property and equipment, at cost, net   | 53,504                | 55,662               |
| Goodwill   | 66,021                | 66,041               |
| Franchise rights and other identifiable intangibles, net   | 17,913                | 20,825               |
| Receivable – marketing and reservation fees  | 54,040                | 42,507               |
| Investments, employee benefit plans, at fair value   | 22,017                | 23,365               |
| Deferred income taxes  | 21,580                | 24,435               |
| Other assets   | 23,089                | 15,305               |
| Total assets   | \$467,921             | \$411,722            |
| <b>LIABILITIES AND SHAREHOLDERS' DEFICIT</b>   |                       |                      |
| Current liabilities  |                       |                      |
| Accounts payable   | \$44,529              | \$41,168             |
| Accrued expenses   | 37,085                | 47,818               |
| Deferred revenue   | 76,643                | 67,322               |
| Current portion of long-term debt  | 691                   | 420                  |
| Deferred compensation and retirement plan obligations  | 2,720                 | 2,552                |
| Revolving credit facility  | 0                     | 200                  |
| Income taxes payable   | 20,129                | 5,778                |
| Total current liabilities  | 181,797               | 165,258              |
| Long-term debt   | 252,320               | 251,554              |
| Deferred compensation and retirement plan obligations  | 33,818                | 35,707               |
| Other liabilities  | 14,427                | 17,274               |
| Total liabilities  | 482,362               | 469,793              |
| Commitments and Contingencies  |                       |                      |
| <b>SHAREHOLDERS' DEFICIT</b>   |                       |                      |
| Common stock, \$0.01 par value, 160,000,000 shares authorized; 95,345,362 shares issued at September 30, 2011 and December 31, 2010 and 59,166,765 and 59,583,770 shares outstanding at September 30, 2011 and December 31, 2010, respectively |                       | 596                  |
| Additional paid-in capital   | 98,681                | 92,774               |
| Accumulated other comprehensive loss   | (6,720)               | (7,192)              |
| Treasury stock (36,178,597 and 35,761,592 shares at September 30, 2011 and December 31, 2010, respectively), at cost   | (887,815)             | (872,306)            |
| Retained earnings  | 780,821               | 728,057              |
| Total shareholders' deficit  | (14,441)              | (58,071)             |
| Total liabilities and shareholders' deficit  | \$467,921             | \$411,722            |

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)

|   | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2011                               | 2010      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                    |           |
| Net income  | \$85,610                           | \$83,298  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |           |
| Depreciation and amortization   | 5,976                              | 6,470     |
| Provision for bad debts, net  | 845                                | 2,421     |
| Non-cash stock compensation and other charges                                     | 10,262                             | 6,969     |
| Non-cash interest and other (income) loss   | 3,079                              | (987)     |
| Dividends received from equity method investments                                 | 316                                | 618       |
| Equity in net income of affiliates  | (262)                              | (890)     |
| Changes in assets and liabilities, net of acquisitions:                           |                                    |           |
| Receivables   | (15,494)                           | (14,511)  |
| Receivable – marketing and reservation fees, net                                  | (1,474)                            | (2,594)   |
| Accounts payable  | 4,468                              | 6,274     |
| Accrued expenses  | (10,584)                           | (1,210)   |
| Income taxes payable/receivable   | 14,354                             | 11,940    |
| Deferred income taxes   | 2,839                              | (2,704)   |
| Deferred revenue  | 9,375                              | 19,443    |
| Other assets  | (556)                              | (11,755)  |
| Other liabilities   | (2,861)                            | 5,457     |
| Net cash provided by operating activities   | 105,893                            | 108,239   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                    |           |
| Investment in property and equipment  | (8,129)                            | (17,673)  |
| Equity method investments   | (3,600)                            | 0         |
| Acquisitions, net of cash acquired  | 0                                  | (466)     |
| Issuance of notes receivable  | (4,320)                            | (8,901)   |
| Collections of notes receivable   | 15                                 | 5,055     |
| Purchases of investments, employee benefit plans                                  | (1,051)                            | (1,396)   |
| Proceeds from sale of investments, employee benefit plans                         | 566                                | 1,018     |
| Other items, net  | (312)                              | (296)     |
| Net cash used in investing activities   | (16,831)                           | (22,659)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                    |           |
| Net borrowings (repayments) pursuant to revolving credit facilities               | (200)                              | (271,100) |
| Proceeds from issuance of long-term debt  | 75                                 | 247,733   |
| Repayments of long-term debt  | (74)                               | (20)      |
| Settlement of forward starting interest rate swap agreement                       | 0                                  | (8,663)   |
| Purchase of treasury stock  | (24,796)                           | (11,171)  |
| Dividends paid  | (32,923)                           | (32,884)  |
| Excess tax benefits from stock-based compensation                                 | 1,108                              | 331       |
| Debt issuance costs   | (2,356)                            | (804)     |
| Proceeds from exercise of stock options   | 3,726                              | 1,321     |
| Net cash used in financing activities   | (55,440)                           | (75,257)  |
| Net change in cash and cash equivalents   | 33,622                             | 10,323    |

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

|  |           |          |
|--|-----------|----------|
| Effect of foreign exchange rate changes on cash and cash equivalents | (147      | ) 1,355  |
| Cash and cash equivalents at beginning of period                     | 91,259    | 67,870   |
| Cash and cash equivalents at end of period                           | \$124,734 | \$79,548 |
| Supplemental disclosure of cash flow information:                    |           |          |
| Cash payments during the period for:                                 |           |          |
| Income taxes, net of refunds   | \$17,222  | \$26,561 |
| Interest   | \$15,098  | \$1,924  |
| Non-cash investing and financing activities:                         |           |          |
| Declaration of dividends   | \$32,846  | \$32,886 |
| Capital lease obligation   | \$1,053   | \$2,483  |
| Issuance of restricted shares of common stock                        | \$9,604   | \$9,233  |
| Issuance of performance vested restricted stock units                | \$0       | \$256    |
| Issuance of treasury stock to employee stock purchase plan           | \$550     | \$424    |

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



Table of Contents

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Company Information and Significant Accounting Policies

The accompanying unaudited consolidated financial statements of Choice Hotels International, Inc. and subsidiaries (together the “Company”) have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). In the opinion of management, all adjustments (which include any normal recurring adjustments) considered necessary for a fair presentation have been included. Certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been omitted. The year-end balance sheet information was derived from audited financial statements, but does not include all disclosures required by GAAP. The Company believes the disclosures made are adequate to make the information presented not misleading. The consolidated financial statements should be read in conjunction with the consolidated financial statements for the year ended December 31, 2010 and notes thereto included in the Company’s Form 10-K, filed with the SEC on March 1, 2011 (the “10-K”). Interim results are not necessarily indicative of the entire year results because of seasonal variations. All inter-company transactions and balances between Choice Hotels International, Inc. and its subsidiaries have been eliminated in consolidation.

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

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.

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 September 30, 2011 and December 31, 2010, \$4.1 million and \$2.8 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.

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

Recently Adopted Accounting Guidance

In September 2009, the Financial Accounting Standards Board (“FASB”) ratified Emerging Issues Task Force (“EITF”) Issue No. 08-1, “Revenue Arrangements with Multiple Deliverables” (“EITF 08-1”). EITF 08-1 updates the current guidance pertaining to multiple-element revenue arrangements included in Accounting Standards Codification (“ASC”) Subtopic 605-25, which originated primarily from EITF 00-21, also titled “Revenue Arrangements with Multiple Deliverables.” EITF 08-1 was effective for annual reporting periods beginning January 1, 2011 for calendar year entities with earlier adoption permitted. The adoption of these provisions did not have a material impact on our consolidated financial statements.

In July 2010, the FASB issued Accounting Standards Update (“ASU”) No. 2010-20, which updates the guidance in ASC Topic 310, Receivables, related to disclosures about the credit quality of financing receivables and the allowance for credit losses. The new disclosures require disaggregated information related to financing receivables and will include for each class of financing receivables, among other things: a roll forward for the allowance for credit losses, credit quality information, impaired loan information, modification information, non-accrual and past-due information. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. Disclosures of reporting period activity (i.e. allowance roll-forward) are required for interim and annual periods beginning after December 15, 2010. The Company has updated its disclosures as appropriate.

Future Adoption of Accounting Standards

In May 2011, the FASB issued ASU No. 2011-04 “Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs” (“ASU No. 2011-04”). ASU No. 2011-04 generally provides a uniform framework for fair value measurements and related disclosures between GAAP and International

Table of Contents

Financial Reporting Standards (“IFRS”). Additional disclosure requirements in the update include: (1) for Level 3 fair value measurements, quantitative information about unobservable inputs used, a description of the valuation processes used by the entity, and a qualitative discussion about the sensitivity of the measurements to changes in the unobservable inputs; (2) for an entity’s use of a non-financial asset that is different from the asset’s highest and best use, the reason for the difference; (3) for financial instruments not measured at fair value but for which disclosure of fair value is required, the fair value hierarchy level in which the fair value measurements were determined; and (4) the disclosure of all transfers between Level 1 and Level 2 of the fair value hierarchy. ASU 2011-04 will be effective for interim and annual periods beginning on or after December 15, 2011. The Company will update its disclosures as appropriate upon adoption of this standard.

In June 2011, the FASB issued ASU No. 2011-05 “Comprehensive Income (Topic 220): Presentation of Comprehensive Income” (“ASU No. 2011-05”). ASU No. 2011-05 amends existing guidance by allowing only two options for presenting the components of net income and other comprehensive income: (1) in a single continuous financial statement, statement of comprehensive income or (2) in two separate but consecutive financial statements, consisting of an income statement followed by a separate statement of other comprehensive income. Also, items that are reclassified from other comprehensive income to net income must be presented on the face of the financial statements. ASU No. 2011-05 requires retrospective application, and it is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, with early adoption permitted. The Company is currently evaluating the financial statement presentation options required by ASU 2011-05.

In September 2011, the FASB issued ASU No. 2011-08, "Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment" ("ASU No. 2011-08"). The guidance in ASU No. 2011-08 is intended to reduce complexity and costs by allowing an entity the option to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it should calculate the fair value of a reporting unit. The amendments also improve previous guidance by expanding upon the examples of events and circumstances that an entity should consider between annual impairment tests in determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Furthermore, the amendments improve the examples of events and circumstances that an entity having a reporting unit with a zero or negative carrying amount should consider in determining whether to measure an impairment loss, if any, under the second step of the goodwill impairment test. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued. The Company is currently evaluating the impact of this guidance, if any, on its financial reporting.

## 2. Other Current Assets

Other current assets consist of the following:

|                               | September 30,<br>2011 | December 31,<br>2010 |
|-------------------------------|-----------------------|----------------------|
|                               | (In thousands)        |                      |
| Land held for sale            | \$8,288               | \$11,089             |
| Prepaid expenses              | 8,815                 | 8,070                |
| Notes receivable (See Note 3) | 3,763                 | 3,966                |
| Other current assets          | 1,719                 | 1,131                |
| Total                         | \$22,585              | \$24,256             |

Land held for sale represents the Company’s purchase of various parcels of real estate as part of its program to incent franchise development in top markets for certain brands. The Company has acquired this real estate with the intent to resell it to third-party developers for the construction of hotels operated under the Company’s brands. During the first quarter of 2011, the Company determined that one parcel of land no longer met the criteria to be classified as a current asset held for sale. As a result, the Company reclassified this land to other long-term assets on the Company’s

consolidated balance sheets at the lower of its carrying amount or fair value. The Company determined that the carrying amount of the land exceeded its estimated fair value by approximately \$1.8 million based on comparable sales. As a result, in the first quarter of 2011, the Company reduced the carrying amount of the land to its estimated fair value and recognized a \$1.8 million loss in other gains and losses in the consolidated statements of income.

Table of Contents

| Description                       | Fair Value Measurements Using<br>(\$ in millions) |  |   |  |  | Total Gains<br>(Losses) |
|-----------------------------------|---|--|---|--|--|-------------------------|
|                                   | September 30,<br>2011                             | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |  |                         |
| Land held for sale <sup>(1)</sup> | \$1.3   | 0  | \$1.3   | 0  |  | \$(1.8 )                |

(1)Included in Other Assets

### 3. Notes Receivable and Allowance for Losses

The Company segregates its notes receivable for the purposes of evaluating allowances for credit losses between two categories: Mezzanine and Other Notes Receivable and Forgivable Notes Receivable. The Company utilizes the level of security it has in the various notes receivable as its primary credit quality indicator (i.e. senior, subordinated or unsecured) when determining the appropriate allowances for uncollectible loans within these categories.

The following table shows the composition of our notes receivable balances:

| Credit Quality<br>Indicator  | September 30, 2011<br>(\$ in thousands) |   |          | December 31, 2010<br>(\$ in thousands) |   |          |
|--|---|---|----------|--|---|----------|
|  | Forgivable<br>Notes<br>Receivable       | Mezzanine<br>& Other<br>Notes<br>Receivable | Total    | Forgivable<br>Notes<br>Receivable      | Mezzanine<br>& Other<br>Notes<br>Receivable | Total    |
| Senior   | \$0                                     | \$4,425                                     | \$4,425  | \$0                                    | \$3,846                                     | \$3,846  |
| Subordinated   | 0                                       | 14,690                                      | 14,690   | 0                                      | 14,494                                      | 14,494   |
| Unsecured  | 7,997                                   | 0   | 7,997    | 7,753                                  | 0   | 7,753    |
| Total notes<br>receivable  | 7,997                                   | 19,115                                      | 27,112   | 7,753                                  | 18,340                                      | 26,093   |
| Allowance for<br>losses on<br>non-impaired loans   | 800                                     | 225   | 1,025    | 775                                    | 613   | 1,388    |
| Allowance for<br>losses on<br>receivables<br>specifically<br>evaluated for<br>impairment | 0                                       | 8,557                                       | 8,557    | 0                                      | 8,638                                       | 8,638    |
| Total loan reserves  | 800                                     | 8,782                                       | 9,582    | 775                                    | 9,251                                       | 10,026   |
| Net carrying value   | \$7,197                                 | \$10,333                                    | \$17,530 | \$6,978                                | \$9,089                                     | \$16,067 |
| Current portion, net   | \$131                                   | \$3,632                                     | \$3,763  | \$114                                  | \$3,852                                     | \$3,966  |
| Long-term portion,<br>net  | 7,066                                   | 6,701                                       | 13,767   | 6,864                                  | 5,237                                       | 12,101   |
| Total  | \$7,197                                 | \$10,333                                    | \$17,530 | \$6,978                                | \$9,089                                     | \$16,067 |

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



Table of Contents

The following table summarizes the activity related to the Company's Forgivable Notes Receivable and Mezzanine and & Other Notes Receivable allowance for losses from December 31, 2010 through September 30, 2011:

|                             | Forgivable<br>Notes<br>Receivable<br>(In thousands) | Mezzanine<br>& Other Notes<br>Receivable |
|-----------------------------|---|--|
| Balance, December 31, 2010  | \$775   | \$9,251                                  |
| Provisions                  | 215   | 338                                      |
| Recoveries                  | (3  | ) (807                                   |
| Write-offs                  | (90   | ) 0                                      |
| Other <sup>(1)</sup>        | (97   | ) 0                                      |
| Balance, September 30, 2011 | \$800   | \$8,782                                  |

(1) Consists of default rate assumption changes

Forgivable Notes Receivable

From time to time, the Company provides financing to franchisees for property improvements and other purposes in the form of forgivable promissory notes. The terms of the notes typically range from 3 to 10 years, bearing market interest rates, and are forgiven and amortized over that time period if the franchisee remains in the system in good standing. The notes are forgivable by the Company and therefore, franchisees are not required to repay the forgivable notes provided that the respective hotels remain in the system and in good standing throughout the term of their note. The Company fully reserves all defaulted notes in addition to recording a reserve on the estimated uncollectible portion of the remaining notes. For those notes not in default, the Company calculates an allowance for losses and determines the ultimate collectibility on these forgivable notes based on the historical default rates for those unsecured notes that are not forgiven but are required to be repaid. The Company records bad debt expense in SG&A expenses in the accompanying consolidated statements of income in the quarter when the note is deemed uncollectible. Recoveries are recorded as a reduction of SG&A expenses in the quarter received.

As of September 30, 2011 and December 31, 2010, the unamortized balance of these notes totaled \$8.0 million and \$7.8 million, respectively. The Company recorded an allowance for credit losses on these forgivable notes receivable of \$0.8 million at both September 30, 2011 and December 31, 2010, respectively. Amortization expense included in the accompanying consolidated statements of income related to the notes was \$0.6 million and \$1.7 million for the three and nine months ended September 30, 2011, respectively. Amortization expense for the three and nine months ended September 30, 2010 was \$0.5 million and \$1.4 million, respectively. At September 30, 2011, the Company had commitments to extend an additional \$5.5 million in forgivable notes receivable provided certain commitments are met by its franchisees, of which \$2.7 million is expected to be advanced in the next twelve months.

Mezzanine and Other Notes Receivable

The Company has provided financing to franchisees in support of the development of properties in key markets. These notes include non-interest bearing receivables as well as notes bearing market interest rates and are due upon maturity. Non-interest bearing notes are recorded net of their unamortized discounts. At September 30, 2011 and December 31, 2010, all discounts were fully amortized. Interest income associated with these note receivable is reflected in the accompanying consolidated statements of income under the caption of interest income.

The Company expects the owners to repay the loans in accordance with the loan agreements, or earlier as the hotels mature and capital markets permit. The Company estimates the collectibility and records an allowance for loss on its mezzanine and other notes receivable when recording the receivables in the Company's financial statements. These estimates are updated quarterly based on available information.

The Company considers a loan to be impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. The Company measures loan

impairment based on the present value of expected future cash flows discounted at the loan's original effective interest rate or the estimated fair value of the collateral. For impaired loans, the Company establishes a specific impairment reserve for the difference between the recorded investment in the loan and the present value of the expected future cash flows or the estimated fair value of the collateral. The Company applies its loan impairment policy individually to all mezzanine and other notes receivable in the portfolio and does not

9

---



Table of Contents

aggregate loans for the purpose of applying such policy. For impaired loans, the Company recognizes interest income on a cash basis. If it is likely that a loan will not be collected based on financial or other business indicators it is the Company's policy to charge off these loans to SG&A expenses in the accompanying consolidated statements of income in the quarter when it is deemed uncollectible. Recoveries of impaired loans are recorded as a reduction of SG&A expenses in the quarter received.

The Company assesses the collectibility of its senior notes receivable by comparing the market value of the underlying assets to the carrying value of the outstanding notes. In addition, the Company evaluates the property's operating performance, the borrower's compliance with the terms of the loan and franchise agreements, and all related personal guarantees that have been provided by the borrower. For subordinated or unsecured receivables, the Company assesses the property's operating performance, the subordinated equity available to the Company, the borrower's compliance with the terms of loan and franchise agreements, and the related personal guarantees that have been provided by the borrower.

The Company considers loans to be past due and in default when payments are not made when due. Although the Company considers loans to be in default if payments are not received on the due date, the Company does not suspend the accrual of interest until those payments are more than 30 days past due. The Company applies payments received for loans on non-accrual status first to interest and then principal. The Company does not resume interest accrual until all delinquent payments are received.

