

CHOICE HOTELS INTERNATIONAL INC /DE

Form 10-Q

November 07, 2014

Table of Contents

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

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FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2014

OR

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

COMMISSION FILE NO. 001-13393

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CHOICE HOTELS INTERNATIONAL, INC.  
(Exact name of registrant as specified in its charter)

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DELAWARE

(State or other jurisdiction of  
incorporation or organization)

1 CHOICE HOTELS CIRCLE, SUITE 400  
ROCKVILLE, MD 20850

(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)

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

Table of Contents

CLASS	SHARES OUTSTANDING AT SEPTEMBER 30, 2014
Common Stock, Par Value \$0.01 per share	58,182,157

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Table of Contents

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
INDEX

PAGE NO.

PART I. FINANCIAL INFORMATION:

<u>Item 1—Financial Statements (Unaudited)</u>	<u>4</u>
<u>Consolidated Statements of Income - For the three and nine months ended September 30, 2014 and 2013</u>	<u>4</u>
<u>Consolidated Statements of Comprehensive Income - For the three and nine months ended September 30, 2014 and 2013</u>	<u>6</u>
<u>Consolidated Balance Sheets - As of September 30, 2014 and December 31, 2013</u>	<u>7</u>
<u>Consolidated Statements of Cash Flow - For the nine months ended September 30, 2014 and 2013</u>	<u>8</u>
<u>Notes to Consolidated Financial Statements</u>	<u>10</u>
<u>Item 2—Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>41</u>
<u>Item 3—Quantitative and Qualitative Disclosures About Market Risk</u>	<u>64</u>
<u>Item 4—Controls and Procedures</u>	<u>65</u>

PART II. OTHER INFORMATION:

<u>Item 1—Legal Proceedings</u>	<u>66</u>
<u>Item 1A—Risk Factors</u>	<u>66</u>
<u>Item 2—Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>66</u>
<u>Item 3—Defaults Upon Senior Securities</u>	<u>66</u>
<u>Item 4—Mine Safety Disclosures</u>	<u>66</u>
<u>Item 5—Other Information</u>	<u>66</u>
<u>Item 6—Exhibits</u>	<u>67</u>

<u>SIGNATURE</u>	<u>68</u>
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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 September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>REVENUES:</b>				
Royalty fees	\$86,091	\$79,460	\$222,301	\$208,206
Initial franchise and relicensing fees	4,299	4,650	12,761	12,843
Procurement services	5,495	4,708	18,293	16,204
Marketing and reservation	115,653	124,809	309,025	311,204
Other	3,630	3,091	10,188	7,362
Total revenues	215,168	216,718	572,568	555,819
<b>OPERATING EXPENSES:</b>				
Selling, general and administrative	30,236	26,409	88,329	82,808
Depreciation and amortization	2,293	2,272	6,903	6,701
Marketing and reservation	115,653	124,809	309,025	311,204
Total operating expenses	148,182	153,490	404,257	400,713
Operating income	66,986	63,228	168,311	155,106
<b>OTHER INCOME AND EXPENSES, NET:</b>				
Interest expense	10,495	10,757	31,376	32,334
Interest income	(355)	(676)	(1,205)	(1,979)
Other (gains) and losses	375	(703)	(158)	(1,266)
Equity in net (income) loss of affiliates	513	(421)	578	(340)
Total other income and expenses, net	11,028	8,957	30,591	28,749
Income from continuing operations before income taxes	55,958	54,271	137,720	126,357
Income taxes	16,542	15,698	41,556	36,384
Income from continuing operations, net of income taxes	39,416	38,573	96,164	89,973
Income (loss) from discontinued operations, net of income taxes	(51)	143	1,711	293
Net income	\$39,365	\$38,716	\$97,875	\$90,266
<b>Basic earnings per share</b>				
Continuing operations	\$0.67	\$0.66	\$1.65	\$1.54
Discontinued operations	—	—	0.03	—
	\$0.67	\$0.66	\$1.68	\$1.54
<b>Diluted earnings per share</b>				
Continuing operations	\$0.67	\$0.65	\$1.63	\$1.53
Discontinued operations	—	0.01	0.03	—
	\$0.67	\$0.66	\$1.66	\$1.53

Cash dividends declared per share	\$0.185	\$0.185	\$0.555	\$0.555
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4

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Table of Contents

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

5

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Table of Contents

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (UNAUDITED, IN THOUSANDS)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Net income	\$39,365	\$38,716	\$97,875	\$90,266
Other comprehensive income (loss), net of tax:				
Amortization of loss on cash flow hedge	215	215	646	646
Foreign currency translation adjustment	(1,387	) 524	(357	) (1,803
Other comprehensive income (loss), net of tax	(1,172	) 739	289	(1,157
Comprehensive income	\$38,193	\$39,455	\$98,164	\$89,109