The Company has determined that approximately \$11.9 million and \$10.8 million of its mezzanine and other notes receivable were impaired at September 30, 2011 and December 31, 2010, respectively. The Company has recorded allowance for credit losses on these impaired loans at September 30, 2011 and December 31, 2010 totaling \$8.6 million and \$8.6 million resulting in a carrying value of impaired loans of \$3.4 million and \$2.2 million, respectively for which we had no related allowance for credit losses. The Company did not recognize interest income during the time that the loans were impaired on either the accrual or cash basis during the periods ended September 30, 2011 and 2010. The Company had provided loan reserves on non-impaired loans totaling \$0.2 million and \$0.6 million at September 30, 2011 and December 31, 2010, respectively.

Past due balances of mezzanine and other notes receivable by credit quality indicators are as follows:

|                          | 30-89 days<br>Past Due<br>(\$ in thousands) | > 90 days<br>Past Due | Total<br>Past Due | Current | Total<br>Receivables |
|--------------------------|---|-----------------------|-------------------|---------|----------------------|
| As of September 30, 2011 |   |                       |                   |         |                      |
| Senior                   | \$0   | \$0                   | \$0               | \$4,425 | \$4,425              |
| Subordinated             | 0   | 12,026                | 12,026            | 2,664   | 14,690               |
|                          | \$0   | \$12,026              | \$12,026          | \$7,089 | \$19,115             |
| As of December 31, 2010  |   |                       |                   |         |                      |
| Senior                   | \$0   | \$0                   | \$0               | \$3,846 | \$3,846              |
| Subordinated             | 0   | 10,931                | 10,931            | 3,563   | 14,494               |
|                          | \$0   | \$10,931              | \$10,931          | \$7,409 | \$18,340             |

#### 4. Receivable – Marketing and Reservation Fees

The marketing fees receivable from cumulative marketing expenses incurred in excess of cumulative marketing fees earned at September 30, 2011 and December 31, 2010 was \$21.7 million and \$17.0 million, respectively. As of September 30, 2011 and December 31, 2010, the reservation fees receivable related to cumulative reservation expenses incurred in excess of cumulative reservation fees earned was \$32.3 million and \$25.5 million, respectively. Depreciation and amortization expense attributable to marketing and reservation activities for the three months ended September 30, 2011 and 2010 was \$3.4 million and \$3.0 million, respectively. Depreciation and amortization expense attributable to marketing and reservation activities for the nine months ended September 30, 2011 and 2010 was \$10.0 million and \$9.1 million, respectively. Interest expense attributable to marketing and reservation activities was \$1.0

million and \$0.3 million for the three months ended September 30, 2011 and 2010, respectively. Interest expense attributable to marketing and reservation activities was \$3.0 million and \$0.5 million for the nine months ended September 30, 2011 and 2010, respectively.

The Company evaluates the receivable for marketing and reservation costs in excess of cumulative marketing and reservation system fees earned on a periodic basis for collectibility. The Company will record an allowance when, based on current information and events, it is probable that it will be unable to collect all amounts due for marketing and reservation activities according to the contractual terms of the franchise agreements. The receivables are considered to be uncollectible if the expected net, undiscounted cash flows from marketing and reservation activities are less than the carrying amount of the asset.

Table of Contents

## 5. Other Assets

Other assets consist of the following:

|                               | September 30,<br>2011 | December 31,<br>2010 |
|-------------------------------|-----------------------|----------------------|
|                               | (In thousands)        |                      |
| Notes receivable (see Note 3) | \$13,767              | \$12,101             |
| Deferred financing fees       | 3,530                 | 2,102                |
| Equity method investments     | 3,740                 | 251                  |
| Other                         | 2,052                 | 851                  |
| Total                         | \$23,089              | \$15,305             |

## 6. Deferred Revenue

Deferred revenue consists of the following:

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
|   | (In thousands)        |                      |
| Loyalty programs                        | \$71,781              | \$61,604             |
| Initial, relicensing and franchise fees | 3,323                 | 4,631                |
| Procurement service fees                | 1,105                 | 1,052                |
| Other                                   | 434                   | 35                   |
| Total                                   | \$76,643              | \$67,322             |

## 7. Debt

Debt consists of the following at:

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
|   | (In thousands)        |                      |
| \$250 million senior notes with an effective interest rate of 6.19% at September 30, 2011 and December 31, 2010                                 | \$249,427             | \$249,379            |
| \$350 million senior unsecured revolving credit facility with an effective interest rate of 0.675% at December 31, 2010                         | 0                     | 200                  |
| Capital lease obligations due 2016 with an effective interest rate of 3.66% and 4.66% at September 30, 2011 and December 31, 2010, respectively | 3,482                 | 2,538                |
| Other notes payable   | 102                   | 57                   |
| Total debt  | \$253,011             | \$252,174            |
| Less current portion  | 691                   | 620                  |
| Total long-term debt  | \$252,320             | \$251,554            |

On February 24, 2011, the Company entered into a new \$300 million senior unsecured revolving credit agreement (the "Revolver") with Wells Fargo Bank, National Association, as administrative agent and a syndicate of lenders. Simultaneously with the closing of the Revolver, the \$350 million unsecured revolving credit agreement dated as of June 2006 (the "Old Revolver") was terminated. The Revolver provides for a \$300 million unsecured revolving credit facility with a final maturity date on February 24, 2016. Up to \$30 million of borrowings under the Revolver may be used for letters of credit and up to \$20 million of borrowings under the Revolver may be used for swing-line loans. The Revolver is unconditionally guaranteed, jointly and severally, on a senior unsecured basis by all of the Company's subsidiaries that currently guaranty the obligations under the Company's Indenture governing the terms of its 5.70%

senior notes due 2020.

The Company may at any time prior to the final maturity date increase the amount of the Revolver by up to an additional \$150

11

---

Table of Contents

million to the extent that any one or more lenders commit to being a lender for the additional amount and certain other customary conditions are met.

The Company may elect to have borrowings under the Revolver bear interest at (i) a base rate plus a margin ranging from 5 to 80 basis points based on the Company's credit rating or (ii) LIBOR plus a margin ranging from 105 to 180 basis points based on the Company's credit rating. In addition, the Revolver requires the Company to pay a quarterly facility fee on the full amount of the commitments under the Revolver (regardless of usage) ranging from 20 to 45 basis points based upon the credit rating of the Company.

The Revolver requires that the Company and its restricted subsidiaries comply with various covenants, including with respect to restrictions on liens, incurring indebtedness, making investments and effecting mergers and/or asset sales. In addition, the Revolver imposes financial maintenance covenants requiring the Company to maintain a total leverage ratio of not more than 3.5 to 1.0 and an interest coverage ratio of at least 3.5 to 1.0. The Revolver includes customary events of default, the occurrence of which, following any applicable cure period, would permit the lenders to, among other things, declare the principal, accrued interest and other obligations of the Company under the Revolver to be immediately due and payable. At September 30, 2011 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, investments and other permitted uses. At September 30, 2011, no amounts were outstanding under the Revolver.

Debt issuance costs incurred in connection with the Revolver totaled \$2.4 million and are being amortized, on a straight-line basis, which is not materially different than the effective interest method, through the maturity of the Revolver. Amortization of these costs is included in interest expense in the accompanying statements of income.

On August 25, 2010, the Company completed a \$250 million senior unsecured note offering ("the Senior Notes") at a discount of \$0.6 million, bearing a coupon of 5.7% with an effective rate of 6.19%. The Senior Notes will mature on August 28, 2020, with interest on the Senior Notes to be paid semi-annually on February 28<sup>th</sup> and August 28<sup>th</sup>. The Company used the net proceeds from the offering, after deducting underwriting discounts and other offering expenses, to repay outstanding borrowings under the Old Revolver and other general corporate purposes. The Company's Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations by eight 100%-owned domestic subsidiaries.

#### 8. Pension Plan

The Company sponsors an unfunded non-qualified defined benefit plan ("SERP") for certain senior executives. No assets are held with respect to the SERP; therefore benefits are funded as paid to participants. For each of the three months ended September 30, 2011 and 2010, the Company recorded \$0.1 million in expenses related to the SERP which are included in SG&A expense in the accompanying consolidated statements of income. The expenses related to the SERP for each of the nine month periods ended September 30, 2011 and 2010 was \$0.4 million. Benefit payments totaling \$0.4 million are currently scheduled to be remitted within the next twelve months.

The following table presents the components of net periodic benefit costs for the three and nine months ended September 30, 2011 and 2010:

| (In thousands)                           | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|--|-------------------------------------|--------|------------------------------------|--------|
|  | 2011                                | 2010   | 2011                               | 2010   |
| Components of net periodic pension cost: |                                     |        |                                    |        |
| Interest cost                            | \$ 135                              | \$ 135 | \$ 406                             | \$ 404 |
| Net periodic pension cost                | \$ 135                              | \$ 135 | \$ 406                             | \$ 404 |

The 2011 monthly net periodic pension costs are approximately \$0.5 million. The components of projected pension costs for the year ended December 31, 2011 are as follows:

(in thousands)

Components of net periodic pension cost:

|                           |       |
|---------------------------|-------|
| Interest cost             | \$541 |
| Net periodic pension cost | \$541 |

12

---

Table of Contents

The following is a reconciliation of the changes in the projected benefit obligation for the nine months ended September 30, 2011:

|  |          |
|--|----------|
| (in thousands)                                   |          |
| Projected benefit obligation, December 31, 2010  | \$10,034 |
| Interest cost                                    | 406      |
| Actuarial loss                                   | 16       |
| Benefit payments                                 | (318 )   |
| Projected benefit obligations September 30, 2011 | \$10,138 |

The amounts in accumulated other comprehensive income (loss) that have not yet been recognized as components of net periodic benefit costs at September 30, 2011 are as follows:

|                               |          |
|-------------------------------|----------|
| (in thousands)                |          |
| Transition asset (obligation) | \$0      |
| Prior service cost            | 0        |
| Accumulated loss              | (657 )   |
| Total                         | \$(657 ) |

#### 9. Non-Qualified Retirement, Savings and Investment Plans

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

In 2002, the Company adopted the Choice Hotels International, Inc. Executive Deferred Compensation Plan ("EDCP") which became effective January 1, 2003. Under the EDCP, certain executive officers may defer a portion of their salary into an irrevocable trust. Prior to January 1, 2010, participants could elect an investment return of either the annual yield of the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points, or a return based on a selection of available diversified investment options. Effective January 1, 2010, the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points is no longer an investment option for salary deferrals made on compensation earned after December 31, 2010. As of September 30, 2011 and December 31, 2010, the Company recorded a deferred compensation liability of \$16.8 million and \$17.6 million, respectively related to these deferrals and credited investment returns. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. Compensation expense recorded in SG&A for the three months ended September 30, 2011 and 2010 were \$16,778 and \$0.3 million respectively. Compensation expense recorded in SG&A for the nine months ended September 30, 2011 and 2010 was \$0.5 million and \$0.7 million, respectively.

The Company has invested the employee salary deferrals in diversified long-term investments which are intended to provide investment returns that partially offset the earnings credited to the participants. The diversified investments held in the trusts totaled \$13.1 million and \$13.6 million as of September 30, 2011 and December 31, 2010, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other gains and losses in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended September 30, 2011 and 2010 of approximately (\$1.4 million) and \$0.8 million, respectively. The Company recorded investments gains (losses) during the nine months ended September 30, 2011 and 2010 totaling (\$0.9 million) and \$0.6 million, respectively.

In 1997, the Company adopted the Choice Hotels International, Inc. Non-Qualified Retirement Savings and Investment Plan ("Non-Qualified Plan"). The Non-Qualified Plan allows certain employees who do not participate in the

EDCP to defer a portion of their salary and invest these amounts in a selection of available diversified investment options. As of September 30, 2011 and December 31, 2010, the Company had recorded a deferred compensation liability of \$9.6 million and \$10.6 million, respectively related to these deferrals. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. The net increase (decrease) in compensation expense recorded in



Table of Contents

SG&A for the three months ended September 30, 2011 and 2010 was (\$1.3 million) and \$0.8 million respectively. The net increase (decrease) in compensation expense recorded in SG&A for the nine months ended September 30, 2011 and September 30, 2010 and was (\$1.1 million) and \$0.5 million, respectively.

The diversified investments held in the trusts were \$9.0 million and \$9.7 million as of September 30, 2011 and December 31, 2010, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other gains and losses in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended September 30, 2011 and 2010 of approximately (\$1.2 million) and \$0.7 million, respectively. The Company recorded investment losses during the nine months ended September 30, 2011 of \$0.9 million and investment gains of \$0.5 million for the nine months ended September 30, 2010. In addition, the Non-Qualified Plan held shares of the Company's common stock with a market value of \$0.7 million and \$0.9 million at September 30, 2011 and December 31, 2010, respectively, which are recorded as a component of shareholders' deficit.

## 10. Fair Value Measurements

The Company estimates the fair value of its financial instruments utilizing a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. There have been no significant transfers into or out of Level 1 or Level 2 inputs during the three and nine months ended September 30, 2011. The following summarizes the three levels of inputs, as well as the assets that the Company values using those levels of inputs.

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

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

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

|   | Fair Value Measurements at |          |          |         |
|---|----------------------------|----------|----------|---------|
|   | Total                      | Level 1  | Level 2  | Level 3 |
| Assets (in thousands)                                     |                            |          |          |         |
| As of September 30, 2011                                  |                            |          |          |         |
| Money market funds, included in cash and cash equivalents | \$10,001                   | \$0      | \$10,001 | \$0     |
| Mutual funds <sup>(1)</sup>                               | 19,831                     | 19,831   | 0        | 0       |
| Money market funds <sup>(1)</sup>                         | 2,186                      | 0        | 2,186    | 0       |
|   | \$32,018                   | \$19,831 | \$12,187 | \$0     |
| As of December 31, 2010                                   |                            |          |          |         |
| Money market funds, included in cash and cash equivalents | \$10,001                   | \$0      | \$10,001 | \$0     |
| Mutual funds <sup>(1)</sup>                               | 20,917                     | 20,917   | 0        | 0       |
| Money market funds <sup>(1)</sup>                         | 2,448                      | 0        | 2,448    | 0       |
|   | \$33,366                   | \$20,917 | \$12,449 | \$0     |

(1) Included in Investments, employee benefit plans fair value on the consolidated balance sheets.

The Company believes that the fair value of its current assets and current liabilities approximate their reported carrying amounts due to the short-term nature of these items. In addition, the interest rates of the Company's Revolver adjust frequently based on current market rates; accordingly its carrying amount approximates fair value.

The Company estimates the fair value of its senior notes, using quoted market prices. At September 30, 2011 and December 31, 2010, the senior notes had an approximate fair value of \$276.5 million and \$244.0 million, respectively.

Table of Contents

## 11. Income Taxes

The effective income tax rate for the quarter was 25.7% compared to 26.4% in 2010. The effective income tax rate for the nine months ended September 30, 2011 was 29.2% compared to 31.6% in 2010.

The effective income tax rates for the three and nine months ended September 30, 2011 were lower than the U.S. federal statutory rate of 35% due to the identification of \$1.7 million of additional federal tax benefits, \$0.4 million of foreign tax credits for open tax years, and an adjustment of \$1.9 million for unrecognized tax positions. Additionally, an adjustment to our current federal taxes payable of \$1.4 million reduced the effective tax rate for the nine months ended September 30, 2011. The effective income tax rates for the three and nine months ended September 30, 2010 were lower than the U.S. federal statutory rate of 35% primarily due to a \$3.3 million adjustment to our deferred tax assets and the identification of \$1.7 million of additional federal income tax benefits, partially offset by an increase of \$1.6 million related to the identification of unrecognized tax positions. The effective income tax rates for the three and nine months ended September 30, 2011 and 2010 were also impacted by the effect of foreign operations, partially offset by state income taxes.

## 12. Share-Based Compensation and Capital Stock

## Stock Options

No stock options were granted during the three month periods ended September 30, 2011 and 2010. The Company granted 0.2 million and 0.3 million options to certain employees of the Company at a fair value of \$2.1 million and \$2.6 million during the nine months ended September 30, 2011 and 2010, 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:

|  | 2011 Grants |   | 2010 Grants |   |
|--|-------------|---|-------------|---|
| Risk-free interest rate                        | 2.10        | % | 2.19        | % |
| Expected volatility                            | 39.51       | % | 41.92       | % |
| Expected life of stock option                  | 4.4 years   |   | 4.4 years   |   |
| Dividend yield                                 | 1.79        | % | 2.26        | % |
| Requisite service period                       | 4 years     |   | 4 years     |   |
| Contractual life                               | 7 years     |   | 7 years     |   |
| Weighted average fair value of options granted | \$12.42     |   | \$10.07     |   |

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

The aggregate intrinsic value of the stock options outstanding and exercisable at September 30, 2011 was \$2.3 million and \$1.7 million, respectively. The total intrinsic value of options exercised during the three months ended September 30, 2011 and 2010 was approximately \$0.2 million and \$16,000, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2011 and 2010 was \$2.5 million and \$1.0 million, respectively.

The Company received approximately \$0.6 million and \$6,000 in proceeds from the exercise of 26,614 and 600 employee stock options during the three month periods ended September 30, 2011 and 2010, respectively. The Company received \$3.7 million and \$1.3 million in proceeds from the exercise of approximately 0.2 million and 66,000 of employee stock options during the nine month periods ended September 30, 2011 and 2010, respectively.



Table of Contents

## Restricted Stock

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

|  | Three Months Ended |         | Nine Months Ended |           |
|--|--------------------|---------|-------------------|-----------|
|  | September 30,      |         | September 30,     |           |
|  | 2011               | 2010    | 2011              | 2010      |
| Restricted share grants                          | 45,674             | 4,203   | 247,298           | 279,157   |
| Weighted average grant date fair value per share | \$30.27            | \$35.69 | \$38.84           | \$33.07   |
| Aggregate grant date fair value (\$000)          | \$1,383            | \$150   | \$9,604           | \$9,233   |
| Restricted shares forfeited                      | 5,884              | 2,354   | 33,252            | 11,183    |
| Vesting service period of shares granted         | 3 years            | 4 years | 1-4 years         | 3-4 years |
| Grant date fair value of shares vested (\$000)   | \$298              | \$200   | \$6,655           | \$5,948   |

Compensation expense related to the fair value of these awards is recognized straight-line over the requisite service period based on those restricted stock grants that ultimately vest. The fair value of grants is measured by the market price of the Company's stock on the date of grant. Restricted stock awards generally vest ratably over the service period beginning with the first anniversary of the grant date. Awards granted to retirement eligible board of directors are recognized over the shorter of the requisite service period or the length of time until retirement since the terms of the grant provide that the awards will vest upon retirement.

## Performance Vested Restricted Stock Units

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

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

|   | Three Months Ended |      | Nine Months Ended |         |
|---|--------------------|------|-------------------|---------|
|   | September 30,      |      | September 30,     |         |
|   | 2011               | 2010 | 2011              | 2010    |
| Performance vested restricted stock units granted at target | —                  | —    | 25,036            | 33,517  |
| Weighted average grant date fair value per share            | \$—                | \$—  | \$41.25           | \$32.60 |
| Aggregate grant date fair value (\$000)                     | \$—                | \$—  | \$1,033           | \$1,093 |
| Stock units forfeited                                       | —                  | —    | 41,512            | 9,650   |
| Requisite service period                                    | —                  | —    | 3 years           | 3 years |

During the three and nine months ended September 30, 2011, no PVRSU grants vested. During the nine months ended September 30, 2011, PVRSU grants totaling 39,070 units were forfeited since the Company did not achieve the minimum performance conditions contained in the stock awards. The remaining 2,442 units were forfeited upon employee termination. During the nine months ended September 30, 2010, PVRSU grants totaling 10,880 vested at a fair value of \$0.3 million and 9,650 units were forfeited since certain performance targets were not achieved.