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, 2014	December 31, 2013
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$244,392	\$167,795
Receivables (net of allowance for doubtful accounts of \$11,443 and \$12,187, respectively)	109,748	82,385
Deferred income taxes	26,258	26,684
Investments, employee benefit plans, at fair value	211	400
Other current assets	24,817	29,710
Total current assets	405,426	306,974
Property and equipment, at cost, net	58,381	67,852
Goodwill	65,813	65,813
Franchise rights and other identifiable intangibles, net	7,516	9,953
Advances, marketing and reservation activities	—	5,844
Notes receivable, net of allowances	35,045	31,872
Investments, employee benefit plans, at fair value	16,845	15,950
Deferred income taxes	14,498	—
Other assets	60,663	52,164
Total assets	\$664,187	\$556,422
<b>LIABILITIES AND SHAREHOLDERS' DEFICIT</b>		
Current liabilities		
Accounts payable	\$64,110	\$41,663
Accrued expenses	46,781	56,625
Deferred revenue	65,839	61,188
Current portion of long-term debt	11,967	10,088
Deferred compensation and retirement plan obligations	620	2,492
Income taxes payable	10,140	2,282
Total current liabilities	199,457	174,338
Long-term debt	774,756	783,471
Deferred compensation and retirement plan obligations	23,118	22,527
Deferred income taxes	—	5,149
Other liabilities	63,871	23,808
Total liabilities	1,061,202	1,009,293
Commitments and Contingencies		
Common stock, \$0.01 par value, 160,000,000 shares authorized; 95,065,638 shares issued at September 30, 2014 and December 31, 2013 and 58,182,157 and 58,638,863 582 shares outstanding at September 30, 2014 and December 31, 2013, respectively		586
Additional paid-in-capital	123,251	117,768
Accumulated other comprehensive loss	(5,928	) (6,217 )
Treasury stock (36,883,481 and 36,426,775 shares at September 30, 2014 and December 31, 2013, respectively), at cost	(933,180	) (918,031 )
Retained earnings	418,260	353,023
Total shareholders' deficit	(397,015	) (452,871 )
Total liabilities and shareholders' deficit	\$664,187	\$556,422



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

7

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Table of Contents

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOW  
(UNAUDITED, IN THOUSANDS)

	Nine Months Ended September 30,	
	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$97,875	\$90,266
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,903	7,094
Gain on sale of assets	(2,809	) —
Provision for bad debts, net	1,676	2,264
Non-cash stock compensation and other charges	8,093	8,635
Non-cash interest and other (income) loss	1,836	1,057
Deferred income taxes	(19,216	) (351
Dividends received from equity method investments	1,101	1,109
Equity in net (income) loss of affiliates	578	(340
Changes in assets and liabilities:		
Receivables	(30,497	) (26,635
Advances to/from marketing and reservation activities, net	60,187	29,712
Forgivable notes receivable, net	(8,776	) (5,722
Accounts payable	21,845	1,280
Accrued expenses	(11,082	) (22,757
Income taxes payable/receivable	7,981	24,107
Deferred revenue	4,751	(9,686
Other assets	(1,125	) (2,395
Other liabilities	(943	) 8,851
Net cash provided by operating activities	138,378	106,489
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Investment in property and equipment	(11,886	) (27,922
Proceeds from sales of assets	15,612	—
Equity method investments	(14,362	) (3,761
Purchases of investments, employee benefit plans	(1,520	) (1,845
Proceeds from sales of investments, employee benefit plans	966	4,052
Issuance of mezzanine and other notes receivable	(3,340	) —
Collections of mezzanine and other notes receivable	9,832	224
Other items, net	(592	) (578
Net cash used in investing activities	(5,290	) (29,830
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net repayments pursuant to revolving credit facility	—	(27,500
Principal payments on long-term debt	(7,110	) (6,158
Proceeds from the issuance of long-term debt	226	3,360
Purchases of treasury stock	(23,757	) (3,684
Dividends paid	(32,767	) (22,026
Excess tax benefits from stock-based compensation	2,297	1,216
Proceeds from exercise of stock options	4,984	6,677
Net cash used in financing activities	(56,127	) (48,115
Net change in cash and cash equivalents	76,961	28,544

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Effect of foreign exchange rate changes on cash and cash equivalents	(364	) (1,583	)
Cash and cash equivalents at beginning of period	167,795	134,177	
Cash and cash equivalents at end of period	\$244,392	\$161,138	
Supplemental disclosure of cash flow information:			
Cash payments during the period for:			
Income taxes, net of refunds	\$51,600	\$12,990	
Interest	\$40,126	\$42,244	
Non-cash investing and financing activities:			
Dividends declared but not paid	\$10,764	\$10,773	
Issuance of common stock pursuant to share based compensation plans	\$8,173	\$9,695	
Equity method investments	\$2,797	\$—	
Investment in property and equipment acquired in accounts payable	\$890	\$763	

8

---

Table of Contents

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

9

---

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"). These unaudited consolidated financial statements include all adjustments that are necessary, in the opinion of management, to fairly present our financial position and results of operations. Except as otherwise disclosed, all adjustments are of a normal recurring nature.

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 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, 2013 and notes thereto included in the Company's Amended Form 10-K, filed with the SEC on November 3, 2014 (the "10-K"). Interim results are not necessarily indicative of the entire year results. 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.

Discontinued Operations

In the first quarter of 2014, the Company's management approved a plan to dispose of the three Company owned Mainstay Suites hotels. As a result, the Company has reported the operations related to these three hotels as discontinued operations in this Quarterly Report on Form 10-Q. The Company's results of operations for the comparative prior year periods have also been retroactively revised to account for these operations as discontinued. For additional information regarding discontinued operations, see Note 17, Discontinued Operations.

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, 2014 and December 31, 2013, \$8.4 million and \$5.0 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, as of September 30, 2014, the Company maintains cash balances of \$180.6 million in international banks which do not provide deposit insurance.

Recently Adopted Accounting Guidance

In February 2013, the Financial Accounting Standards Board ("FASB") issued ASU No. 2013-04, "Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date" ("ASU 2013-04"). The ASU requires entities to measure obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this guidance is fixed at the reporting date, as the sum of the following: (a) The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and (b) any additional amount the reporting entity expects to pay on behalf of its co-obligors. Required disclosures include a description of the joint-and-several arrangement and the total outstanding amount of the obligation for all joint parties. The ASU permits entities to aggregate disclosures (as opposed to providing separate disclosures for each joint-and-several obligation). ASU 2013-04 was effective for all interim and annual periods beginning after December 15, 2013. The Company adopted this ASU on January 1, 2014 and it did not have a material impact on its financial statements.

In March 2013, the FASB issued ASU No. 2013-05, "Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity" ("ASU 2013-05"). ASU 2013-05 clarifies that when a reporting entity ceases to have a controlling financial interest in a

10

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Table of Contents

subsidiary or group of assets that is a nonprofit activity or a business within a foreign entity, the parent is required to apply the guidance in ASC 830 "Foreign Currency Matters" Subtopic 830-30 to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The provisions of ASU 2013-05 are effective prospectively for reporting periods beginning after December 15, 2013 and the Company adopted this ASU on January 1, 2014. The adoption of this ASU did not have a material impact on the Company's financial statements.

In July 2013, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists" ("ASU 2013-11"). ASU 2013-11 requires an entity to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss ("NOL") carryforward, or similar tax loss or tax credit carryforward, rather than as a liability when (1) the uncertain tax position would reduce the NOL or other carryforward under the tax law of the applicable jurisdiction and (2) the entity intends to use the deferred tax asset for that purpose. The ASU does not require new recurring disclosures. The provisions of ASU 2013-11 are effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Company adopted this ASU on January 1, 2014 and the adoption of this ASU did not have a material impact on its financial statements.

#### Future Adoption of Recently Announced Accounting Guidance

In April 2014, the FASB issued ASU No. 2014-08, "Presentation of Financial Statements and Property, Plant, and Equipment: Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity" ("ASU 2014-08"). ASU 2014-08 changes the definition of a discontinued operation to include only those disposals of components of an entity that represent a strategic shift that has (or will have) a major effect on an entity's operations and financial results. ASU 2014-08 is effective for all disposals (or classifications as held for sale) of components of an entity that occur within annual periods beginning on or after December 15, 2014, and interim periods within those years. The Company is currently evaluating what impact, if any, the adoption of this ASU will have on the presentation of its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue From Contracts with Customers" ("ASU 2014-09"), which impacts virtually all aspects of an entity's revenue recognition. ASU No. 2014-09 supersedes the revenue recognition requirements in Topic 605, Revenue Recognition, as well as most industry-specific guidance, and significantly enhances comparability of revenue recognition practices across entities and industries by providing a principles-based, comprehensive framework for addressing revenue recognition issues. In order for a provider of promised goods or services to recognize as revenue the consideration that it expects to receive in exchange for the promised goods or services, the provider should apply the following five steps: (1) identify the contract with a customer(s); (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when (or as) the entity satisfies a performance obligation. ASU No. 2014-09 also specifies the accounting for some costs to obtain or fulfill a contract with a customer and provides enhanced disclosure requirements. ASU No. 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The guidance permits the retrospective or modified retrospective method when adopting ASU No. 2014-09. The Company is still assessing the impact that ASU No. 2014-09 will have on its financial statements and disclosures.

## 2. Other Current Assets

Other current assets consist of the following:

	September 30, 2014	December 31, 2013
	(in thousands)	
Notes receivable, net of allowances (See Note 3)	\$7,287	\$12,816
Prepaid expenses	14,329	13,746
Other current assets	3,201	3,148

Total	\$24,817	\$29,710
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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

11

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Table of Contents

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 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. For impaired loans, the Company recognizes interest income on a cash basis.