Table of Contents

A summary of stock-based award activity as of September 30, 2011 and changes during the nine months ended are presented below:

|   | Stock Options |                                 | Restricted Stock                            |            | Performance Vested Restricted Stock Units |           |  |
|---|---------------|---------------------------------|---|------------|---|-----------|--|
|   | Options       | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Shares     | Weighted Average Grant Date Fair Value    | Shares    | Weighted Average Grant Date Fair Value |
| Outstanding at January 1, 2011            | 1,732,674     | \$31.43                         |   | 592,131    | \$31.81                                   | 127,912   | \$33.43                                |
| Granted                                   | 166,306       | 41.25                           |   | 247,298    | 38.84                                     | 25,036    | 41.25                                  |
| Exercised/Vested                          | (164,150 )    | 22.70                           |   | (204,972 ) | 32.47                                     | 0         | 0                                      |
| Forfeited/Expired                         | (126,587 )    | 32.97                           |   | (33,252 )  | 33.33                                     | (41,512 ) | 32.18                                  |
| Outstanding at September 30, 2011         | 1,608,243     | \$33.21                         | 4.5 years                                   | 601,205    | \$34.39                                   | 111,436   | \$35.66                                |
| Options exercisable at September 30, 2011 | 954,395       | \$33.06                         | 4.0 years                                   |            |   |           |  |

The components of the Company's pretax stock-based compensation expense and associated income tax benefits are as follows for the three and nine months ended September 30, 2011 and 2010:

| (in millions)                             | Three Months Ended September 30, |        | Nine Months Ended September 30, |        |
|---|----------------------------------|--------|---------------------------------|--------|
|   | 2011                             | 2010   | 2011                            | 2010   |
| Stock options                             | \$0.7                            | \$0.7  | \$2.0                           | \$1.9  |
| Restricted stock                          | 1.9                              | 1.8    | 5.6                             | 5.3    |
| Performance vested restricted stock units | 0.1                              | (0.7 ) | 0.4                             | (0.4 ) |
| Total                                     | \$2.7                            | \$1.8  | \$8.0                           | \$6.8  |
| Income tax benefits                       | \$1.0                            | \$0.7  | \$3.0                           | \$2.5  |

## Dividends

On September 16, 2011, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$10.9 million in the aggregate), which was paid on October 14, 2011 to shareholders of record as of October 3, 2011. On May 5, 2011, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on July 15, 2011 to shareholders of record as of July 1, 2011. On February 21, 2011, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on April 15, 2011 to shareholders of record as of April 1, 2011.

On September 17, 2010, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on October 15, 2010 to shareholders of record as of October 1, 2010. On April 29, 2010, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on July 16, 2010 to shareholders of record as of July 2, 2010. On February 16, 2010, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on April 16, 2010 to shareholders of record as of April 5, 2010.

## Share Repurchases and Redemptions

During the three and nine months ended September 30, 2011, the Company purchased 0.7 million shares of common stock under the share repurchase program at a total cost of \$22.2 million. During the three months ended September 30, 2010, the Company purchased approximately 50,000 shares of common stock under the share repurchase program at a total cost of \$1.9 million. During the nine months ended September 30, 2010, the Company purchased 0.3 million shares of common stock under the share repurchase program at a total cost of \$8.7 million. During the three and nine months ended September 30, 2011, the Company redeemed 3,309 and 67,336 shares of common

Table of Contents

stock at a total cost of approximately \$0.1 million and \$2.6 million, respectively, from employees to satisfy statutory minimum tax requirements from the vesting of restricted stock grants.

During the three and nine months ended September 30, 2010, the Company redeemed 1,736 and 75,432 shares of common stock at a total cost of approximately \$60,000 and \$2.4 million, respectively, from employees to satisfy statutory minimum tax requirements from the vesting of restricted stock grants and PVRSU grants.

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

## 13. Comprehensive Income

The components of accumulated other comprehensive income (loss) is as follows:

| (In thousands)  | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| Foreign currency translation adjustments  | \$1,375               | \$1,540              |
| Deferred loss on cash flow hedge  | (7,684                | ) (8,331             |
| Changes in pension benefit obligation recognized in other comprehensive income (loss) | (411                  | ) (401               |
| Total accumulated other comprehensive income (loss)                                   | \$(6,720              | ) \$(7,192           |

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

| (In thousands)  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|----------|------------------------------------|----------|
|   | 2011                                | 2010     | 2011                               | 2010     |
| Net income  | \$42,302                            | \$40,494 | \$85,610                           | \$83,298 |
| Other comprehensive income (loss), net of tax:              |                                     |          |                                    |          |
| Settlement of forward starting interest rate swap agreement | —                                   | (8,663   | ) —                                | (8,663   |
| Amortization of loss on cash flow hedge                     | 215                                 | 117      | 646                                | 117      |
| Foreign currency translation adjustment, net                | (1,167                              | ) 1,851  | (164                               | ) 668    |
| Actuarial pension loss, net of tax                          | 0                                   | 0        | (10                                | ) 0      |
| Other comprehensive income (loss), net of tax               | (952                                | ) (6,695 | ) 472                              | (7,878   |
| Comprehensive income  | \$41,350                            | \$33,799 | \$86,082                           | \$75,420 |



Table of Contents

## 14. Earnings Per Share

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

| (In thousands, except per share amounts)           | Three Months Ended |          | Nine Months Ended |          |
|--|--------------------|----------|-------------------|----------|
|  | September 30,      |          | September 30,     |          |
|  | 2011               | 2010     | 2011              | 2010     |
| Computation of Basic Earnings Per Share:           |                    |          |                   |          |
| Net income   | \$42,302           | \$40,494 | \$85,610          | \$83,298 |
| Income allocated to participating securities       | (417               | ) (426   | ) (848            | ) (865   |
| Net income available to common shareholders        | \$41,885           | \$40,068 | \$84,762          | \$82,433 |
| Weighted average common shares outstanding – basic | 59,182             | 58,965   | 59,169            | 58,948   |
| Basic earnings per share                           | \$0.71             | \$0.68   | \$1.43            | \$1.40   |
| Computation of Diluted Earnings Per Share:         |                    |          |                   |          |
| Net income   | \$42,302           | \$40,494 | \$85,610          | \$83,298 |
| Income allocated to participating securities       | (417               | ) (425   | ) (848            | ) (864   |
| Net income available to common shareholders        | \$41,885           | \$40,069 | \$84,762          | \$82,434 |
| Weighted average common shares outstanding – basic | 59,182             | 58,965   | 59,169            | 58,948   |
| Diluted effect of stock options and PVRsUs         | 36                 | 66       | 44                | 80       |
| Weighted average shares outstanding-diluted        | 59,218             | 59,031   | 59,213            | 59,028   |
| Diluted earnings per share                         | \$0.71             | \$0.68   | \$1.43            | \$1.40   |

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

At September 30, 2011 and 2010, the Company had 1.6 million and 1.8 million outstanding stock options, respectively. Stock options are included in the diluted earnings per share calculation using the treasury stock method and average market prices during the period, unless the stock options would be anti-dilutive. For the three and nine month periods ended September 30, 2011, the Company excluded 1.1 million and 0.7 million of anti-dilutive stock options from the diluted earnings per share calculation, respectively. For both the three and nine months ended September 30, 2010, the Company excluded 0.6 million of anti-dilutive stock options from the diluted earnings per share calculation.

PVRsUs are also included in the diluted earnings per share calculation assuming the performance conditions have been met at the reporting date. However, at September 30, 2011 and 2010, PVRsUs totaling 111,436 and 131,372, respectively were excluded from the computation since the performance conditions had not been met.

Table of Contents

## 15. Condensed Consolidating Financial Statements

Effective August 2010, the Company's Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations, by eight 100%-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 the 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 September 30, 2011

(Unaudited, in Thousands)

|  | Parent   | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|----------|---------------------------|-------------------------------|--------------|--------------|
| <b>REVENUES:</b>                                   |          |                           |                               |              |              |
| Royalty fees                                       | \$69,968 | \$20,112                  | \$8,746                       | \$(21,471)   | ) \$77,355   |
| Initial franchise and relicensing fees             | 3,363    | 0                         | 106                           | 0            | 3,469        |
| Procurement services                               | 3,984    | 0                         | 0                             | 0            | 3,984        |
| Marketing and reservation                          | 91,827   | 89,219                    | 4,803                         | (81,456)     | ) 104,393    |
| Other items, net                                   | 1,652    | 1,236                     | 232                           | 0            | 3,120        |
| Total revenues                                     | 170,794  | 110,567                   | 13,887                        | (102,927)    | ) 192,321    |
| <b>OPERATING EXPENSES:</b>                         |          |                           |                               |              |              |
| Selling, general and administrative                | 20,510   | 19,019                    | 4,497                         | (21,471)     | ) 22,555     |
| Marketing and reservation                          | 94,644   | 86,779                    | 4,426                         | (81,456)     | ) 104,393    |
| Other items, net                                   | 703      | 2,044                     | 226                           | 0            | 2,973        |
| Total operating expenses                           | 115,857  | 107,842                   | 9,149                         | (102,927)    | ) 129,921    |
| Operating income                                   | 54,937   | 2,725                     | 4,738                         | 0            | 62,400       |
| <b>OTHER INCOME AND<br/>EXPENSES, NET:</b>         |          |                           |                               |              |              |
| Interest expense                                   | 4,209    | (984)                     | ) 3                           | 0            | 3,228        |
| Equity in earnings of consolidated<br>subsidiaries | (5,186)  | ) 0                       | 0                             | 5,186        | 0            |
| Other items, net                                   | (153)    | ) 2,646                   | (287)                         | ) 0          | 2,206        |
| Total other income and expenses,<br>net            | (1,130)  | ) 1,662                   | (284)                         | ) 5,186      | 5,434        |
| Income before income taxes                         | 56,067   | 1,063                     | 5,022                         | (5,186)      | ) 56,966     |
| Income taxes                                       | 13,765   | 533                       | 366                           | 0            | 14,664       |
| Net income   | \$42,302 | \$530                     | \$4,656                       | \$(5,186)    | ) \$42,302   |

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Three Months Ended September 30, 2010  
(Unaudited, in Thousands)

|   | Parent   | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|----------|---------------------------|-------------------------------|--------------|--------------|
| <b>REVENUES:</b>                                |          |                           |                               |              |              |
| Royalty fees                                    | \$66,259 | \$21,727                  | \$ 7,507                      | \$(22,928 )  | \$72,565     |
| Initial franchise and relicensing fees          | 1,970    | 0                         | 0                             | 0            | 1,970        |
| Procurement services                            | 3,756    | 0                         | 0                             | 0            | 3,756        |
| Marketing and reservation                       | 90,518   | 86,315                    | 4,386                         | (78,352 )    | 102,867      |
| Other items, net                                | 1,568    | 1,069                     | 6                             | 0            | 2,643        |
| Total revenues                                  | 164,071  | 109,111                   | 11,899                        | (101,280 )   | 183,801      |
| <b>OPERATING EXPENSES:</b>                      |          |                           |                               |              |              |
| Selling, general and administrative             | 23,243   | 19,622                    | 3,219                         | (22,928 )    | 23,156       |
| Marketing and reservation                       | 95,355   | 82,306                    | 3,558                         | (78,352 )    | 102,867      |
| Other items, net                                | 880      | 1,820                     | 201                           | 0            | 2,901        |
| Total operating expenses                        | 119,478  | 103,748                   | 6,978                         | (101,280 )   | 128,924      |
| Operating income                                | 44,593   | 5,363                     | 4,921                         | 0            | 54,877       |
| <b>OTHER INCOME AND EXPENSES, NET:</b>          |          |                           |                               |              |              |
| Interest expense                                | 2,134    | (272 )                    | ) 2                           | 0            | 1,864        |
| Equity in earnings of consolidated subsidiaries | (9,756 ) | ) 0                       | 0                             | 9,756        | 0            |
| Other items, net                                | (147 )   | ) (1,492 )                | ) (374 )                      | ) 0          | (2,013 )     |
| Total other income and expenses, net            | (7,769 ) | ) (1,764 )                | ) (372 )                      | ) 9,756      | (149 )       |
| Income before income taxes                      | 52,362   | 7,127                     | 5,293                         | (9,756 )     | 55,026       |
| Income taxes                                    | 11,868   | 2,137                     | 527                           | 0            | 14,532       |
| Net income                                      | \$40,494 | \$4,990                   | \$ 4,766                      | \$(9,756 )   | \$40,494     |

Table of Contents

Choice Hotels International, Inc.  
 Condensed Consolidating Statement of Income  
 For the Nine Months Ended September 30, 2011  
 (Unaudited, in Thousands)

|  | Parent     | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|------------|---------------------------|-------------------------------|--------------|--------------|
| <b>REVENUES:</b>                                   |            |                           |                               |              |              |
| Royalty fees                                       | \$ 163,639 | \$ 73,930                 | \$ 24,619                     | \$(78,292)   | ) \$ 183,896 |
| Initial franchise and relicensing fees             | 8,550      | 0                         | 118                           | 0            | ) 8,668      |
| Procurement services                               | 13,706     | 0                         | 0                             | 0            | ) 13,706     |
| Marketing and reservation                          | 220,512    | 245,302                   | 13,292                        | (220,914)    | ) 258,192    |
| Other items, net                                   | 4,692      | 3,173                     | 576                           | 0            | ) 8,441      |
| Total revenues                                     | 411,099    | 322,405                   | 38,605                        | (299,206)    | ) 472,903    |
| <b>OPERATING EXPENSES:</b>                         |            |                           |                               |              |              |
| Selling, general and administrative                | 72,589     | 65,805                    | 12,839                        | (78,292)     | ) 72,941     |
| Marketing and reservation                          | 228,660    | 237,509                   | 12,937                        | (220,914)    | ) 258,192    |
| Other items, net                                   | 2,117      | 5,787                     | 665                           | 0            | ) 8,569      |
| Total operating expenses                           | 303,366    | 309,101                   | 26,441                        | (299,206)    | ) 339,702    |
| Operating income                                   | 107,733    | 13,304                    | 12,164                        | 0            | ) 133,201    |
| <b>OTHER INCOME AND<br/>EXPENSES, NET:</b>         |            |                           |                               |              |              |
| Interest expense                                   | 12,612     | (2,900)                   | ) 7                           | 0            | ) 9,719      |
| Equity in earnings of consolidated<br>subsidiaries | (19,056)   | ) 0                       | 0                             | 19,056       | 0            |
| Other items, net                                   | (558)      | ) 1,884                   | 1,153                         | 0            | ) 2,479      |
| Total other income and expenses,<br>net            | (7,002)    | ) (1,016)                 | ) 1,160                       | 19,056       | ) 12,198     |
| Income before income taxes                         | 114,735    | 14,320                    | 11,004                        | (19,056)     | ) 121,003    |
| Income taxes                                       | 29,125     | 5,826                     | 442                           | 0            | ) 35,393     |
| Net income   | \$ 85,610  | \$ 8,494                  | \$ 10,562                     | \$(19,056)   | ) \$ 85,610  |

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Nine Months Ended September 30, 2010  
(Unaudited, in Thousands)

|  | Parent    | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-----------|---------------------------|-------------------------------|--------------|--------------|
| <b>REVENUES:</b>                             |           |                           |                               |              |              |
| Royalty fees                                 | \$153,597 | \$68,596                  | \$21,137                      | \$(72,301)   | ) \$171,029  |
| Initial franchise and relicensing fees       | 6,537     | 0                         | 0                             | 0            | 6,537        |
| Procurement services                         | 13,612    | 0                         | 0                             | 0            | 13,612       |
| Marketing and reservation                    | 209,543   | 233,654                   | 11,554                        | (212,655)    | ) 242,096    |
| Other items, net                             | 4,606     | 3,045                     | 145                           | 0            | 7,796        |
| Total revenues                               | 387,895   | 305,295                   | 32,836                        | (284,956)    | ) 441,070    |
| <b>OPERATING EXPENSES:</b>                   |           |                           |                               |              |              |
| Selling, general and administrative          | 68,450    | 61,119                    | 10,528                        | (72,301)     | ) 67,796     |
| Marketing and reservation                    | 219,945   | 224,359                   | 10,447                        | (212,655)    | ) 242,096    |
| Other items, net                             | 2,848     | 5,411                     | 598                           | 0            | 8,857        |
| Total operating expenses                     | 291,243   | 290,889                   | 21,573                        | (284,956)    | ) 318,749    |
| Operating income                             | 96,652    | 14,406                    | 11,263                        | 0            | 122,321      |
| <b>OTHER INCOME AND EXPENSES, NET:</b>       |           |                           |                               |              |              |
| Interest expense                             | 3,597     | (441)                     | ) 4                           | 0            | 3,160        |
| Equity earnings of consolidated subsidiaries | (20,718)  | ) 0                       | 0                             | 20,718       | 0            |
| Other items, net                             | (328)     | ) (1,043)                 | ) (1,164)                     | ) 0          | (2,535)      |
| Total other income and expenses, net         | (17,449)  | ) (1,484)                 | ) (1,160)                     | ) 20,718     | 625          |
| Income before income taxes                   | 114,101   | 15,890                    | 12,423                        | (20,718)     | ) 121,696    |
| Income taxes                                 | 30,803    | 6,242                     | 1,353                         | 0            | 38,398       |
| Net income                                   | \$83,298  | \$9,648                   | \$11,070                      | \$(20,718)   | ) \$83,298   |

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Balance Sheet  
As of September 30, 2011  
(Unaudited, in thousands)

|   | Parent    | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|-----------|---------------------------|-------------------------------|--------------|--------------|
| <b>ASSETS</b>   |           |                           |                               |              |              |
| Cash and cash equivalents                                   | \$40,518  | \$386                     | \$83,830                      | 0            | \$124,734    |
| Receivables   | 53,976    | 1,805                     | 6,228                         | 0            | 62,009       |
| Other current assets  | 5,598     | 15,169                    | 4,018                         | (1,771)      | 23,014       |
| Total current assets  | 100,092   | 17,360                    | 94,076                        | (1,771)      | 209,757      |
| Property and equipment, at cost, net                        | 10,188    | 42,096                    | 1,220                         | 0            | 53,504       |
| Goodwill  | 60,620    | 5,193                     | 208                           | 0            | 66,021       |
| Franchise rights and other<br>identifiable intangibles, net | 11,488    | 3,488                     | 2,937                         | 0            | 17,913       |
| Receivable – marketing and<br>reservation fees              | 54,040    | 0                         | 0                             | 0            | 54,040       |
| Investment in and advances to<br>affiliates                 | 278,794   | 213,423                   | 4,992                         | (497,209)    | 0            |
| Investments, employee benefit<br>plans, at fair value       | 0         | 22,017                    | 0                             | 0            | 22,017       |
| Deferred income taxes                                       | 1,817     | 19,751                    | 12                            | 0            | 21,580       |
| Other assets  | 10,230    | 7,528                     | 5,331                         | 0            | 23,089       |
| Total assets  | \$527,269 | \$330,856                 | \$108,776                     | \$(498,980)  | \$467,921    |
| <b>LIABILITIES AND<br/>SHAREHOLDERS' DEFICIT</b>            |           |                           |                               |              |              |
| Accounts payable  | \$11,639  | \$28,616                  | \$4,274                       | \$0          | \$44,529     |
| Accrued expenses  | 14,886    | 20,744                    | 1,455                         | 0            | 37,085       |
| Deferred revenue  | 20,317    | 55,406                    | 920                           | 0            | 76,643       |
| Current portion of long-term debt                           | 0         | 671                       | 20                            | 0            | 691          |
| Income taxes payable  | 20,154    | 0                         | 1,092                         | (1,117)      | 20,129       |
| Other current liabilities                                   | 0         | 3,374                     | 0                             | (654)        | 2,720        |
| Total current liabilities                                   | 66,996    | 108,811                   | 7,761                         | (1,771)      | 181,797      |
| Long-term debt  | 249,427   | 2,811                     | 82                            | 0            | 252,320      |
| Deferred compensation &<br>retirement plan obligations      | 0         | 33,812                    | 6                             | 0            | 33,818       |
| Advances from affiliates                                    | 218,768   | 471                       | 12,779                        | (232,018)    | 0            |
| Other liabilities   | 6,519     | 7,876                     | 32                            | 0            | 14,427       |
| Total liabilities   | 541,710   | 153,781                   | 20,660                        | (233,789)    | 482,362      |
| Total shareholders' (deficit) equity                        | (14,441)  | ) 177,075                 | 88,116                        | (265,191)    | ) (14,441)   |
| Total liabilities and shareholders'<br>deficit              | \$527,269 | \$330,856                 | \$108,776                     | \$(498,980)  | \$467,921    |