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

Credit Quality Indicator	September 30, 2014 (in thousands)			December 31, 2013 (in thousands)		
	Forgivable Notes Receivable	Mezzanine & Other Notes Receivable	Total	Forgivable Notes Receivable	Mezzanine & Other Notes Receivable	Total
Senior	\$—	\$10,150	\$10,150	\$—	\$18,052	\$18,052
Subordinated	—	14,867	14,867	—	14,152	14,152
Unsecured	25,660	4,071	29,731	20,625	3,405	24,030
Total notes receivable	25,660	29,088	54,748	20,625	35,609	56,234
Allowance for losses on non-impaired loans	1,951	1,570	3,521	1,650	1,607	3,257
Allowance for losses on receivables specifically evaluated for impairment	547	8,348	8,895	—	8,289	8,289
Total loan reserves	2,498	9,918	12,416	1,650	9,896	11,546
Net carrying value	\$23,162	\$19,170	\$42,332	\$18,975	\$25,713	\$44,688
Current portion, net	\$65	\$7,222	\$7,287	\$361	\$12,455	\$12,816
Long-term portion, net	23,097	11,948	35,045	18,614	13,258	31,872
Total	\$23,162	\$19,170	\$42,332	\$18,975	\$25,713	\$44,688

The Company classifies notes receivable due within one year as other current assets in the Company's consolidated balance sheets.

The following table summarizes the activity related to the Company's Forgivable Notes Receivable and Mezzanine and Other Notes Receivable allowance for losses for the nine months ended September 30, 2014:

	Forgivable Notes Receivable (in thousands)	Mezzanine & Other Notes Receivable
Beginning balance	\$1,650	\$9,896
Provisions	1,253	102
Recoveries	(208)	(80)
Write-offs	(217)	—

Other <sup>(1)</sup>	20	—
Ending balance	\$2,498	\$9,918

(1) Consists of default rate assumption changes

12

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Table of Contents

## Forgivable Notes Receivable

As of September 30, 2014 and December 31, 2013, the unamortized balance of the Company's forgivable notes receivable totaled \$25.7 million and \$20.6 million, respectively. The Company recorded an allowance for credit losses on these forgivable notes receivable of \$2.5 million and \$1.7 million at September 30, 2014 and December 31, 2013, respectively. Amortization expense included in the accompanying consolidated statements of income related to the notes for the three months ended September 30, 2014 and 2013 was \$1.2 million and \$1.1 million, respectively. Amortization expense for the nine months ended September 30, 2014 and 2013 was \$3.6 million and \$3.0 million, respectively.

Past due balances of forgivable notes receivable are as follows:

	30-89 days Past Due	> 90 days Past Due	Total Past Due	Current	Total Notes Receivable
(in thousands)					
As of September 30, 2014					
Forgivable Notes	\$—	\$ 1,277	\$ 1,277	\$ 24,383	\$ 25,660
	\$—	\$ 1,277	\$ 1,277	\$ 24,383	\$ 25,660
As of December 31, 2013					
Forgivable Notes	\$—	\$—	\$—	\$ 20,625	\$ 20,625
	\$—	\$—	\$—	\$ 20,625	\$ 20,625

## Mezzanine and Other Notes Receivable

The Company determined that approximately \$11.8 million and \$12.5 million of its mezzanine and other notes receivable were impaired at September 30, 2014 and December 31, 2013, respectively. The Company recorded allowance for credit losses on these impaired loans at September 30, 2014 and December 31, 2013 totaling \$8.3 million and \$8.3 million, respectively, resulting in a carrying value of impaired loans of \$3.4 million and \$4.2 million, respectively. For the nine months ended September 30, 2014 and 2013, the average mezzanine and other notes receivable on non-accrual status was approximately \$12.2 million and \$13.2 million, respectively. The Company recognized approximately \$11 thousand and \$87 thousand of interest income on impaired loans during the three and nine months ended September 30, 2014, respectively, on the cash basis. The Company recognized approximately \$81 thousand and \$0.2 million of interest on impaired loans during the three and nine months ended September 30, 2013. The Company provided loan reserves on non-impaired loans totaling \$1.6 million at both September 30, 2014 and December 31, 2013.