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Balance Sheet  
As of December 31, 2010  
(In Thousands)

|   | Parent    | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|-----------|---------------------------|-------------------------------|--------------|--------------|
| <b>ASSETS</b>   |           |                           |                               |              |              |
| Cash and cash equivalents                                   | \$4,849   | \$18,659                  | \$67,751                      | \$0          | \$91,259     |
| Receivables   | 40,160    | 2,055                     | 5,423                         | 0            | 47,638       |
| Other current assets  | 5,193     | 19,616                    | 6,444                         | (6,568)      | 24,685       |
| Total current assets  | 50,202    | 40,330                    | 79,618                        | (6,568)      | 163,582      |
| Property and equipment, at cost, net                        | 11,586    | 42,678                    | 1,398                         | 0            | 55,662       |
| Goodwill  | 60,620    | 5,193                     | 228                           | 0            | 66,041       |
| Franchise rights and other<br>identifiable intangibles, net | 13,315    | 3,953                     | 3,557                         | 0            | 20,825       |
| Receivable, marketing and<br>reservation fees               | 42,507    | 0                         | 0                             | 0            | 42,507       |
| Investments, employee benefit<br>plans, at fair value       | 0         | 23,365                    | 0                             | 0            | 23,365       |
| Investment in and advances to<br>affiliates                 | 251,245   | 186,045                   | 7,338                         | (444,628)    | 0            |
| Deferred income taxes                                       | 4,560     | 19,745                    | 130                           | 0            | 24,435       |
| Other assets  | 7,339     | 7,366                     | 600                           | 0            | 15,305       |
| Total assets  | \$441,374 | \$328,675                 | \$92,869                      | \$(451,196)  | \$411,722    |
| <b>LIABILITIES AND<br/>SHAREHOLDERS' DEFICIT</b>            |           |                           |                               |              |              |
| Accounts payable  | \$5,700   | \$31,475                  | \$3,993                       | \$0          | \$41,168     |
| Accrued expenses  | 19,257    | 26,890                    | 1,671                         | 0            | 47,818       |
| Deferred revenue  | 14,070    | 52,256                    | 996                           | 0            | 67,322       |
| Current portion of long-term debt                           | 0         | 403                       | 17                            | 0            | 420          |
| Other current liabilities                                   | 0         | 3,206                     | 0                             | (654)        | 2,552        |
| Revolving credit facility                                   | 200       | 0                         | 0                             | 0            | 200          |
| Income taxes payable  | 9,395     | 0                         | 2,297                         | (5,914)      | 5,778        |
| Total current liabilities                                   | 48,622    | 114,230                   | 8,974                         | (6,568)      | 165,258      |
| Long-term debt  | 249,379   | 2,137                     | 38                            | 0            | 251,554      |
| Deferred compensation &<br>retirement plan obligations      | 0         | 35,707                    | 0                             | 0            | 35,707       |
| Advances from affiliates                                    | 192,077   | 1,097                     | 10,137                        | (203,311)    | 0            |
| Other liabilities   | 9,367     | 7,880                     | 27                            | 0            | 17,274       |
| Total liabilities   | 499,445   | 161,051                   | 19,176                        | (209,879)    | 469,793      |
| Total shareholders' (deficit) equity                        | (58,071)  | 167,624                   | 73,693                        | (241,317)    | (58,071)     |
| Total liabilities and shareholders'<br>deficit              | \$441,374 | \$328,675                 | \$92,869                      | \$(451,196)  | \$411,722    |

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Cash Flows  
For the Nine Months ended September 30, 2011  
(Unaudited, in thousands)

|  | Parent   | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|----------|---------------------------|-------------------------------|--------------|--------------|
| Net cash provided (used) from operating activities                   | \$96,333 | \$(10,502                 | ) \$20,062                    | \$0          | \$105,893    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                         |          |                           |                               |              |              |
| Investment in property and equipment                                 | (2,460   | ) (5,395                  | ) (274                        | ) 0          | (8,129       |
| Equity method of investments   | 0        | 0                         | (3,600                        | ) 0          | (3,600       |
| Issuance of notes receivable   | (1,404   | ) (2,916                  | ) 0                           | 0            | (4,320       |
| Collections of notes receivable                                      | 0        | 15                        | 0                             | 0            | 15           |
| Purchases of investments, employee benefit plans                     | 0        | (1,051                    | ) 0                           | 0            | (1,051       |
| Proceeds from sales of investments, employee benefit plans           | 0        | 566                       | 0                             | 0            | 566          |
| Other items, net   | (289     | ) (5                      | ) (18                         | ) 0          | (312         |
| Net cash used in investing activities                                | (4,153   | ) (8,786                  | ) (3,892                      | ) 0          | (16,831      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                         |          |                           |                               |              |              |
| Net borrowings (repayments) pursuant to revolving credit facilities  | (200     | ) 0                       | 0                             | 0            | (200         |
| Repayments of long-term debt   | 0        | (55                       | ) (19                         | ) 0          | (74          |
| Proceeds from the issuance of long-term debt                         | 0        | 0                         | 75                            | 0            | 75           |
| Purchase of treasury stock   | (24,796  | ) 0                       | 0                             | 0            | (24,796      |
| Debt issuance costs  | (2,356   | ) 0                       | 0                             | 0            | (2,356       |
| Excess tax benefits from stock-based compensation                    | 38       | 1,070                     | 0                             | 0            | 1,108        |
| Dividends paid   | (32,923  | ) 0                       | 0                             | 0            | (32,923      |
| Proceeds from exercise of stock options                              | 3,726    | 0                         | 0                             | 0            | 3,726        |
| Net cash provided (used) in financing activities                     | (56,511  | ) 1,015                   | 56                            | 0            | (55,440      |
| Net change in cash and cash equivalents                              | 35,669   | (18,273                   | ) 16,226                      | 0            | 33,622       |
| Effect of foreign exchange rate changes on cash and cash equivalents | 0        | 0                         | (147                          | ) 0          | (147         |
| Cash and cash equivalents at beginning of period                     | 4,849    | 18,659                    | 67,751                        | 0            | 91,259       |



|  |          |       |          |     |           |
|--|----------|-------|----------|-----|-----------|
| Cash and cash equivalents at end of period | \$40,518 | \$386 | \$83,830 | \$0 | \$124,734 |
|--|----------|-------|----------|-----|-----------|

26

---

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Cash Flows  
For the Nine Months Ended September 30, 2010  
(Unaudited, in Thousands)

|  | Parent   | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|----------|---------------------------|-------------------------------|--------------|--------------|
| Net cash provided from operating activities                          | \$79,156 | \$17,001                  | \$12,082                      | \$0          | \$108,239    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                         |          |                           |                               |              |              |
| Investment in property and equipment                                 | (1,409   | ) (15,993                 | ) (271                        | ) 0          | (17,673      |
| Acquisitions, net of cash acquired                                   | 0        | 0                         | (466                          | ) 0          | (466         |
| Issuance of notes receivable   | (7,906   | ) (995                    | ) 0                           | 0            | (8,901       |
| Purchases of investments, employee benefit plans                     |          | (1,396                    | ) 0                           | 0            | (1,396       |
| Proceeds from sales of investments, employee benefit plans           | 0        | 1,018                     | 0                             | 0            | 1,018        |
| Collections of notes receivable                                      | 5,000    | 55                        | 0                             | 0            | 5,055        |
| Other items, net   | (351     | ) 23                      | 32                            | 0            | (296         |
| Net cash used in investing activities                                | (4,666   | ) (17,288                 | ) (705                        | ) 0          | (22,659      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                         |          |                           |                               |              |              |
| Net repayments pursuant to revolving credit facility                 | (271,100 | ) 0                       | 0                             | 0            | (271,100     |
| Proceeds from the issuance of long-term debt                         | 247,733  | 0                         | 0                             | 0            | 247,733      |
| Principal payments of long-term debt                                 | 0        | 0                         | (20                           | ) 0          | (20          |
| Settlement of forward starting interest rate swap agreement          | (8,663   | ) 0                       | 0                             | 0            | (8,663       |
| Purchase of treasury stock   | (11,171  | ) 0                       | 0                             | 0            | (11,171      |
| Dividends paid   | (32,884  | ) 0                       | 0                             | 0            | (32,884      |
| Other items, net   | 512      | 336                       | 0                             | 0            | 848          |
| Net cash provided (used) in financing activities                     | (75,573  | ) 336                     | (20                           | ) 0          | (75,257      |
| Net change in cash and cash equivalents                              | (1,083   | ) 49                      | 11,357                        | 0            | 10,323       |
| Effect of foreign exchange rate changes on cash and cash equivalents | 0        | 0                         | 1,355                         | 0            | 1,355        |
| Cash and cash equivalents at beginning of period                     | 4,281    | 303                       | 63,286                        | 0            | 67,870       |
| Cash and cash equivalents at end of period                           | \$3,198  | \$352                     | \$75,998                      | \$0          | \$79,548     |



Table of Contents

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

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

| (In thousands)                    | Three Months Ended September 30, 2011 |                   |              | Three Months Ended September 30, 2010 |                   |              |
|-----------------------------------|---------------------------------------|-------------------|--------------|---------------------------------------|-------------------|--------------|
|                                   | Franchising                           | Corporate & Other | Consolidated | Franchising                           | Corporate & Other | Consolidated |
| Revenues                          | \$191,085                             | \$1,236           | \$192,321    | \$182,733                             | \$1,068           | \$183,801    |
| Operating income (loss)           | \$71,628                              | \$(9,228)         | \$62,400     | \$64,424                              | \$(9,547)         | \$54,877     |
| Income (loss) before income taxes | \$71,589                              | \$(14,623)        | \$56,966     | \$64,766                              | \$(9,740)         | \$55,026     |
|                                   |                                       |                   |              |                                       |                   |              |
| (In thousands)                    | Nine Months Ended September 30, 2011  |                   |              | Nine Months Ended September 30, 2010  |                   |              |
|                                   | Franchising                           | Corporate & Other | Consolidated | Franchising                           | Corporate & Other | Consolidated |
| Revenues                          | \$469,730                             | \$3,173           | \$472,903    | \$438,026                             | \$3,044           | \$441,070    |
| Operating income (loss)           | \$165,065                             | \$(31,864)        | \$133,201    | \$150,056                             | \$(27,735)        | \$122,321    |
| Income (loss) before income taxes | \$163,560                             | \$(42,557)        | \$121,003    | \$150,946                             | \$(29,250)        | \$121,696    |

## 17. Commitments and Contingencies

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

In June 2008, the Company guaranteed \$1 million of a bank loan funding a franchisee's construction of a Cambria Suites in Columbus, Ohio. During the current quarter, the Company was released from its obligation under the guaranty.

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

In addition to the guarantees noted in the preceding paragraphs, the Company had the following commitments outstanding:

The Company occasionally provides financing to franchisees for property improvements, hotel development efforts and other purposes. At September 30, 2011, the Company had commitments to extend an additional \$5.5 million for these purposes provided certain conditions are met by its franchisees, of which \$2.7 million is expected to be advanced in the next twelve months.

The Company has made commitments to purchase various parcels of real estate to support the development of its brands which include non-refundable deposits. Providing certain conditions are met by the seller, the Company expects to acquire these parcels of land for a total price of approximately \$3.5 million during the year ended December 31, 2011.

Table of Contents

The Company has invested \$3.6 million in a joint venture and has a commitment to invest an additional \$1.4 million which is expected to be funded completely in 2011.

On July 11, 2011, Choice Hotels International Services Corp., a wholly-owned subsidiary of the Company, as tenant, and F.P. Rockville II Limited Partnership (the "Landlord"), as landlord, executed an Office Lease (the "Lease") for office space to which the Company intends to relocate its corporate headquarters. The obligations of the tenant under the Lease have been guaranteed by the Company. The relocation is expected to occur upon construction of an office building, completion of other improvements to the property and building, and satisfaction of other conditions and contingencies set forth in the Lease, including significant conditions related to the scope and timing of the construction, development and permitting of the office building.

The target commencement date for the Lease, which is the date on which the Company will take occupancy of its leased premises for purposes of commencing an interior fit-out of the premises, is December 1, 2012. The target rent commencement date for the Lease, which is the date on which the Company will begin to make rental payments to the Landlord under the Lease, is June 1, 2013. The Lease runs for an initial term of 10 years from the rent commencement date. The leased premises will consist of approximately 138,000 square feet of office space in a to-be constructed office building located in Rockville, Maryland (the "Building"). The Company has an option to extend the Lease beyond the initial term for up to 15 years at then-current fair market rent.

As part of the consideration to the Company for execution of the Lease, the Landlord agreed to provide the Company, during the Lease term, a cash flow participation and preference in the cash flow of the Landlord ("Cash Flow Participation"). The Cash Flow Participation is equal to the greater of: (1) 41.58 times the total rentable square feet of the initial Leased Premises along with any creditable square footage, each determined one-time only as of the Rent Commencement Date, per lease year ("Fixed Payment Amount"), or (2) seven percent (7%) of the annual distributable cash flow (as defined in the Lease) including excess proceeds of sale or refinancing, provided, however, in the event the distributable cash flow is less than the Fixed Payment Amount in any lease year, such shortfall shall accrue and earn interest at six percent (6%) compounded annually to be paid out from the next available cash flow. The Cash Flow Participation shall be payable in arrears not later than July 31 (beginning July 31, 2014) for the preceding Lease year. The Cash Flow Participation shall continue during the Lease and any extension options unless the Landlord no longer owns the Building, the Company is in default under the Lease or the Company no longer leases at least four floors of the building for office use.

No rent is due under the Lease until the rent commencement date, which is currently targeted to occur on or about June 1, 2013. Thereafter, the annual rent is established at a specific minimum amount and is re-set to a new minimum amount each year. Subject to one or more applicable adjustments set forth in the Lease, the Company's minimum annual rent amount, without set-off, deduction for improvement allowances or abatement of any kind, during the initial term ranges from approximately \$5.5 million during the initial year to approximately \$7.6 million during the final year. During the initial 10-year term of the Lease, the minimum expected rent payments by the Company are expected to be approximately \$67 million. In addition, beginning on or about the first anniversary of the rent commencement date, the Company is obligated to pay its proportionate share of increases in the cost of operating, managing and maintaining the Building.

In the ordinary course of business, the Company enters into numerous agreements that contain standard indemnities whereby the Company indemnifies another party for breaches of representations and warranties. Such indemnifications are granted under various agreements, including those governing (i) purchases or sales of assets or businesses, (ii) leases of real estate, (iii) licensing of trademarks, (iv) access to credit facilities, (v) issuances of debt or equity securities, and (vi) certain operating agreements. The indemnifications issued are for the benefit of the (i) buyers in sale agreements and sellers in purchase agreements, (ii) landlords in lease contracts, (iii) franchisees in licensing agreements, (iv) financial institutions in credit facility arrangements, (v) underwriters in debt or equity security issuances and (vi) parties under certain operating agreements. In addition, these parties are also generally indemnified against any third party claim resulting from the transaction that is contemplated in the underlying agreement. While some of these indemnities extend only for the duration of the underlying agreement, many survive

the expiration of the term of the agreement or extend into perpetuity (unless subject to a legal statute of limitations). There are no specific limitations on the maximum potential amount of future payments that the Company could be required to make under these indemnities, nor is the Company able to develop an estimate of the maximum potential amount of future payments to be made under these indemnifications as the triggering events are not subject to predictability. With respect to certain of the aforementioned indemnities, such as indemnifications of landlords against third party claims for the use of real estate property leased by the Company, the Company maintains insurance coverage that mitigates potential liability.

#### 18. Termination Charges

During the nine months ended September 30, 2011, the Company recorded one-time employee termination charges totaling \$1.5 million in SG&A and marketing and reservation expenses. These charges related to salary and benefits continuation payments for employees separating from service with the Company. At September 30, 2011, the Company had approximately

Table of Contents

\$1.0 million of these salary and benefits continuation payments remaining to be remitted. During the nine months ended September 30, 2011, the Company remitted an additional \$3.0 million of termination benefits related to employee termination charges recorded in prior periods and had approximately \$1.0 million of these benefits remaining to be paid. At September 30, 2011 and December 31, 2010, total termination benefits of approximately \$2.0 million and \$4.0 million remained payable and were included in current and non-current liabilities in the Company's consolidated financial statements. The Company expects \$1.6 million of these benefits to be paid in the next twelve months.

19. Subsequent Events

Subsequent to September 30, 2011 through November 9, 2011, the Company repurchased an additional 0.7 million shares of its common stock at a total cost of \$23.7 million under its share repurchase program.

In October 2011, the Company acquired a parcel of real estate for a total cost of \$1.6 million as part of its program to incent franchise development in top markets for certain brands. The Company has acquired this real estate with the intent to resell it to third-party developers for the construction of a hotel operated under one of the Company's brands. In October 2011, the Company entered into a commitment to invest no less than \$3.0 million for 50% ownership in a joint venture, provided certain contingencies are met. The Company expects to fund this commitment within the next three years.

In October 2011, the Company made a \$3.1 million loan commitment, provided certain conditions are met by the borrower, related to the construction of a hotel under one of the Company brands. This commitment is expected to be funded in the next twelve months.



Table of Contents

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

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

Overview

We are a hotel franchisor with franchise agreements representing 6,138 hotels open and 524 hotels under construction, awaiting conversion or approved for development as of September 30, 2011, with 493,500 rooms and 43,829 rooms, respectively, in 49 states, the District of Columbia and over 40 countries and territories outside the United States. Our brand names include Comfort Inn®, Comfort Suites®, Quality®, Clarion®, Ascend Collection®, Sleep Inn®, Econo Lodge®, Rodeway Inn®, MainStay Suites®, Suburban Extended Stay Hotel®, and Cambria Suites® (collectively, the "Choice brands").