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

	30-89 days Past Due	> 90 days Past Due	Total Past Due	Current	Total Notes Receivable
(in thousands)					
As of September 30, 2014					
Senior	\$—	\$—	\$—	\$ 10,150	\$ 10,150
Subordinated	—	10,986	10,986	3,881	14,867
Unsecured	—	47	47	4,024	4,071
	\$—	\$ 11,033	\$ 11,033	\$ 18,055	\$ 29,088
As of December 31, 2013					
Senior	\$—	\$—	\$—	\$ 18,052	\$ 18,052
Subordinated	—	9,629	9,629	4,523	14,152
Unsecured	—	47	47	3,358	3,405
	\$—	\$ 9,676	\$ 9,676	\$ 25,933	\$ 35,609



Table of Contents

## Loans Acquired with Deteriorated Credit Quality

On December 2, 2011, the Company acquired an \$11.5 million mortgage, held on a franchisee hotel asset, from a financial institution for \$7.9 million. At the time of acquisition, the Company determined that it would be unable to collect all contractually required payments under the original mortgage terms. The contractually required payments receivable, including principal and interest, under the terms of the acquired mortgage totaled \$12.0 million. During the nine months ended September 30, 2014, the borrower repaid the Company an amount equal to its original loan acquisition cost of \$7.9 million and the Company does not expect to receive further payments. At December 31, 2013, the carrying amount of this loan, which is reported under senior mezzanine and other notes receivables, was \$7.9 million and there was no allowance for uncollectible amounts. The Company's accretable yield at acquisition was \$1.8 million or 7.36% and a reconciliation of the accretable yield for the nine months ended September 30, 2014 is as follows:

	Accretable Yield (in thousands)
Beginning balance	\$ 582
Additions	—
Accretion	(143 )
Disposals	(439 )
Reclassifications from nonaccretable yield	—
Ending balance	\$—

## 4. Marketing and Reservation Activities

The Company's franchise agreements require the payment of franchise fees, which include marketing and reservation system fees. The Company is obligated to use the marketing and reservation system revenues it collects from the current franchisees comprising its various hotel brands to provide marketing and reservation services appropriate to support the operation of the overall system. In discharging its obligation to provide sufficient and appropriate marketing and reservation services, the Company has the right to expend funds in an amount reasonably necessary to ensure the provision of such services, whether or not such amount is currently available to the Company for reimbursement. The franchise agreements provide the Company the right to advance monies to the franchise system when the needs of the system surpass the balances currently available. As a result, expenditures by the Company in support of marketing and reservation services in excess of available revenues are deferred and recorded as an asset in the Company's financial statements. Conversely, cumulative marketing and reservation system revenues not expended in the current period are deferred and recorded as a liability in the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements or utilized to reimburse the Company for prior year advances.

Under the terms of these agreements, the Company has the contractually enforceable right to assess and collect from its current franchisees, fees sufficient to pay for the marketing and reservation services the Company has procured for the benefit of the franchise system, including fees to reimburse the Company for past services rendered. The Company has the contractual authority to require that the franchisees in the system at any given point repay any deficits related to marketing and reservation activities. The Company's current franchisees are contractually 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.

At December 31, 2013, the Company incurred marketing and reservation system expenses in excess of cumulative marketing and reservation system fees earned of \$5.8 million. Based on the Company's analysis of projected net cash flows from marketing and reservation activities, the Company concluded that the cumulative advances for marketing and reservation activities recorded as an asset on the balance sheet as of December 31, 2013 were fully recoverable and as a result no reserves were necessary.

At September 30, 2014, cumulative marketing and reservation system fees collected exceeded expenses by \$39.9 million with the excess reflected as an other long-term liabilities in the accompanying consolidated balance sheets. Depreciation and amortization expense attributable to marketing and reservation activities for the three and nine months ended September 30, 2014 was \$4.4 million and \$12.4 million, respectively. Depreciation and amortization expense attributable to marketing and reservation activities for the three and nine months ended September 30, 2013 was \$3.9 million and \$12.0 million, respectively. Interest expense attributable to marketing and reservation activities for the three and nine months ended September 30, 2014

Table of Contents

was \$0.5 million and \$1.5 million, respectively. Interest expense attributable to marketing and reservation activities for the three and nine months ended September 30, 2013 was \$0.9 million and \$2.8 million, respectively.

## 5. Other Assets

Other assets consist of the following:

	September 30, 2014	December 31, 2013
	(in thousands)	
Equity method investments	\$47,703	\$32,257
Deferred financing fees, net	7,763	8,954
Land	4,011	10,097
Other assets	1,186	856
Total	\$60,663	\$52,164

Land represents the Company's purchase of real estate as part of its program to incent franchise development in strategic markets for certain brands. The Company has acquired this real estate with the intent to either resell it to third-party developers for the construction of hotels operated under the Company's brands or contribute the land into joint ventures for the same purpose. The real estate is carried at the lower of its carrying value or its estimated fair value (based on comparable sales).