The Company conducts its international franchise operations through a combination of direct franchising and master franchising relationships. Master franchising relationships allow the use of our brands by third parties in foreign countries. These relationships are governed by master franchising agreements which generally provide the master franchise with the right to use our brands in a specific geographic region, usually for a fee. As a result of our use of master franchising relationships and international market conditions, total revenues from international franchising operations comprised only 8% of our total revenues for the three and nine months ended September 30, 2011, while representing approximately 19% of hotels open at September 30, 2011.

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

With a focus on hotel franchising instead of ownership, we benefit from the economies of scale inherent in the franchising business. The fee and cost structure of our business provides opportunities to improve operating results by increasing the number of franchised hotel rooms and effective royalty rates of our franchise contracts resulting in increased initial fee and relicensing revenue, ongoing royalty fees and procurement services revenues. In addition, our operating results can also be improved through our company-wide efforts related to improving property level performance. The Company currently estimates that based on its current domestic portfolio of hotels under franchise that a 1% change in revenue per available room ("RevPAR") or rooms under franchise would increase or decrease annual domestic royalty revenues by approximately \$2.2 million and a 1 basis point change in the Company's effective royalty rate would increase or decrease annual domestic royalties by approximately \$0.5 million. In addition to these revenues, we also collect marketing and reservation system fees to support centralized marketing and reservation activities for the franchise system. As a lodging franchisor, the Company currently has relatively low capital expenditure requirements.

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

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

Our Company articulates its mission as a commitment to our franchisees' profitability by providing them with hotel franchises that strive to 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

Table of Contents

owners.

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

**Profitable Growth.** We believe our success is dependent on improving the performance of our hotels, increasing our system size by selling additional hotel franchises, effective royalty rate improvement and maintaining a disciplined cost structure. 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 qualified vendor relationships. We believe that healthy brands, which deliver a compelling return on investment for franchisees, will enable us to sell additional hotel franchises and raise royalty rates. We have established multiple brands that meet the needs of many types of guests, and can be developed at various price points and applied to both new and existing hotels. This ensures that we have brands suitable for creating growth in a variety of market conditions. Improving the performance of the hotels under franchise, growing the system through additional franchise sales and improving franchise agreement pricing while maintaining a disciplined cost structure are the keys to profitable growth.

**Maximizing Financial Returns and Creating Value for Shareholders.** Our capital allocation decisions, including capital structure and uses of capital, are intended to maximize our return on invested capital and create value for our shareholders. We believe our strong and predictable cash flows create a strong financial position that provides us a competitive advantage. Currently, our business does not require significant capital to operate and grow. Therefore, we can maintain a capital structure that generates high financial returns and use our excess cash flow to increase returns to our shareholders.

Historically, we have returned value to our shareholders in two primary ways: share repurchases and dividends. In 1998, we instituted a share repurchase program which has generated substantial value for our shareholders. During the nine months ended September 30, 2011, the Company repurchased approximately 0.7 million shares of its common stock under the share repurchase program at an average price of \$29.79 for a total cost of \$22.2 million. Since the program's inception through September 30, 2011, we have repurchased 43.9 million shares (including 33.0 million prior to the two-for-one stock split effected in October 2005) of common stock at a total cost of \$1.0 billion.

Considering the effect of the two-for-one stock split, the Company has repurchased 76.9 million shares at an average price of \$13.51 per share. We currently believe that our cash flows from operations will support our ability to complete the current board of directors repurchase authorization of approximately 2.8 million shares remaining as of September 30, 2011. Subsequent to September 30, 2011 through November 9, 2011, the Company purchased an additional 0.7 million shares of its common stock under the share repurchase program at an average price of \$32.60 for a total cost of \$23.7 million. Upon completion of the current authorization, our board of directors will evaluate the advisability of additional share repurchases.

During the nine months ended September 30, 2011, we paid cash dividends totaling approximately \$32.9 million and we presently expect to continue to pay dividends in the future, subject to future business performance, economic conditions, changes in income tax regulations and other factors. Based on our present dividend rate and outstanding share count, aggregate annual dividends for 2011 would be approximately \$43.8 million.

Our board of directors previously authorized us to enter into programs which permit us to offer investment, financing and guaranty support to qualified franchisees as well as to acquire and resell real estate to incent franchise development for certain brands in top markets. Recent market conditions have resulted in an increase in opportunities to incentivize development under these programs and as a result over the next several years, we expect to deploy capital opportunistically pursuant to these programs to promote growth of our emerging brands. The amount and timing of the investment in these programs will be dependent on market and other conditions. Our current expectation is that our annual investment in these programs will range from \$20 million to \$40 million. Notwithstanding these programs, the Company expects to continue to return value to its shareholders through a combination of share repurchases and dividends, subject to business performance, economic conditions, changes in income tax regulations and other factors.

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 September 30, 2011, royalty fees revenue totaled \$77.4 million, a 7% increase from the same period in 2010. Operating income totaled \$62.4 million for the three months ended September 30, 2011, a \$7.5 million or 14% increase from the same period in 2010. Net income increased 4% from the same period of the prior year to \$42.3 million. Diluted earnings per share for the quarter ended September 30, 2011 were \$0.71 compared to \$0.68 for the three months ended September 30, 2010. These measurements will continue to be a key management focus in 2011 and beyond.

Table of Contents

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

Liquidity and Capital Resources: Historically, the Company has generated significant cash flows from operations. Since our business does not currently require significant reinvestment of capital, we utilize cash in ways that management believes provide the greatest returns to our shareholders, which include share repurchases and dividends. We believe the Company's cash flow from operations and available financing capacity is sufficient to meet the expected future operating, investing, and financing needs of the business.

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

## Operations Review

## Comparison of Operating Results for the Three-Month Periods Ended September 30, 2011 and 2010

The Company recorded net income of \$42.3 million for the three month period ended September 30, 2011, a 4% increase from the \$40.5 million for the quarter ended September 30, 2010. The increase in net income for the three months ended September 30, 2011, is primarily attributable to the \$7.5 million or 14% increase in operating income offset by a \$5.6 million increase in other income and expenses, net. The increase in other income and expenses, net is primarily due to a \$1.4 million increase in interest expense due to higher effective borrowing rates on the fixed rate long-term debt issued on August 25, 2010 and a \$4.2 million increase in other losses primarily due to a \$2.6 million decline in fair value of the investments held in the Company's non-qualified benefit plans compared to a \$1.5 million appreciation in the fair value of these investments in the prior year period.

Summarized financial results for the three months ended September 30, 2011 and 2010 are as follows:

| (in thousands, except per share amounts)  | 2011     | 2010     |
|---|----------|----------|
| <b>REVENUES:</b>                          |          |          |
| Royalty fees                              | \$77,355 | \$72,565 |
| Initial franchise and relicensing fees    | 3,469    | 1,970    |
| Procurement services                      | 3,984    | 3,756    |
| Marketing and reservation                 | 104,393  | 102,867  |
| Hotel operations                          | 1,236    | 1,068    |
| Other                                     | 1,884    | 1,575    |
| Total revenues                            | 192,321  | 183,801  |
| <b>OPERATING EXPENSES:</b>                |          |          |
| Selling, general and administrative       | 22,555   | 23,156   |
| Depreciation and amortization             | 2,073    | 2,078    |
| Marketing and reservation                 | 104,393  | 102,867  |
| Hotel operations                          | 900      | 823      |
| Total operating expenses                  | 129,921  | 128,924  |
| Operating income                          | 62,400   | 54,877   |
| <b>OTHER INCOME AND EXPENSES, NET:</b>    |          |          |
| Interest expense                          | 3,228    | 1,864    |
| Interest income                           | (506)    | (161)    |
| Other (gains) and losses                  | 2,673    | (1,510)  |
| Equity in net (income) loss of affiliates | 39       | (342)    |
| Total other expenses, net                 | 5,434    | (149)    |
| Income before income taxes                | 56,966   | 55,026   |
| Income taxes                              | 14,664   | 14,532   |
| Net income                                | \$42,302 | \$40,494 |
| Diluted earnings per share                | \$0.71   | \$0.68   |

The Company utilizes certain measures such as adjusted net income, adjusted diluted EPS, adjusted selling, general and administrative (“SG&A”) expense, adjusted operating income and franchising revenues which do not conform to

generally accepted accounting principles in the United States (“GAAP”) when analyzing and discussing its results with the investment community. This information should not be considered as an alternative to any measure of performance as promulgated under GAAP, such as net income, diluted EPS, SG&A, operating income and total revenues. The Company's calculation of these

Table of Contents

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

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

**Calculation of Franchising Revenues**

|   | Three Months Ended September 30,<br>(\$ amounts in thousands) |            |
|---|---|------------|
|   | 2011  | 2010       |
| Franchising Revenues:                     |   |            |
| Total Revenues                            | \$ 192,321  | \$ 183,801 |
| Adjustments:                              |   |            |
| Marketing and reservation system revenues | (104,393  | ) (102,867 |
| Hotel operations                          | (1,236  | ) (1,068   |
| Franchising Revenues                      | \$ 86,692   | \$ 79,866  |

**Adjusted Net Income, Adjusted Diluted EPS, Adjusted SG&A and Adjusted Operating Income:** We also use adjusted net income, adjusted diluted EPS, adjusted SG&A and adjusted operating income all of which exclude employee termination benefits for the three months ended September 30, 2011 and 2010. The Company utilizes these non-GAAP measures to enable investors to perform meaningful comparisons of past, present and future operating results and as a means to emphasize the results of on-going operations.

**Calculation of Adjusted Operating Income**

|                               | Three Months Ended September 30,<br>(\$ amounts in thousands) |           |
|-------------------------------|---|-----------|
|                               | 2011  | 2010      |
| Operating Income              | \$ 62,400   | \$ 54,877 |
| Adjustments:                  |   |           |
| Employee termination benefits | 408   | 263       |
| Adjusted Operating Income     | \$ 62,808   | \$ 55,140 |

Table of Contents

## Calculation of Adjusted SG&amp;A

|                               | Three Months Ended September 30,<br>(\$ amounts in thousands) |          |
|-------------------------------|---|----------|
|                               | 2011  | 2010     |
| SG&A                          | \$22,555  | \$23,156 |
| Adjustments:                  |   |          |
| Employee termination benefits | (408  | ) (263   |
| Adjusted SG&A                 | \$22,147  | \$22,893 |

## Calculation of Adjusted Net Income and Adjusted Diluted EPS

|   | Three Months Ended September 30,<br>(In thousands, except per share amounts) |           |
|---|--|-----------|
|   | 2011   | 2010      |
| Net Income                                    | \$ 42,302  | \$ 40,494 |
| Adjustments, net of tax:                      |  |           |
| Employee termination benefits                 | 257  | 165       |
| Adjusted Net Income                           | \$ 42,559  | \$ 40,659 |
| Weighted average shares outstanding – diluted | 59,807   | 59,658    |
| Diluted EPS                                   | \$ 0.71  | \$ 0.68   |
| Adjustments:                                  |  |           |
| Employee termination benefits                 | —  | —         |
| Adjusted Diluted EPS                          | \$ 0.71  | \$ 0.68   |

The Company recorded adjusted net income of \$42.6 million for the three months ended September 30, 2011, a \$1.9 million increase compared to an adjusted net income of \$40.7 million for the three months ended September 30, 2010. The increase in adjusted net income for the three months ended September 30, 2011 is primarily due to a \$7.7 million increase in adjusted operating income partially offset by a \$4.1 million increase in investment losses due to the decline in the fair value of investments held in the Company's non-qualified benefit plans compared to an increase in fair value of these investments in the prior year period and a \$1.4 million increase in interest expense due to the issuance of \$250 million of senior notes on August 25, 2010 which carry a higher effective interest rate than the Company's revolving credit facility. Adjusted operating income increased \$7.7 million as the Company's franchising revenues for the three months ended September 30, 2011 increased \$6.8 million or 9% from the same period of the prior year and adjusted SG&A expenses declined \$0.7 million.

Franchising Revenues: Franchising revenues were \$86.7 million for the three months ended September 30, 2011 compared to \$79.9 million for the three months ended September 30, 2010, an increase of 9%. The increase in franchising revenues is primarily due to 7% increase in royalty revenues and a \$1.5 million increase in initial franchise and relicensing fees.

Domestic royalty fees for the three months ended September 30, 2011 increased \$3.8 million to \$70.2 million from \$66.4 million in the three months ended September 30, 2010, an increase of 6%. The increase in royalties is attributable to a 5.4% increase in RevPAR and a 2 basis point increase in the effective royalty rate of the domestic hotel system from 4.27% to 4.29%. System-wide RevPAR increased due to a combination of a 1.9% increase in average daily rates and a 200 bps increase in occupancy.



Table of Contents

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

|                   | For the Three Months Ended<br>September 30, 2011* |           |           | For the Three Months Ended<br>September 30, 2010* |           |           | Change                   |            |        |   |
|-------------------|---|-----------|-----------|---|-----------|-----------|--------------------------|------------|--------|---|
|                   | Average<br>Daily<br>Rate                          | Occupancy | RevPAR    | Average<br>Daily<br>Rate                          | Occupancy | RevPAR    | Average<br>Daily<br>Rate | Occupancy  | RevPAR |   |
| Comfort Inn       | \$85.05   | 68.6      | % \$58.31 | \$82.46   | 66.7      | % \$54.99 | 3.1                      | % 190 bps  | 6.0    | % |
| Comfort Suites    | 87.23   | 67.8      | % 59.13   | 85.78   | 64.2      | % 55.03   | 1.7                      | % 360 bps  | 7.5    | % |
| Sleep             | 73.15   | 62.9      | % 46.02   | 72.03   | 60.4      | % 43.52   | 1.6                      | % 250 bps  | 5.7    | % |
| Quality           | 72.90   | 59.8      | % 43.60   | 71.76   | 58.3      | % 41.84   | 1.6                      | % 150 bps  | 4.2    | % |
| Clarion           | 78.13   | 55.1      | % 43.01   | 80.18   | 51.5      | % 41.27   | (2.6)                    | )% 360 bps | 4.2    | % |
| Econo Lodge       | 59.32   | 56.4      | % 33.45   | 58.62   | 55.4      | % 32.47   | 1.2                      | % 100 bps  | 3.0    | % |
| Rodeway           | 58.23   | 58.8      | % 34.22   | 57.40   | 56.0      | % 32.15   | 1.4                      | % 280 bps  | 6.4    | % |
| MainStay          | 69.45   | 77.3      | % 53.68   | 68.96   | 72.5      | % 49.98   | 0.7                      | % 480 bps  | 7.4    | % |
| Suburban          | 41.00   | 72.8      | % 29.85   | 40.61   | 67.8      | % 27.52   | 1.0                      | % 500 bps  | 8.5    | % |
| Ascend Collection | 113.61  | 67.3      | % 76.50   | 109.71  | 67.9      | % 74.45   | 3.6                      | % (60) bps | 2.8    | % |
| Total             | \$76.53   | 63.2      | % \$48.39 | \$75.07   | 61.2      | % \$45.92 | 1.9                      | % 200 bps  | 5.4    | % |

Operating statistics represent hotel operations from June through August

The number of domestic rooms on-line declined by 488 rooms to 390,027 as of September 30, 2011 from 390,515 as of September 30, 2010. The total number of domestic hotels on-line increased by 0.4% to 4,969 as of September 30, 2011 from 4,951 as of September 30, 2010.

A summary of domestic hotels and rooms on-line at September 30, 2011 and 2010 by brand is as follows:

|                           | September 30, 2011 |         | September 30, 2010 |         | Variance |         |          |
|---------------------------|--------------------|---------|--------------------|---------|----------|---------|----------|
|                           | Hotels             | Rooms   | Hotels             | Rooms   | Hotels   | Rooms   | %        |
| Comfort Inn               | 1,413              | 110,652 | 1,450              | 113,952 | (37)     | (3,300) | (2.6) %  |
| Comfort Suites            | 616                | 47,667  | 624                | 48,411  | (8)      | (744)   | (1.3) %  |
| Sleep                     | 392                | 28,431  | 394                | 28,714  | (2)      | (283)   | (0.5) %  |
| Quality                   | 1,037              | 90,368  | 990                | 88,831  | 47       | 1,537   | 4.7 %    |
| Clarion                   | 189                | 27,448  | 176                | 25,208  | 13       | 2,240   | 7.4 %    |
| Econo Lodge               | 782                | 48,381  | 774                | 48,022  | 8        | 359     | 1.0 %    |
| Rodeway                   | 378                | 20,820  | 387                | 21,522  | (9)      | (702)   | (2.3) %  |
| MainStay                  | 39                 | 3,027   | 37                 | 2,868   | 2        | 159     | 5.4 %    |
| Suburban                  | 58                 | 6,934   | 63                 | 7,608   | (5)      | (674)   | (7.9) %  |
| Ascend Collection         | 46                 | 4,084   | 34                 | 2,821   | 12       | 1,263   | 35.3 %   |
| Cambria Suites            | 19                 | 2,215   | 22                 | 2,558   | (3)      | (343)   | (13.6) % |
| Total Domestic Franchises | 4,969              | 390,027 | 4,951              | 390,515 | 18       | (488)   | 0.4 %    |

International available rooms increased 1.8% to 103,473 as of September 30, 2011 from 101,637 as of September 30, 2010. The total number of international hotels increased 2.5% from 1,140 as of September 30, 2010 to 1,169 as of September 30, 2011.

As of September 30, 2011, the Company had 430 franchised hotels with 35,114 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 545 hotels and 44,627 rooms at

September 30, 2010. The number of new construction franchised hotels in the Company's domestic pipeline declined 22% to 307 at September 30, 2011 from 394 at September 30, 2010. The number of conversion franchised hotels in the Company's domestic pipeline declined by 28 units or 19% from September 30, 2010 to 123 hotels at September 30, 2011. The Company had an additional 94 franchised hotels with 8,715 rooms under construction, awaiting conversion or approved for development in its international system as of

36

---

Table of Contents

September 30, 2011 compared to 93 hotels and 8,096 rooms at September 30, 2010. 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 September 30, 2011 and 2010 by brand is as follows:

|                   | September 30, 2011 |                  |       | September 30, 2010 |                  |       | Variance   |         |                  |        |       |        |
|-------------------|--------------------|------------------|-------|--------------------|------------------|-------|------------|---------|------------------|--------|-------|--------|
|                   | Units              |                  |       | Units              |                  |       | Conversion |         | New Construction |        | Total |        |
|                   | Conversion         | New Construction | Total | Conversion         | New Construction | Total | Units      | %       | Units            | %      | Units | %      |
| Comfort Inn       | 23                 | 47               | 70    | 35                 | 64               | 99    | (12)       | (34 )%  | (17 )            | (27 )% | (29 ) | (29 )% |
| Comfort Suites    | 1                  | 105              | 106   | 1                  | 126              | 127   | 0          | 0 %     | (21 )            | (17 )% | (21 ) | (17 )% |
| Sleep Inn         | —                  | 62               | 62    | 1                  | 81               | 82    | (1 )       | (100 )% | (19 )            | (23 )% | (20 ) | (24 )% |
| Quality           | 29                 | 5                | 34    | 38                 | 9                | 47    | (9 )       | (24 )%  | (4 )             | (44 )% | (13 ) | (28 )% |
| Clarion           | 10                 | 1                | 11    | 20                 | 4                | 24    | (10)       | (50 )%  | (3 )             | (75 )% | (13 ) | (54 )% |
| Econo Lodge       | 31                 | 1                | 32    | 37                 | 2                | 39    | (6 )       | (16 )%  | (1 )             | (50 )% | (7 )  | (18 )% |
| Rodeway           | 18                 | 1                | 19    | 16                 | 2                | 18    | 2          | 13 %    | (1 )             | (50 )% | 1     | 6 %    |
| MainStay          | 3                  | 28               | 31    | 0                  | 40               | 40    | 3          | NM      | (12 )            | (30 )% | (9 )  | (23 )% |
| Suburban          | 1                  | 20               | 21    | 0                  | 26               | 26    | 1          | NM      | (6 )             | (23 )% | (5 )  | (19 )% |
| Ascend Collection | 7                  | 5                | 12    | 3                  | 5                | 8     | 4          | 133 %   | 0                | 0 %    | 4     | 50 %   |
| Cambria Suites    | —                  | 32               | 32    | 0                  | 35               | 35    | 0          | NM      | (3 )             | (9 )%  | (3 )  | (9 )%  |
| Total             | 123                | 307              | 430   | 151                | 394              | 545   | (28)       | (19 )%  | (87 )            | (22 )% | (115) | (21 )% |

Domestic hotels open and operating increased by 8 hotels during the three months ended September 30, 2011 compared to an net increase of 15 domestic hotels open and operating during the three months ended September 30, 2010. Gross domestic franchise additions declined from 62 for the three months ended September 30, 2010 to 57 for the same period of 2011. New construction hotels represented 5 of the gross domestic additions during three months ended September 30, 2011 compared to 14 hotels in the same period of the prior year. The decline in new construction hotel openings is primarily due to a lack of new hotel construction financing which has resulted in a decline in new executed franchise agreements. Gross domestic additions for conversion hotels during the three months ended September 30, 2011 increased by 4 to 52 hotels from 48 hotels in the same period of the prior year.

Net domestic franchise terminations increased slightly from 47 in the three months ended September 30, 2010 to 49 for the three months ended September 30, 2011.

International royalties increased by \$1.1 million or 18% from \$6.1 million in the third quarter of 2010 to \$7.2 million for the same period of 2011 primarily due to foreign currency fluctuations, global RevPAR increases and an increase in the number of rooms in the international system.

New domestic franchise agreements executed in the three months ended September 30, 2011 totaled 79 representing 6,509 rooms compared to 79 agreements representing 6,943 rooms executed in the third quarter of 2010. During the third quarter of 2011, 14 of the executed agreements were for new construction hotel franchises representing 1,270 rooms compared to 11 contracts representing 917 rooms for the three months ended September 30, 2010. Conversion hotel executed franchise agreements totaled 65 representing 5,239 rooms for the three months ended September 30, 2011 compared to 68 agreements representing 6,026 rooms for the same period a year ago. Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise agreements increased \$1.1 million to \$2.5 million for the three months ended September 30, 2011 from \$1.4 million for the three months ended September 30, 2010. Initial fee revenue increased despite executing the same number of new franchise agreements in both periods due to the decline in the number of franchise agreements that include

incentives. Revenues associated with agreements including incentives are deferred and recognized when the incentive criteria are met or the agreement is terminated, whichever comes first.

Table of Contents

A summary of executed domestic franchise agreements by brand for the three months ended September 30, 2011 and 2010 is as follows:

|                          | For the Three Months Ended<br>September 30, 2011 |            |       | For the Three Months Ended<br>September 30, 2010 |            |       | % Change            |            |         |    |
|--------------------------|--|------------|-------|--|------------|-------|---------------------|------------|---------|----|
|                          | New<br>Construction                              | Conversion | Total | New<br>Construction                              | Conversion | Total | New<br>Construction | Conversion | Total   |    |
| Comfort Inn              | 1  | 10         | 11    | 1  | 9          | 10    | 0                   | % 11       | % 10    | %  |
| Comfort Suites           | 6  | —          | 6     | 5  | —          | 5     | 20                  | % NM       | 20      | %  |
| Sleep                    | 3  | —          | 3     | 1  | —          | 1     | 200                 | % NM       | 200     | %  |
| Quality                  | —  | 14         | 14    | —  | 23         | 23    | NM                  | (39)       | )% (39) | )% |
| Clarion                  | —  | 4          | 4     | —  | 11         | 11    | NM                  | (64)       | )% (64) | )% |
| Econo Lodge              | —  | 18         | 18    | —  | 16         | 16    | NM                  | 13         | % 13    | %  |
| Rodeway                  | —  | 14         | 14    | —  | 7          | 7     | NM                  | 100        | % 100   | %  |
| MainStay                 | —  | —          | —     | 1  | —          | 1     | (100)               | )% NM      | (100)   | )% |
| Suburban                 | —  | 1          | 1     | —  | —          | —     | NM                  | NM         | NM      |    |
| Ascend<br>Collection     | 2  | 4          | 6     | 1  | 2          | 3     | 100                 | % 100      | % 100   | %  |
| Cambria Suites           | 2  | —          | 2     | 2  | —          | 2     | 0                   | % NM       | 0       | %  |
| Total Domestic<br>System | 14   | 65         | 79    | 11   | 68         | 79    | 27                  | % (4)      | )% 0    | %  |

Relicensing fees include fees charged to the new owners of a franchised property whenever an ownership change occurs and the property remains in the franchise system as well as fees required to renew expiring franchise contracts. Relicensing and renewal contracts increased 70% from 23 in the third quarter of 2010 to 39 for the three months ended September 30, 2011. As a result of the increase in contracts, relicensing revenues increased \$0.4 million from \$0.6 million for the three months ended September 30, 2010 to \$1.0 million for the three months ended September 30, 2011. The Company's relicensing activity in 2011 and beyond is dependent on the availability and cost of capital as well as the presence of an active real estate market for hotel transactions.

**Selling, General and Administrative Expenses:** The cost to operate the franchising business is reflected in SG&A on the consolidated statements of income. SG&A expenses were \$22.6 million for the three months ended September 30, 2011, a decline of \$0.6 million or 3% from the three months ended September 30, 2010. Adjusted SG&A costs, which exclude certain items described above, decreased \$0.8 million to \$22.1 million for the three months ended September 30, 2011 from \$22.9 million for the same period of 2010. Adjusted SG&A for the three months ended September 30, 2011 decreased 3% over the same period of the prior year primarily due to bad debt recoveries on impaired development loans and lower compensation expense recognized on deferred compensation arrangements as described in more detail in Other Income and Expenses, Net partially offset by foreign currency fluctuations and higher management incentive plan compensation than the prior year period.

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

Total marketing and reservation system fees were \$104.4 million and \$102.9 million for the three months ended September 30, 2011 and 2010, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$3.4 million and \$3.0 million for the three month periods ended September 30, 2011 and 2010, respectively. Interest expense attributable to marketing and reservation activities was approximately \$1.0 million and \$0.3 million for the three month periods ended September 30, 2011 and 2010, respectively.

As of September 30, 2011 and December 31, 2010, the Company's balance sheet includes a receivable of \$54.0 million and \$42.5 million, respectively from cumulative marketing and reservation expenses incurred in excess of cumulative marketing and reservations system fee revenues earned. These receivables are recorded as an asset in the financial statements as the Company has the contractual authority to require that the franchisees in the system at any given point repay the Company for any deficits related to marketing and reservation activities. The Company's current franchisees are legally obligated to pay any assessment the Company imposes on its franchisees to obtain reimbursement of such deficit regardless of whether those

Table of Contents

constituents continue to generate gross room revenue and whether or not they joined the system following the deficit's occurrence. The Company has no present intention to accelerate repayment of the deficit from current franchisees. Conversely, cumulative marketing and reservation system fees not expended are recorded as a payable in the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements. Our ability to recover these receivables may be adversely impacted by certain factors, including, among others, declines in the ability of our franchisees to generate revenues at properties they franchise from us, lower than expected franchise system growth of certain brands and/or lower than expected international franchise system growth. An extended period of occupancy or room rate declines or a decline in the number of hotel rooms in our franchise system could result in the generation of insufficient funds to recover marketing and reservation advances as well as meet the ongoing marketing and reservation needs of the overall system.

Other Income and Expenses, Net: Other income and expenses, net, increased \$5.5 million to an expense of \$5.4 million for the three months ended September 30, 2011 compared to income of \$0.1 million in the same period of the prior year primarily due to the following items:

Interest expense increased \$1.4 million to \$3.2 million for the three months ended September 30, 2011 from \$1.9 million for the same period of 2010 due to the issuance of the Company's \$250 million senior notes with an effective rate of 6.19% on August 25, 2010. The proceeds were utilized to repay outstanding borrowings under the Company's \$350 million revolving line of credit which had an effective interest rate of approximately 0.7%.

Other gains and losses, net declined from a gain of \$1.5 million for the three months ended September 30, 2010 to a loss of \$2.7 million for the three months ended September 30, 2011 primarily due to fluctuations in the fair value of investments held in the Company's non-qualified employee benefit plans. As discussed in the accompanying critical accounting policies, the Company sponsors two non-qualified retirement and savings plans: the Non-Qualified Plan and the EDCP plan. The fair value of the Non-Qualified Plan investments declined by \$1.2 million during the three months ended September 30, 2011 compared to a gain of \$0.7 million during the three months ended September 30, 2010. The fair value of the Company's investments held in the EDCP plan decreased by \$1.4 million during the three months ended September 30, 2011 compared to an increase in fair value of \$0.8 million during the same period of the prior year.

The Company accounts for the Non-Qualified Plan in accordance with accounting for deferred compensation arrangements when investments are held in a rabbi trust and invested. Therefore, the Company also recognizes compensation expense or benefits in SG&A related to changes in the fair value of investments held in the Non-Qualified Plan, excluding investments in the Company's stock. As a result, during the three months ended September 30, 2011, the Company's SG&A expense was reduced by \$1.3 million due to the change in the fair value of these investments. For the three months ended September 30, 2010, the Company's SG&A expense was increased by \$0.8 million due to the change in the fair value of these investments.

Income taxes. The effective income tax rate was 25.7% compared with 26.4% for the three months ended September 30, 2011 and 2010, respectively.

The effective income tax rate for the three months ended September 30, 2011 was lower than the U.S. federal statutory rate of 35% due to the identification of \$1.7 million of additional federal tax benefits, \$0.4 million of foreign tax credits for open tax years, and an adjustment of \$1.9 million for unrecognized tax positions. The effective income tax rates for the three months ended September 30, 2010 was lower than the U.S. federal statutory rate of 35% primarily due to a \$3.3 million adjustment to our deferred tax assets and the identification of \$1.7 million of additional federal income tax benefits, partially offset by an increase of \$1.6 million related to the identification of unrecognized tax positions. The effective income tax rates for the three months ended September 30, 2011 and 2010 were also impacted by the effect of foreign operations, partially offset by state income taxes.

Net income: Net income for the three months ended September 30, 2011 increased by 4% to \$42.3 million from \$40.5 million in the same period of the prior year. Adjusted net income, as adjusted for certain items described above, increased by \$1.9 million to for the three months ended September 30, 2011 from \$40.7 million for the same period of the prior year.

Diluted EPS: Diluted EPS were \$0.71 and \$0.68 for the three months ended September 30, 2011 and 2010, respectively.



Table of Contents

## Comparison of Operating Results for the Nine-Month Periods Ended September 30, 2011 and 2010

The Company recorded net income of \$85.6 million for the nine months ended September 30, 2011, a \$2.3 million, or 3% increase from the \$83.3 million for the nine months ended September 30, 2010. The increase in net income for the nine months ended September 30, 2011 is primarily attributable to a \$10.9 million or 9% increase in operating income and a decline in the Company's effective income tax rate from 31.6% for the nine months ended September 30, 2010 to 29.2% for the current period. These items were partially offset by a \$11.6 million increase in other income and expenses, net due to a \$6.6 million increase in interest expense due to higher effective borrowing rates on the fixed rate long-term debt issued in the third quarter of 2010, a \$1.8 million decline in the fair value of investments held in the Company's non-qualified benefit plans compared to a \$1.1 million appreciation in the fair value of these investments in the prior year period and the recordation of a \$1.8 million loss on assets held for sale.

Summarized financial results for the nine months ended September 30, 2011 and 2010 are as follows:

| (in thousands, except per share amounts) | 2011      | 2010      |
|--|-----------|-----------|
| <b>REVENUES:</b>                         |           |           |
| Royalty fees                             | \$183,896 | \$171,029 |
| Initial franchise and relicensing fees   | 8,668     | 6,537     |
| Procurement services                     | 13,706    | 13,612    |
| Marketing and reservation                | 258,192   | 242,096   |
| Hotel operations                         | 3,173     | 3,044     |
| Other                                    | 5,268     | 4,752     |
| Total revenues                           | 472,903   | 441,070   |
| <b>OPERATING EXPENSES:</b>               |           |           |
| Selling, general and administrative      | 72,941    | 67,796    |
| Depreciation and amortization            | 5,976     | 6,470     |
| Marketing and reservation                | 258,192   | 242,096   |
| Hotel operations                         | 2,593     | 2,387     |
| Total operating expenses                 | 339,702   | 318,749   |
| Operating income                         | 133,201   | 122,321   |
| <b>OTHER INCOME AND EXPENSES, NET:</b>   |           |           |
| Interest expense                         | 9,719     | 3,160     |
| Interest income                          | (937)     | (356)     |
| Other (gains) and losses                 | 3,678     | (1,289)   |
| Equity in net income of affiliates       | (262)     | (890)     |
| Total other income and expenses, net     | 12,198    | 625       |
| Income before income taxes               | 121,003   | 121,696   |
| Income taxes                             | 35,393    | 38,398    |
| Net income                               | \$85,610  | \$83,298  |
| Diluted earnings per share               | \$1.43    | \$1.40    |

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

Franchising Revenues: The Company utilizes franchising revenues which exclude marketing and reservation system revenues and hotel operations rather than total revenues when analyzing the performance of the business. Marketing and reservation activities are excluded from revenues since the Company is contractually required by its franchise agreements to use these fees collected for marketing and reservation activities; as such, no income or loss to the Company is generated. Cumulative

40

---

Table of Contents

marketing and reservation system fees not expended are recorded as a payable on the Company's financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements. Cumulative marketing and reservation expenditures in excess of fees collected for marketing and reservation activities are recorded as a receivable on the Company's financial statements. Hotel operations are excluded since they do not reflect the most accurate measure of the Company's core franchising business. This non-GAAP measure is a commonly used measure of performance in our industry and facilitates comparisons between the Company and its competitors.

## Calculation of Franchising Revenues

|   | Nine Months Ended September 30,<br>(\$ amounts in thousands) |            |
|---|--|------------|
|   | 2011   | 2010       |
| Franchising Revenues:                     |  |            |
| Total Revenues                            | \$472,903  | \$441,070  |
| Adjustments:                              |  |            |
| Marketing and reservation system revenues | (258,192 )   | (242,096 ) |
| Hotel operations                          | (3,173 )   | (3,044 )   |
| Franchising Revenues                      | \$211,538  | \$195,930  |

Adjusted Net Income, Adjusted Diluted EPS, Adjusted SG&A and Adjusted Operating Income: We also use adjusted net income, adjusted diluted EPS, adjusted SG&A and adjusted operating income which exclude employee termination benefits for the nine months ended September 30, 2011 and 2010. Adjusted net income and adjusted diluted EPS for the nine months ended September 30, 2011 also exclude a \$1.8 million loss on assets held for sale resulting from the Company reducing the carrying amount of a parcel of land held for sale to its estimated fair value. The Company utilizes these non-GAAP measures to enable investors to perform meaningful comparisons of past, present and future operating results and as a means to emphasize the results of on-going operations.

## Calculation of Adjusted Operating Income

|                               | Nine Months Ended September 30,<br>(\$ amounts in thousands) |           |
|-------------------------------|--|-----------|
|                               | 2011   | 2010      |
| Operating Income              | \$133,201  | \$122,321 |
| Adjustments:                  |  |           |
| Employee termination benefits | 825  | 497       |
| Adjusted Operating Income     | \$134,026  | \$122,818 |

## Calculation of Adjusted SG&amp;A

|                               | Nine Months Ended September 30,<br>(\$ amounts in thousands) |          |
|-------------------------------|--|----------|
|                               | 2011   | 2010     |
| SG&A                          | \$72,941   | \$67,796 |
| Adjustments:                  |  |          |
| Employee termination benefits | (825 )   | (497 )   |
| Adjusted SG&A                 | \$72,116   | \$67,299 |



Table of Contents

## Calculation of Adjusted Net Income and Adjusted Diluted EPS

|   | Nine Months Ended September 30,<br>(In thousands, except per share amounts) |           |
|---|---|-----------|
|   | 2011  | 2010      |
| Net Income                                    | \$ 85,610   | \$ 83,298 |
| Adjustments, net of tax:                      |   |           |
| Loss on land held for sale                    | 1,111   | —         |
| Employee termination benefits                 | 519   | 311       |
| Adjusted Net Income                           | \$ 87,240   | \$ 83,609 |
| Weighted average shares outstanding – diluted | 59,805  | 59,646    |
| Diluted EPS                                   | \$ 1.43   | \$ 1.40   |
| Adjustments:                                  |   |           |
| Loss on land held for sale                    | 0.02  | —         |
| Employee termination benefits                 | 0.01  | —         |
| Adjusted Diluted EPS                          | \$ 1.46   | \$ 1.40   |

The Company recorded adjusted net income of \$87.2 million for the nine months ended September 30, 2011 compared to an adjusted net income of \$83.6 million for the nine months ended September 30, 2010. The increase in adjusted net income for the nine months ended September 30, 2011 is primarily attributable to a \$11.2 million increase in adjusted operating income and a lower effective income tax rate. These increases were partially offset by a \$6.6 million increase in interest expense due to the issuance of \$250 million of senior notes in August 2010 which carry a higher effective interest rate than the revolving credit facility in place in 2010 and a \$1.8 million decline in the fair value of investments held in the Company's non-qualified employee benefit plans compared to a \$1.1 million appreciation of these investments during the nine months ended September 30, 2010. Adjusted operating income increased \$11.2 million as the Company's adjusted franchising revenues for the nine months ended September 30, 2011 increased \$15.6 million or 8% from the same period of the prior year partially offset by a \$4.8 million or 7% increase in adjusted SG&A expenses.

Franchising Revenues: Franchising revenues were \$211.5 million for the nine months ended September 30, 2011 compared to \$195.9 million for the nine months ended September 30, 2010. The increase in franchising revenues is primarily due to an 8% increase in royalty fees and a 33% increase in initial franchise and relicensing fees.

Domestic royalty fees for the nine months ended September 30, 2011 increased \$10.0 million to \$164.2 million from \$154.2 million for the nine months ended September 30, 2010, an increase of 6.5%. The increase in royalties is attributable to a combination of factors including a 5.7% increase in RevPAR and an increase in the effective royalty rate of the domestic hotel system from 4.29% to 4.32%. System-wide RevPAR increased due to a combination of a 210 basis point increase in occupancy as well as a 1.6% increase in average daily rates.