## Equity Method Investments - Variable Interest Entities

Equity method investments include investments in joint ventures totaling \$44.2 million and \$28.9 million at September 30, 2014 and December 31, 2013, respectively that the Company determined to be variable interest entities ("VIEs"). These investments relate to the Company's program to offer equity support to qualified franchisees to develop and operate Cambria Suites hotels in strategic markets. Based on an analysis of who has the power to direct the activities that most significantly impact these entities performance and who has an obligation to absorb losses of these entities or a right to receive benefits from these entities that could potentially be significant to the entity, the Company determined that it is not the primary beneficiary of any of its VIEs. The Company based its qualitative analysis on its review of the design of the entity, its organizational structure including decision-making ability and the relevant development, operating management and financial agreements. Although the Company is not the primary beneficiary of these VIEs, it does exercise significant influence through its equity ownership and as a result the Company's investment in these entities is accounted for under the equity method. For the three and nine months ended September 30, 2014, the Company recognized losses totaling \$0.8 million and \$0.9 million, respectively from these investments. For the three and nine months ended September 30, 2013, the Company recognized income totaling \$81 thousand and \$9 thousand, respectively, from these investments. The Company's maximum exposure to losses related to its investments in VIEs is limited to its equity investments as well as certain guarantees described in Note 16 "Commitments and Contingencies" of these financial statements.

## 6. Deferred Revenue

Deferred revenue consists of the following:

	September 30, 2014	December 31, 2013
	(in thousands)	
Loyalty programs	\$58,711	\$53,875
Initial, relicensing and franchise fees	4,899	5,354
Procurement service fees	1,419	1,504
Other	810	455

Total	\$65,839	\$61,188
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15

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Table of Contents

## 7. Debt

Debt consists of the following at:

	September 30, 2014	December 31, 2013
	(in thousands)	
\$400 million senior unsecured notes with an effective interest rate of 5.94% at September 30, 2014 and December 31, 2013	\$400,000	\$400,000
\$250 million senior unsecured notes with an effective interest rate of 6.19% less discount of \$0.4 million at September 30, 2014 and December 31, 2013	249,620	249,572
\$350 million senior secured credit facility with an effective interest rate of 2.16% and 2.17% at September 30, 2014 and December 31, 2013, respectively	132,187	138,750
Economic development loans with an effective interest rate of 3.00% at September 30, 2014 and December 31, 2013	3,536	3,360
Capital lease obligations due 2016 with an effective interest rate of 3.18% at September 30, 2014 and December 31, 2013	1,325	1,848
Other notes payable	55	29
Total debt	\$786,723	\$793,559
Less current portion	11,967	10,088
Total long-term debt	\$774,756	\$783,471

## Senior Notes Due 2022

On June 27, 2012, the Company issued unsecured senior notes in the principal amount of \$400 million (the "2012 Senior Notes") at par, bearing a coupon of 5.75% with an effective rate of 5.94%. The 2012 Senior Notes will mature on July 1, 2022, with interest to be paid semi-annually on January 1<sup>st</sup> and July 1<sup>st</sup>. The Company used the net proceeds of this offering, after deducting underwriting discounts and commissions and other offering expenses, together with a portion of the proceeds from a new credit facility, to pay a special cash dividend in 2012 totaling approximately \$600.7 million. The Company's 2012 Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations by certain of the Company's domestic subsidiaries.

## Senior Notes Due 2020

On August 25, 2010, the Company issued unsecured senior notes in the principal amount of \$250 million (the "2010 Senior Notes") at a discount of \$0.6 million, bearing a coupon of 5.7% with an effective rate of 6.19%. The 2010 Senior Notes will mature on August 28, 2020, with interest 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 and for other general corporate purposes. The Company's 2010 Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations by certain of the Company's domestic subsidiaries.

## Revolving Credit Facility

On July 25, 2012, the Company entered into a \$350 million senior secured credit facility, comprised of a \$200 million revolving credit tranche (the "Revolver") and a \$150 million term loan tranche (the "Term Loan") with Deutsche Bank AG New York Branch, as administrative agent, Wells Fargo Bank, National Association, as administrative agent and a syndication of lenders (the "Credit Facility"). The Credit Facility has a final maturity date of July 25, 2016, subject to an optional one-year extension provided certain conditions are met. Up to \$25 million of the borrowings under the Revolver may be used for letters of credit, up to \$10 million of borrowings under the Revolver may be used for swing-line loans and up to \$35 million of borrowings under the Revolver may be used for alternative currency loans. The Term Loan requires quarterly amortization payments (a) during the first two years, in equal installments aggregating 5% of the original principal amount of the Term Loan per year, (b) during the second two years, in equal installments aggregating 7.5% of the original principal amount of the Term Loan per year, and (c) during the one-year extension period (if exercised), equal installments aggregating 10% of the original principal amount of the Term Loan.

The Credit Facility is unconditionally guaranteed, jointly and severally, by certain of the Company's domestic subsidiaries. The subsidiary guarantors currently include all subsidiaries that guarantee the obligations under the Company's Indenture governing the terms of its 2010 and 2012 Senior Notes.