Table of Contents

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

|                      | For the Nine Months Ended<br>September 30, 2011* |           |           | For the Nine Months Ended<br>September 30, 2010* |           |           | Change        |           |        |
|----------------------|--|-----------|-----------|--|-----------|-----------|---------------|-----------|--------|
|                      | Average  |           |           | Average  |           |           | Average       |           |        |
|                      | Daily<br>Rate                                    | Occupancy | RevPAR    | Daily<br>Rate                                    | Occupancy | RevPAR    | Daily<br>Rate | Occupancy | RevPAR |
| Comfort Inn          | \$79.24  | 57.0      | % \$45.18 | \$77.16  | 55.4      | % \$42.72 | 2.7%          | 160 bps   | 5.8%   |
| Comfort Suites       | 83.92  | 58.4      | % 49.05   | 82.92  | 55.1      | % 45.72   | 1.2%          | 330 bps   | 7.3%   |
| Sleep                | 69.92  | 53.5      | % 37.39   | 68.94  | 51.8      | % 35.69   | 1.4%          | 170 bps   | 4.8%   |
| Quality              | 67.95  | 49.9      | % 33.90   | 67.30  | 48.0      | % 32.31   | 1.0%          | 190 bps   | 4.9%   |
| Clarion              | 73.76  | 46.7      | % 34.42   | 75.54  | 43.3      | % 32.73   | (2.4)%        | 340 bps   | 5.2%   |
| Econo Lodge          | 54.75  | 47.2      | % 25.83   | 54.26  | 45.7      | % 24.81   | 0.9%          | 150 bps   | 4.1%   |
| Rodeway              | 52.13  | 48.6      | % 25.33   | 51.42  | 46.0      | % 23.64   | 1.4%          | 260 bps   | 7.1%   |
| MainStay             | 66.17  | 67.1      | % 44.38   | 66.03  | 63.8      | % 42.09   | 0.2%          | 330 bps   | 5.4%   |
| Suburban             | 40.24  | 67.7      | % 27.25   | 39.24  | 64.2      | % 25.20   | 2.5%          | 350 bps   | 8.1%   |
| Ascend<br>Collection | 109.82   | 59.9      | % 65.81   | 106.48   | 56.6      | % 60.25   | 3.1%          | 330 bps   | 9.2%   |
| Total                | \$71.78  | 53.3      | % \$38.24 | \$70.64  | 51.2      | % \$36.18 | 1.6%          | 210 bps   | 5.7%   |

\*Operating statistics represent hotel operations from December through August.

Domestic hotels open and operating declined by 24 hotels during the nine months ended September 30, 2011 compared to an increase of 45 domestic hotels open and operating during the nine months ended September 30, 2010. Gross domestic franchise additions decreased from 219 for the nine months ended September 30, 2010 to 174 for the same period in 2011. New construction hotels represented 20 of the gross domestic additions during the nine months ended September 30, 2011 compared to 64 hotels in the same period of the prior year. Gross domestic additions for conversion hotels declined from 155 hotels during the nine months ended September 30, 2010 to 154 hotels during the same period of the current year. The decline in hotel openings is primarily due to new construction hotels as the limited availability of new hotel construction financing has significantly impacted the number of new construction hotel franchise agreements executed as well as the ability of existing projects to obtain financing and commence construction.

The Company expects the number of new franchise additions that will open during 2011 to decline from 327 for the year ended December 31, 2010 to approximately 273 hotels. The decline is expected to be driven by new construction hotels which are projected to decline by 45 hotels from 78 in 2010 to 33 hotels in 2011 due to the impact of the tight credit markets have had on the number of new construction franchise agreements executed in 2009 and 2010 as well as the availability of capital to commence construction on existing projects.

Net domestic franchise terminations increased to 198 for the nine months ended September 30, 2011 from 174 for the same period of the prior year primarily related to the removal of hotels related to non-compliance with the Company's rules, regulations and standards.

International royalties increased \$2.8 million or 17% from \$16.9 million for the nine months ended September 30, 2010 to \$19.7 million for the same period in 2011 primarily due to foreign currency fluctuations, global RevPAR increases and a 1.8% increase in the number of rooms in the international system.

New domestic franchise agreements executed in the nine months ended September 30, 2011 totaled 204 representing 18,236 rooms compared to 196 agreements representing 16,932 rooms executed during the same period of the prior year. During the nine months ended September 30, 2011, 28 of the executed agreements were for new construction hotel franchises, representing 2,489 rooms, compared to 33 contracts, representing 2,735 rooms for the same period a year ago. Conversion hotel franchise executed contracts totaled 176 representing 15,747 rooms for the nine months ended September 30, 2011 compared to 163 agreements representing 14,197 rooms for the same period a year ago.

Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise agreements increased 49% to \$6.4 million for the nine months ended September 30, 2011 from \$4.3 million for the nine months ended September 30, 2010. The increase in revenues primarily reflects a 4% increase in the number of contracts executed, the recognition of revenue during 2011 related to franchise agreements containing developer incentives executed in prior periods and fewer franchise agreements executed in the current year that included incentives compared to the prior year. Revenues associated with agreements including incentives are

43

---

Table of Contents

deferred and recognized when the incentive criteria are met or the agreement is terminated, whichever occurs first.

A summary of executed domestic franchise agreements by brand for the nine months ended September 30, 2011 and 2010 is as follows:

|                          | For the Nine Months Ended<br>September 30, 2011 |            |       | For the Nine Months Ended<br>September 30, 2010 |            |       | % Change            |            |        |    |
|--------------------------|---|------------|-------|---|------------|-------|---------------------|------------|--------|----|
|                          | New<br>Construction                             | Conversion | Total | New<br>Construction                             | Conversion | Total | New<br>Construction | Conversion | Total  |    |
| Comfort Inn              | 6   | 28         | 34    | 4   | 22         | 26    | 50                  | % 27       | % 31   | %  |
| Comfort Suites           | 7   | 4          | 11    | 13  | 1          | 14    | (46                 | )% 300     | % (21  | )% |
| Sleep                    | 6   | 1          | 7     | 3   | —          | 3     | 100                 | % NM       | 133    | %  |
| Quality                  | —   | 49         | 49    | 1   | 54         | 55    | (100                | )% (9      | )% (11 | )% |
| Clarion                  | —   | 12         | 12    | —   | 17         | 17    | NM                  | (29        | )% (29 | )% |
| Econo Lodge              | —   | 36         | 36    | —   | 38         | 38    | NM                  | (5         | )% (5  | )% |
| Rodeway                  | —   | 32         | 32    | 1   | 26         | 27    | (100                | )% 23      | % 19   | %  |
| MainStay                 | 1   | 3          | 4     | 4   | —          | 4     | (75                 | )% NM      | 0      | %  |
| Suburban                 | 2   | 2          | 4     | 1   | —          | 1     | 100                 | % NM       | 300    | %  |
| Ascend<br>Collection     | 2   | 9          | 11    | 1   | 5          | 6     | 100                 | % 80       | % 83   | %  |
| Cambria Suites           | 4   | —          | 4     | 5   | —          | 5     | (20                 | )% NM      | (20    | )% |
| Total Domestic<br>System | 28  | 176        | 204   | 33  | 163        | 196   | (15                 | )% 8       | % 4    | %  |

Relicensing fees include fees charged to the new owners of a franchised property whenever an ownership change occurs and the property remains in the franchise system as well as fees required to renew expiring franchise contracts. Relicensing and renewal contracts increased 25% from 72 during the nine months ending September 30, 2010 to 90 for the same period of 2011. Although the Company increased the number of contracts by 25%, relicensing revenues increased only 1% from \$2.2 million for the nine months ended September 30, 2010 to \$2.3 million for the nine months ended September 30, 2011 primarily due to lower average relicensing fees charged per property. The Company's relicensing activity in 2011 and beyond is dependent on the availability and cost of capital as well as the presence of an active real estate market for hotel transactions.

**Selling, General and Administrative Expenses:** The cost to operate the franchising business is reflected in SG&A on the consolidated statements of income. SG&A expenses were \$72.9 million for the nine months ended September 30, 2011 a \$5.1 million or 8% increase from the nine months ended September 30, 2010. Adjusted SG&A costs, which exclude certain items described above, for the nine months ended September 30, 2011 totaled \$72.1 million compared to adjusted SG&A of \$67.3 million for the same period of the prior year. The \$4.8 million increase in adjusted SG&A was primarily attributable to higher variable franchise sales and management incentive compensation, increased costs related to the Company's annual franchisee convention and foreign currency fluctuations partially offset by lower compensation expense recognized on deferred compensation arrangements as described in more detail in Other Income and Expenses, Net and bad debt recoveries on impaired development loans.

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

Total marketing and reservations revenues were \$258.2 million and \$242.1 million for the nine months ended September 30, 2011 and 2010, respectively. Depreciation and amortization attributable to marketing and reservation



activities was \$10.0 million for the nine months ended September 30, 2011 compared to \$9.1 million for the nine months ended September 30, 2010. Interest expense attributable to marketing and reservation activities was \$3.0 million and \$0.5 million for the nine months ended September 30, 2011 and 2010, respectively.

As of September 30, 2011 and December 31, 2010, the Company's balance sheet includes a receivable of \$54.0 million and \$42.5 million, respectively from cumulative marketing and reservation expenses incurred in excess of cumulative marketing and reservations system fee revenues earned. These receivables are recorded as an asset in the financial statements as the

Table of Contents

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 and whether or not they joined the system following the deficit's occurrence. The Company has no present intention to accelerate repayment of the deficit from current franchisees. Conversely, cumulative marketing and reservation system fees not expended are recorded as a payable in the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

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

Other Income and Expenses, Net: Other income and expenses, net, increased \$11.6 million to an expense of \$12.2 million for the nine months ended September 30, 2011 compared to an expense of \$0.6 million in the same period of the prior year primarily due to the following items.

Interest expense increased from \$3.2 million for nine months ended September 30, 2010 to \$9.7 million for the same period of 2011 due to the issuance of the Company's \$250 million senior notes with an effective rate of 6.19% on August 25, 2010. The proceeds were utilized to repay outstanding borrowings under the Company's \$350 million revolving line of credit which had an effective interest rate of approximately 0.7%.

Other gains and losses increased \$5.0 million from a gain of \$1.3 million for the nine months ended September 30, 2010 to a loss of \$3.7 million in the same period of the current year. The increase in the loss reflects a \$1.8 million loss on assets held for sale recorded in the nine months ended September 30, 2011 resulting from the Company reducing the carrying amount of a parcel of land held for sale to its estimated fair value and a \$1.8 million decline in the fair value of investments held in the Company's non-qualified benefit plans compared to a \$1.1 million appreciation of the fair value of these investments in the same period of the prior year. As discussed in the accompanying critical accounting policies, the Company sponsors two non-qualified retirement and savings plans: the Non-Qualified Plan and the EDCP plan. The fair value of the Non-Qualified Plan investments declined \$0.9 million during the nine months ended September 30, 2011 compared to a \$0.5 million increase in fair value during the same period of 2010. The fair value of the Company's investments held in the EDCP plan declined by \$0.9 million during the nine months ended September 30, 2011 compared to an increase in fair value of \$0.6 million during the same period of the prior year.

The Company accounts for the Non-Qualified Plan in accordance with accounting for deferred compensation arrangements when investments are held in a rabbi trust and invested. Therefore, the Company also recognizes compensation expense or benefits in SG&A related to changes in the fair value of investments held in the Non-Qualified Plan, excluding investments in the Company's stock. As a result, during the nine months ended September 30, 2011, the Company's compensation expense was reduced by \$1.1 million while the Company's compensation expense was increased by \$0.5 million in the nine month period ended September 30, 2010.

Income taxes: The effective income tax rate was 29.2% compared with 31.6% for the nine months ended September 30, 2011 and 2010, respectively.

The effective income tax rate for the nine months ended September 30, 2011 was lower than the U.S. federal statutory rate of 35% primarily due to the identification of \$1.7 of additional federal tax benefits, an adjustment to our current federal taxes payable of \$1.4 million, \$0.4 million of foreign tax credits for open tax years, and \$1.9 million of unrecognized tax positions. The effective income tax rate for the nine months ended September 30, 2010 was lower than the U.S. federal statutory rate of 35% primarily due to a \$3.3 million adjustment to our deferred tax assets and the identification of \$1.7 million of additional federal income tax benefits, partially offset by an increase of \$1.6 million related to the identification of unrecognized tax positions. The effective income tax rates for the nine months ended

September 30, 2011 and 2010 were also impacted by the effect of foreign operations, partially offset by state income taxes.

Net income: Net income for the nine months ended September 30, 2011 increased by \$2.3 million to \$85.6 million from \$83.3 million in the same period of the prior year. Adjusted net income, as adjusted for certain items described above, increased by \$3.6 million for the nine months ended September 30, 2011 to \$87.2 million from \$83.6 million for the same period of the prior year.

Diluted EPS: Diluted EPS were \$1.43 for nine months ended September 30, 2011 compared to \$1.40 for the nine months ended

## Table of Contents

September 30, 2010, respectively. Adjusted diluted EPS, which excludes certain items described above, totaled \$1.46 for the nine months ended September 30, 2011 compared to \$1.40 for the same period of the prior year.

### Liquidity and Capital Resources

#### Operating Activities

During the nine months ended September 30, 2011 and 2010, net cash provided by operating activities totaled \$105.9 million and \$108.2 million, respectively. The decline in cash flows from operating activities primarily reflects the timing of working capital items primarily related to the payment of the Company's management incentive plan compensation, interest payments on the Company's senior notes and cash flows related to the Company's customer loyalty program. These declines were partially offset by lower cash outlays related to the Company's purchase of real estate held for sale to third parties.

Net cash advanced for marketing and reservations activities totaled \$1.5 million and \$2.6 million during the nine months ended September 30, 2011 and 2010, respectively. Cash advances during the nine months ended September 30, 2011 related primarily to planned advertising and promotional cost spending in excess of fees collected and investments in information technology initiatives. Based on the current economic conditions, the Company expects marketing and reservation activities to provide approximately \$2.0 million in operating cash flows in 2011.

#### Investing Activities

Cash utilized for investing activities totaled \$16.8 million and \$22.7 million for the nine months ended September 30, 2011 and 2010, respectively. The decline in cash utilized for investing activities was primarily due to lower capital expenditures than the prior year partially offset by an increase in net financing provided to franchisees and equity method investments entered into during the nine months ended September 30, 2011. During the nine months ended September 30, 2011 and 2010, capital expenditures totaled \$8.1 million and \$17.7 million, respectively. Capital expenditures for 2011 primarily include upgrades of system-wide property and yield management systems, upgrades to information systems infrastructure and the purchase of computer software and equipment.

The Company occasionally provides financing to franchisees for property improvements, hotel development efforts and other purposes. During the nine months ended September 30, 2011 and 2010, the Company advanced \$4.3 million and \$8.9 million, respectively for these purposes. However, during the nine months ended September 30, 2010, the Company collected approximately \$5.1 million of the advances made during the period. At September 30, 2011, the Company had commitments to extend an additional \$5.5 million for these purposes provided certain conditions are met by its franchisees, of which \$2.7 million is expected to be advanced in the next twelve months.

#### Financing Activities

Financing cash flows relate primarily to the Company's borrowings, treasury stock purchases and dividends.

#### Debt

On February 24, 2011, the Company entered into a new \$300 million senior unsecured revolving credit agreement (the "Revolver") with Wells Fargo Bank, National Association, as administrative agent and a syndicate of lenders.

Simultaneously with the closing of the Revolver, the \$350 million unsecured revolving credit agreement dated as of June 2006 (the "Old Revolver") was terminated. The Revolver provides for a \$300 million unsecured revolving credit facility with a final maturity date on February 24, 2016. Up to \$30 million of borrowings under the Revolver may be used for letters of credit and up to \$20 million of borrowings under the Revolver may be used for swing-line loans.

The Revolver is unconditionally guaranteed, jointly and severally, on a senior unsecured basis by all of the Company's subsidiaries that currently guaranty the obligations under the Company's Indenture governing the terms of its 5.70% senior notes due 2020.

The Company may at any time prior to the final maturity date increase the amount of the Revolver by up to an additional \$150 million to the extent that any one or more lenders commit to being a lender for the additional amount and certain other customary conditions are met. The Company may elect to have borrowings under the Revolver bear interest at (i) a base rate plus a margin ranging from 5 to 80 basis points based on the Company's credit rating or (ii) LIBOR plus a margin ranging from 105 to 180 basis points based on the Company's credit rating. In addition, the Revolver requires the Company to pay a quarterly facility fee on the full amount of the commitments under the

Revolver (regardless of usage) ranging from 20 to 45 basis points based upon the credit rating of the Company. The Revolver requires that the Company and its restricted subsidiaries comply with various covenants, including with respect

46

---

## Table of Contents

to restrictions on liens, incurring indebtedness, making investments and effecting mergers and/or asset sales. In addition, the Revolver imposes financial maintenance covenants requiring the Company to maintain a total leverage ratio of not more than 3.5 to 1.0 and interest coverage ratio of at least 3.5 to 1.0. At September 30, 2011, the Company maintained a total leverage ratio of approximately 1.3x and an interest ratio coverage of approximately 11.5x. At September 30, 2011, 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, investments and other permitted uses. As of September 30, 2011, the Company had no outstanding amounts pursuant to the Revolver.

Debt issuance costs incurred in connection with the Revolver totaled \$2.4 million and are being amortized, on a straight-line basis, which is not materially different than the effective interest method, through the maturity of the Revolver. Amortization of these costs is included in interest expense in the accompanying statements of income.

On August 25, 2010, the Company completed a \$250 million senior unsecured note offering ("the Senior Notes") at a discount of \$0.6 million, bearing a coupon of 5.7% with an effective rate of 6.19%. The Senior Notes will mature on August 28, 2020, with interest on the Senior Notes to be paid semi-annually on February 28<sup>th</sup> and August 28<sup>th</sup>. The Company used the net proceeds from the offering, after deducting underwriting discounts and other offering expenses, to repay outstanding borrowings under the Old Revolver and other general corporate purposes. The Company's Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations, by eight 100%-owned domestic subsidiaries.

The Company may redeem the Senior Notes at its option at a redemption price equal to the greater of (a) 100% of the principal amount of the notes to be redeemed and (b) the sum of the present values of the remaining scheduled principal and interest payments from the redemption date to the date of maturity discounted to the redemption date on a semi-annual basis at the Treasury rate, plus 45 basis points.

As a result of the issuance of the Senior Notes in August 2010 and the Revolver in February 2011, the Company's borrowing costs have increased as the Company's Old Revolver carried an interest rate of LIBOR plus approximately 50 basis points which has been lower than the effective rate of the Senior Notes and well as the borrowings under the Revolver.

### Dividends

The Company currently maintains the payment of a quarterly dividend on its common shares outstanding, however, the declaration of future dividends are subject to the discretion of our board of directors. On February 21, 2011, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on April 15, 2011 to shareholders of record as of April 1, 2011. On May 5, 2011, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$11.0 million in the aggregate), which was paid on July 15, 2011 to shareholders of record as of July 1, 2011. On September 16, 2011, the Company's board of directors declared a cash dividend of \$0.185 per share (or approximately \$10.9 million in the aggregate), which was paid on October 14, 2011 to shareholders of record as of October 3, 2011. The Company's quarterly dividend rate declared during the nine months ended September 30, 2011 has remained unchanged from the previous quarterly declarations. We expect that cash dividends will continue to be paid in the future, subject to future business performance, economic conditions, changes in tax regulations and other matters. Based on our present dividend rate and outstanding share count, aggregate annual dividends for 2011 would be approximately \$43.8 million.