## Table of Contents

The Credit Facility is secured by first priority pledges of (i) 100% of the ownership interests in certain domestic subsidiaries owned by the Company and the guarantors, (ii) 65% of the ownership interests in (a) the top-tier foreign holding company of the Company's foreign subsidiaries, and (b) the domestic subsidiary that owns the top-tier foreign holding company of the Company's foreign subsidiaries and (iii) all presently existing and future domestic franchise agreements (the "Franchise Agreements") between the Company and individual franchisees, but only to the extent that the Franchise Agreements may be pledged without violating any law of the relevant jurisdiction or conflicting with any existing contractual obligation of the Company or the applicable franchisee. At the time that the maximum total leverage ratio is required to be no greater than 4.0 to 1.0 (beginning of year 4 of the Credit Facility), the security interest in the Franchise Agreements will be released.

The Company may at any time prior to the final maturity date increase the amount of the Credit Facility by up to an additional \$100 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. Such additional amounts may take the form of an increased revolver or term loan.

The Company may elect to have borrowings under the Credit Facility bear interest at a rate equal to (i) LIBOR, plus a margin ranging from 200 to 425 basis points based on the Company's total leverage ratio or (ii) a base rate plus a margin ranging from 100 to 325 basis points based on the Company's total leverage ratio.

The Credit Facility requires the Company to pay a fee on the undrawn portion of the Revolver, calculated on the basis of the average daily unused amount of the Revolver multiplied by 0.30% per annum.

The Company may reduce the Revolver commitment and/or prepay the Term Loan in whole or in part at any time without penalty, subject to reimbursement of customary breakage costs, if any. Any Term Loan prepayments made by the Company shall be applied to reduce the scheduled amortization payments in direct order of maturity.

Additionally, the Credit Facility requires that the Company and its restricted subsidiaries comply with various covenants, including with respect to restrictions on liens, incurring indebtedness, making investments, paying dividends or repurchasing stock, and effecting mergers and/or asset sales. With respect to dividends, the Company may not make any payment if there is an existing event of default or if the payment would create an event of default. In addition, if the Company's total leverage ratio exceeds 4.50 to 1.00, the Company is generally restricted from paying aggregate dividends in excess of \$50.0 million during any calendar year.

The Credit Facility also imposes financial maintenance covenants requiring the Company to maintain:

- a total leverage ratio of not more than 5.75 to 1.00 in year 1, 5.00 to 1.00 in year 2, 4.50 to 1.00 in year 3 and 4.00 to 1.00 thereafter,
- a maximum secured leverage ratio of not more than 2.50 to 1.00 in year 1, 2.25 to 1.00 in year 2, 2.00 to 1.00 in year 3 and 1.75 to 1.00 thereafter, and
- a minimum fixed charge coverage ratio of not less than 2.00 to 1.00 in years 1 and 2, 2.25 to 1.00 in year 3 and 2.50 to 1.00 thereafter.

The Credit Facility 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 Credit Facility to be immediately due and payable. At September 30, 2014, the Company was in compliance with all financial covenants under the Credit Facility.

At September 30, 2014, the Company had \$132.2 million under the Term Loan and no amounts outstanding under the Revolver. At December 31, 2013, the Company had \$138.8 million outstanding under the Term Loan and no amounts outstanding under the Revolver.

### Economic Development Loans

The Company entered into economic development agreements with various governmental entities in conjunction with the relocation of its corporate headquarters in April 2013. In accordance with these agreements, the governmental entities agreed to advance approximately \$4.4 million to the Company to offset a portion of the corporate headquarters relocation and tenant improvement costs in consideration of the employment of permanent, full-time employees within the jurisdictions. At September 30, 2014, the Company had been advanced approximately \$3.5 million pursuant to these agreements and expects to receive the remaining \$0.9 million over the next several years, subject to annual appropriations by the governmental entities. These advances bear interest at a rate of 3% per annum.

Repayment of the advances is contingent upon the Company achieving certain performance conditions. Performance conditions are measured annually on December 31<sup>st</sup> and primarily relate to maintaining certain levels of employment within the various jurisdictions. If the Company fails to meet an annual performance condition, the Company may be required to repay a

17

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Table of Contents

portion or all of the advances including accrued interest by April 30<sup>th</sup> following the measurement date. Any outstanding advances at the expiration of the Company's 10 year corporate headquarters lease in 2023 will be forgiven in full. The advances will be included in long-term debt in the Company's consolidated balance sheets until the Company determines that the future performance conditions will be met over the entire term of the agreement and the Company will not be required to repay the advances. The Company accrues interest on the portion of the advances that it expects to repay. The Company was in compliance with all current performance conditions as of September 30, 2014.