### Share Repurchases

During the nine months ended September 30, 2011, the Company repurchased 0.7 million shares of its common stock under the share repurchase program at a total cost of \$22.2 million for an average price of \$29.79 per share. Since the program's inception through September 30, 2011, we have repurchased 43.9 million shares (including 33.0 million prior to the two-for-one stock split effected in October 2005) of common stock at a total cost of \$1.0 billion.

Considering the effect of the two-for-one stock split, the Company has repurchased 76.9 million shares at an average price of \$13.51 per share through September 30, 2011. At September 30, 2011 the Company had approximately 2.8 million shares remaining under the current stock repurchase authorization. Subsequent to September 30, 2011 through November 9, 2011, the Company repurchased an additional 0.7 million shares of its common stock under the

share repurchase program at a total cost of \$23.7 million for an average price of \$32.60 per share. Upon completion of the current authorization, our board of directors will evaluate the advisability of additional share repurchases.

Other items

Our board of directors previously authorized us to enter into programs which permit us to offer financing, investment and

47

---

Table of Contents

guaranty support to qualified franchisees as well as to acquire and resell real estate to incent franchise development for certain brands in top markets. Recent market conditions have resulted in an increase in opportunities to incentivize development under these programs. Over the next several years, we expect to continue to deploy capital opportunistically pursuant to these programs to promote growth of our emerging brands. The amount and timing of the investment in these programs will be dependent on market and other conditions. Our current expectation is that our annual investment in these programs will range from \$20 million to \$40 million. Notwithstanding these programs, the Company expects to continue to return value to its shareholders through a combination of share repurchases and dividends, subject to market and other conditions.

Approximately \$83.8 million of the Company's cash and cash equivalents at September 30, 2011 pertains to undistributed earnings of the Company's consolidated foreign subsidiaries. Since the Company's intent is for such earnings to be reinvested by the foreign subsidiaries, the Company has not provided additional United States income taxes on these amounts. While the Company has no intention to utilize these cash and cash equivalents in its domestic operations, any change to this policy would result in the Company incurring additional United States income taxes on any amounts utilized domestically.

During the nine months ended September 30, 2011, the Company recorded one-time employee termination charges totaling \$1.5 million in SG&A and marketing and reservation expenses. These charges related to salary and benefits continuation payments for employees separating from service with the Company. At September 30, 2011, the Company had approximately \$1.0 million of these salary and benefits continuation payments remaining to be remitted. During the nine months ended September 30, 2011, the Company remitted an additional \$3.0 million of termination benefits related to employee termination charges recorded in prior periods and had approximately \$1.0 million of these benefits remaining to be paid. At September 30, 2011, total termination benefits of approximately \$2.0 million remained to be paid and the Company expects \$1.6 million of these benefits to be paid in the next twelve months. In addition, the Company expects to satisfy approximately \$2.3 million of deferred compensation and retirement plan obligations during the next twelve months.

The following table summarized our contractual obligations as of September 30, 2011:

| Contractual Obligations                    | Payment due by period |                     |           |           |                      |
|--|-----------------------|---------------------|-----------|-----------|----------------------|
|  | Total                 | Less than<br>1 year | 1-3 years | 3-5 years | More than<br>5 years |
| Long-term debt <sup>(1)</sup>              | \$ 378.4              | \$ 14.3             | \$ 28.6   | \$ 28.5   | \$ 307.0             |
| Capital lease obligations <sup>(2)</sup>   | 3.5                   | 0.7                 | 1.4       | 1.4       | 0.0                  |
| Operating lease obligations                | 102.8                 | 8.4                 | 17.7      | 19.3      | 57.4                 |
| Purchase obligations <sup>(3)</sup>        | 9.4                   | 6.2                 | 2.5       | 0.1       | 0.6                  |
| Other long-term liabilities <sup>(4)</sup> | 42.7                  | 0.0                 | 12.0      | 6.2       | 24.5                 |
| Total contractual cash obligations         | \$ 536.8              | \$ 29.6             | \$ 62.2   | \$ 55.5   | \$ 389.5             |

(1) Long-term debt amounts include interest on fixed rate debt obligations.

(2) Capital lease obligations include interest and related maintenance agreements on equipment.

(3) Purchase obligations also include commitments to provide financing under various Company programs.

(4) The total amount of unrecognized tax benefits (inclusive of related interest and penalties) totaled \$5.5 million at September 30, 2011, and is not reflected in the Contractual Obligations table. We have several open tax positions, and it is possible that the amount of the liability of unrecognized tax benefits could change over the next year. While it is possible that one or more of these positions may be resolved in the next year, it is not anticipated that a significant impact to the unrecognized tax benefit balance will occur.



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

## Table of Contents

### Critical Accounting Policies

Our accounting policies comply with principles generally accepted in the United States. We have described below those policies that we believe are critical or require the use of complex judgment or significant estimates in their application. Additional discussion of these policies is included in Note 1 to our consolidated financial statements as of and for the year ended December 31, 2010 included in our Annual Report on Form 10-K.

#### Revenue Recognition.

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

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

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

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

#### Marketing and Reservation Revenues and Expenses.

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

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

Marketing and reservation system 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 and reservation system fee payable or receivable. Under the terms of the franchise agreements, the Company may advance capital as necessary for marketing and reservation activities and recover such advances through future fees. Our current assessment is that the credit risk associated with the marketing and reservation system fees receivable is mitigated due to our contractual right to recover these amounts from a large geographically dispersed group of franchisees. However, our ability to recover these receivables may be adversely impacted by certain factors, including, among others, declines in the ability of our franchisees to generate revenues at properties they franchise from us, lower than expected franchise system growth of certain brands and/or lower than expected international franchise system growth. An extended period of occupancy or room rate declines or a decline in the number of hotel rooms in our franchise system could result in the generation of insufficient funds to recover marketing and reservation advances as well as meet the ongoing marketing and reservation needs of the overall system.

The Company evaluates the receivable for marketing and reservation costs in excess of cumulative marketing and reservation system fees earned on a periodic basis for collectibility. The Company will record an allowance when, based on current information and events, it is probable that we will be unable to collect all amounts due for marketing and reservation activities according to the contractual terms of the franchise agreements. The receivables are considered to be uncollectible if the

## Table of Contents

expected net, undiscounted cash flows from marketing and reservation activities are less than the carrying amount of the asset.

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

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

### Valuation of Intangibles and Long-Lived Assets

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

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

### Loan Loss Reserves

The Company segregates its notes receivable for the purposes of evaluating allowances for credit losses between two categories: Mezzanine and Other Notes Receivable and Forgivable Notes Receivable. The Company utilizes the level of security it has in the various notes receivable as its primary credit quality indicator (i.e. senior, subordinated or unsecured) when determining the appropriate allowances for uncollectible loans within these categories.

### Mezzanine, and Other Notes Receivables

The Company has provided financing to franchisees in support of the development of properties in key markets. The Company expects the owners to repay the loans in accordance with the loan agreements, or earlier as the hotels mature and capital markets permit. The Company estimates the collectibility and records an allowance for loss on its mezzanine and other notes receivable when recording the receivables in the Company's financial statements. These estimates are updated quarterly based on available information.

The Company considers a loan to be impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. The Company measures loan impairment based on the present value of expected future cash flows discounted at the loan's original effective interest rate or the estimated fair value of the collateral. For impaired loans, the Company establishes a specific impairment reserve for the difference between the recorded investment in the loan and the present value of the expected future cash flows or the estimated fair value of the collateral. The Company applies its loan impairment policy individually

to all mezzanine and other notes receivable in the portfolio and does not aggregate loans for the purpose of applying such policy. For impaired loans, the Company recognizes interest income on a cash basis. If it is likely that a loan will not be collected based on financial or other business indicators it is the Company's policy to charge off these loans to SG&A expenses in the accompanying consolidated statements of income in the quarter when it is deemed uncollectible. Recoveries of impaired loans are recorded as a reduction of SG&A expenses in the quarter received.

## Table of Contents

The Company assesses the collectibility of its senior notes receivable by comparing the market value of the underlying assets to the carrying value of the outstanding notes. In addition, the Company evaluates the property's operating performance, the borrower's compliance with the terms of the loan and franchise agreements, and all related personal guarantees that have been provided by the borrower. For subordinated or unsecured receivables, the Company assesses the property's operating performance, the subordinated equity available to the Company, the borrower's compliance with the terms of loan and franchise agreements, and the related personal guarantees that have been provided by the borrower.

The Company considers loans to be past due and in default when payments are not made when due. Although the Company considers loans to be in default if payments are not received on the due date, the Company does not suspend the accrual of interest until those payments are more than 30 days past due. The Company applies payments received for loans on non-accrual status first to interest and then principal. The Company does not resume interest accrual until all delinquent payments are received.

### Forgivable Notes Receivable

From time to time, the Company provides unsecured financing to franchisees for property improvements and other purposes in the form of forgivable promissory notes. The notes bear market interest rates, and are forgiven and amortized over that time period if the franchisee remains in the system in good standing.

Franchisees are not required to repay the forgivable notes provided that the respective hotels remain in the system and in good standing throughout the term of their note. The Company fully reserves all defaulted notes in addition to recording a reserve on the estimated uncollectible portion of the remaining notes. For those notes not in default, the Company calculates an allowance for losses and determines the ultimate collectibility on these forgivable notes based on the historical default rates for those unsecured notes that are not forgiven but are required to be repaid. The Company records bad debt expense in SG&A expenses in the accompanying consolidated statements of income in the quarter when the note is deemed uncollectible. Recoveries are recorded as a reduction of SG&A expenses in the quarter received.

### Stock Compensation.

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

### Income Taxes.

Income taxes are recorded using the asset and liability method of accounting for income taxes. Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. A valuation allowance is provided for deferred tax assets if it is more likely than not such assets will be unrealized. Deferred U.S. income taxes have not been recorded for temporary differences related to investments in certain foreign subsidiaries and corporate affiliates. The temporary differences consist primarily of undistributed earnings that are considered permanently reinvested in operations outside the U.S. If management's intentions change in the future, deferred taxes may need to be provided.

With respect to uncertain income tax positions, a tax liability is recorded in full when management determines that the position does not meet the more likely than not threshold of being sustained on examination. A tax liability may also be recognized for a position that meets the more likely than not threshold, based upon management's assessment of the position's probable settlement value. The Company records interest and penalties on unrecognized tax benefits in the provision for income taxes.

### Pension, Profit Sharing and Incentive Plans

The Company sponsors two non-qualified retirement savings and investment plans for certain employees and senior executives. Employee and Company contributions are maintained in separate irrevocable trusts. Legally, the assets of the trusts remain those of the Company; however, access to the trusts' assets is severely restricted. The trusts' cannot

be revoked by the Company or an acquirer, but the assets are subject to the claims of the Company's general creditors. The participants do not have the right to assign or transfer contractual rights in the trusts. In 2002, the Company adopted the Choice Hotels International, Inc. Executive Deferred Compensation Plan ("EDCP") which became effective January 1, 2003. Under the EDCP, certain executive officers may defer a portion of their salary into an irrevocable trust. Prior to January 1, 2010, participants could elect an investment return of either the annual yield of the

Table of Contents

Moody's Average Corporate Bond Rate Yield Index plus 300 basis points, or a return based on a selection of available diversified investment options. Effective January 1, 2010, the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points is no longer an investment option for salary deferrals made on compensation earned after December 31, 2010. As of September 30, 2011 and December 31, 2010, the Company recorded a deferred compensation liability of \$16.8 million and \$17.6 million, respectively related to these deferrals and credited investment returns. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. Compensation expense recorded in SG&A for the three months ended September 30, 2011 and 2010 were \$16,778 and \$0.3 million respectively. Compensation expense recorded in SG&A for the nine months ended September 30, 2011 and 2010 was \$0.5 million and \$0.7 million, respectively.

The Company has invested the employee salary deferrals in diversified long-term investments which are intended to provide investment returns that partially offset the earnings credited to the participants. The diversified investments held in the trusts totaled \$13.1 million and \$13.6 million as of September 30, 2011 and December 31, 2010, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other gains and losses in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended September 30, 2011 and 2010 of approximately (\$1.4 million) and \$0.8 million, respectively. The Company recorded investments gains (losses) during the nine months ended September 30, 2011 and 2010 totaling (\$0.9 million) and \$0.6 million, respectively.

In 1997, the Company adopted the Choice Hotels International, Inc. Non-Qualified Retirement Savings and Investment Plan ("Non-Qualified Plan"). The Non-Qualified Plan allows certain employees who do not participate in the EDCP to defer a portion of their salary and invest these amounts in a selection of available diversified investment options. As of September 30, 2011 and December 31, 2010, the Company had recorded a deferred compensation liability of \$9.6 million and \$10.6 million, respectively related to these deferrals. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. The net increase (decrease) in compensation expense recorded in SG&A for the three months ended September 30, 2011 and 2010 was (\$1.3 million) and \$0.8 million respectively. The net increase (decrease) in compensation expense recorded in SG&A for the nine months ended September 30, 2011 and September 30, 2010 and was (\$1.1 million) and \$0.5 million, respectively.

The diversified investments held in the trusts were \$9.0 million and \$9.7 million as of September 30, 2011 and December 31, 2010, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other gains and losses in the accompanying statements of income. The Company recorded investment gains (losses) during the three months ended September 30, 2011 and 2010 of approximately (\$1.2 million) and \$0.7 million, respectively. The Company recorded investment losses during the nine months ended September 30, 2011 of \$0.9 million and investment gains of \$0.5 million for the nine months ended September 30, 2010. In addition, the Non-Qualified Plan held shares of the Company's common stock with a market value of \$0.7 million and \$0.9 million at September 30, 2011 and December 31, 2010, respectively, which are recorded as a component of shareholders' deficit.

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

**New Accounting Standards**

See Footnote No. 1 "Recently Adopted Accounting Guidance" of the Notes to our Financial Statements for information related to our adoption of new accounting standards in 2011 and for information on our anticipated adoption of recently issued accounting standards.

**FORWARD-LOOKING STATEMENTS**



Certain matters discussed in this quarterly report constitute forward-looking statements within the meaning of federal securities law. Generally, our use of words such as “expect,” “estimate,” “believe,” “anticipate,” “will,” “forecast,” “plan,” “pro” “assume” or similar words of futurity identify 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 of the Company's revenue, earnings and other financial and operational measures, Company debt levels, payment of stock dividends, and future operations or other matters. We caution you not to place undue reliance on any forward-looking

Table of Contents

statements, which are made as of the date of this quarterly report. Forward-looking statements do not guarantee future performance and involve known and unknown risks, uncertainties and other factors.

Several factors could cause actual results, performance or achievements of the Company to differ materially from those expressed in or contemplated by the forward-looking statements. Such risks include, but are not limited to, changes to general, domestic and foreign economic conditions; operating risks common in the lodging and franchising industries; changes to the desirability of our brands as viewed by hotel operators and customers; changes to the terms or termination of our contracts with franchisees; our ability to keep pace with improvements in technology utilized for reservations systems and other operating systems; fluctuations in the supply and demand for hotels rooms; and our ability to manage effectively our indebtedness, among other factors. These and other risk factors are discussed in detail in Item 1A "Risk Factors" of the Company's Form 10-K for the year ended December 31, 2010, filed with the Securities and Exchange Commission on March 1, 2011. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as may be required by law.

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

The Company is exposed to market risk from changes in interest rates and the impact of fluctuations in foreign currencies on the Company's foreign investments and operations. The Company manages its exposure to these market risks through the monitoring of its available financing alternatives including in certain circumstances the use of derivative financial instruments. We are also subject to risk from changes in debt and equity prices from our non-qualified retirement savings plan investments in debt securities and common stock, which have a carrying value of \$22.0 million and \$23.4 million at September 30, 2011 and December 31, 2010, respectively which we account for as trading securities. The Company will continue to monitor the exposure in these areas and make the appropriate adjustments as market conditions dictate.

At September 30, 2011, the Company had no amounts outstanding under its variable interest rate debt instruments compared to \$0.2 million outstanding at December 31, 2010. The Company expects to refinance its fixed and variable long-term debt obligations prior to their scheduled maturities.

The Company does not presently have any derivative financial instruments.

**ITEM 4. CONTROLS AND PROCEDURES**

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

An evaluation was performed under the supervision and with the participation of the Company's CEO and CFO of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2011.

There has been no change in the Company's internal controls over financial reporting that occurred during the quarter ended September 30, 2011, that materially affected, or is reasonably likely to materially affect the Company's internal controls over financial reporting.

Table of Contents

## PART II. OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

None.

## ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2010, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

## Issuer Purchases of Equity Securities

The following table sets forth purchases and redemptions of Choice Hotels International, Inc. common stock made by the Company during the nine months ended September 30, 2011:

| Month Ending       | Total Number of Shares Purchased or Redeemed | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>(1),(2)</sup> | Maximum Number of Shares that may yet be Purchased Under the Plans or Programs, End of Period |
|--------------------|--|------------------------------|---|---|
| January 31, 2011   | —  | \$—                          | —   | 3,570,460   |
| February 28, 2011  | 50,681                                       | 39.82                        | —   | 3,570,460   |
| March 31, 2011     | 4,614  | 38.86                        | —   | 3,570,460   |
| April 30, 2011     | 355  | 38.23                        | —   | 3,570,460   |
| May 31, 2011       | 8,377  | 37.80                        | —   | 3,570,460   |
| June 30, 2011      | —  | —                            | —   | 3,570,460   |
| July 31, 2011      | 511  | 32.30                        | —   | 3,570,460   |
| August 31, 2011    | —  | —                            | —   | 3,570,460   |
| September 30, 2011 | 746,925                                      | 29.79                        | 744,127   | 2,826,333   |
| Total              | 811,463                                      | \$30.56                      | 744,127   | 2,826,333   |

(1) The Company's share repurchase program was initially approved by the board of directors on June 25, 1998. The program has no fixed dollar amount or expiration date.

(2) During the nine months ended September 30, 2011, the Company redeemed 67,336 shares of common stock from employees to satisfy minimum tax-withholding requirements related to the vesting of restricted stock grants. These redemptions were not part of the board repurchase authorization.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 4. (REMOVED AND RESERVED)

## ITEM 5. OTHER INFORMATION

None.

Table of Contents

ITEM 6. 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(b)        | Amended and Restated Bylaws of Choice Hotels International, Inc.   |
| 10.01*         | Office Lease, dated July 11, 2011, between Choice Hotels International Services Corp., a wholly owned subsidiary of Choice Hotels International Inc., and FP Rockville II Limited Partnership. |
| 10.02(c)       | Non-Competition, Non-Solicitation and Severance Benefit Agreement between the Company and David White, dated August 1, 2011.   |
| 31.1*          | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)  |
| 31.2*          | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)  |
| 32*            | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350   |
| 101.INS*       | XBRL Instance Document   |
| 101.SCH*       | XBRL Taxonomy Extension Schema Document  |
| 101.CAL*       | XBRL Taxonomy Calculation Linkbase Document  |
| 101.DEF*       | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB*       | XBRL Taxonomy Label Linkbase Document  |
| 101.PRE*       | XBRL Taxonomy Presentation Linkbase Document   |

We advise users of this data that pursuant to Rule 406T of Regulation S-T this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

\* 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 30, 1998 (Reg. No. 333-62543).
- (b) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels international, Inc.'s Current Report on Form 8-K filed February 16, 2010.
- (c) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc.'s Current Report on Form 8-K, filed August 4, 2011.



Table of Contents

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CHOICE HOTELS INTERNATIONAL, INC.

November 9, 2011

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

56