## 8. Accumulated Other Comprehensive Income (Loss)

The following represents the changes in accumulated other comprehensive loss, net of tax, by component for the nine months ended September 30, 2014:

	Loss on Cash Flow Hedge (in thousands)	Foreign Currency Items	Total
Beginning balance, December 31, 2013	\$ (5,745 )	\$ (472 )	) \$ (6,217 )
Other comprehensive income (loss) before reclassification	—	(357 )	) (357 )
Amounts reclassified from accumulated other comprehensive income (loss)	646	—	646
Net current period other comprehensive income (loss)	646	(357 )	) 289
Ending balance, September 30, 2014	\$ (5,099 )	\$ (829 )	) \$ (5,928 )

The amounts reclassified from accumulated other comprehensive income (loss) during the three and nine months ended September 30, 2014 were reclassified to the following line items in the Company's Consolidated Statements of Income.

Component	Amount Reclassified from Accumulated Other Comprehensive Income(Loss)		Affected Line Item in the Consolidated Statement of Net Income
	Three Months Ended September 30, 2014 (in thousands)	Nine Months Ended September 30, 2014	
Loss on cash flow hedge			
Interest rate contract	\$ 215	\$ 646	Interest expense
	—	—	Tax (expense) benefit
	\$ 215	\$ 646	Net of tax

## 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, 2009. The Company recorded current and long-term deferred compensation liabilities of \$9.8 million and \$11.3 million, as of

Table of Contents

September 30, 2014 and December 31, 2013, 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 related to the EDCP for the three months ended September 30, 2014 and 2013 was \$48 thousand and \$0.3 million, respectively. Compensation expense recorded in SG&A related to the EDCP for the nine months ended September 30, 2014 and 2013 was \$0.4 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 \$4.4 million and \$4.1 million as of September 30, 2014 and December 31, 2013, respectively, and are recorded at their fair value, based on quoted market prices. At September 30, 2014, the Company expects \$0.2 million of the assets held in the trusts to be distributed to participants during the next twelve months. 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 consolidated statements of income. The Company recorded investment gains (losses) related to the EDCP during the three months ended September 30, 2014 and 2013 of approximately (\$98) thousand and \$165 thousand, respectively. The Company recorded investment gains related to the EDCP during the nine months ended September 30, 2014 and 2013 of approximately \$41 thousand and \$252 thousand, respectively. In addition, the EDCP Plan held shares of the Company's common stock with a market value of \$0.2 million at both September 30, 2014 and December 31, 2013, which were recorded as a component of shareholders' deficit.

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, 2014 and December 31, 2013, the Company had recorded a deferred compensation liability of \$13.9 million and \$13.7 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 related to the Non-Qualified Plan for the three months ended September 30, 2014 and 2013 was \$(0.1) million and \$0.6 million, respectively. The net increase in compensation expense recorded in SG&A related to the Non-Qualified Plan for the nine months ended September 30, 2014 and 2013 was \$0.1 million and \$1.3 million, respectively.

The diversified investments held in the trusts were \$12.6 million and \$12.3 million as of September 30, 2014 and December 31, 2013, 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 consolidated statements of income. The Company recorded investment gains (losses) related to the Non-Qualified Plan during the three months ended September 30, 2014 and 2013 of approximately (\$0.3) million and \$0.5 million, respectively. The Company recorded investment gains related to the Non-Qualified Plan during the nine months ended September 30, 2014 and 2013 of approximately \$0.1 million and \$1.1 million, respectively. In addition, the Non-Qualified Plan held shares of the Company's common stock with a market value of \$1.3 million and \$1.4 million at September 30, 2014 and December 31, 2013, respectively, which are recorded as a component of shareholders' deficit.

Table of Contents

## 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. 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's policy is to recognize transfers in and transfers out of the three levels of the fair value hierarchy as of the end of each quarterly reporting period. There were no transfers between Level 1, 2 and 3 assets during the three and nine months ended September 30, 2014.

As of September 30, 2014 and December 31, 2013, the Company had the following assets measured at fair value on a recurring basis:

	Fair Value Measurements at Reporting Date Using			
	Total (in thousands)	Level 1	Level 2	Level 3
Assets				
As of September 30, 2014				
Money market funds, included in cash and cash equivalents	\$50,001	\$—	\$50,001	\$—
Mutual funds <sup>(1)</sup>	15,641	15,641	—	—
Money market funds <sup>(1)</sup>	1,415	—	1,415	—
	\$67,057	\$15,641	\$51,416	\$—
As of December 31, 2013				
Money market funds, included in cash and cash equivalents	\$50,001	\$—	\$50,001	\$—
Mutual funds <sup>(1)</sup>	14,564	14,564	—	—
Money market funds <sup>(1)</sup>	1,786	—	1,786	—
	\$66,351	\$14,564	\$51,787	\$—

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

Other Financial Instruments

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 Credit Facility adjust frequently based on current market rates; accordingly its carrying amount approximates fair value. The Company estimates the fair value of notes receivable which approximate their carrying value, utilizing an analysis of future cash flows and credit worthiness for similar types of arrangements. Based upon the availability of market data, these notes receivables have been classified as Level 3 fair value measures. The primary sensitivity in these calculations is based on the selection of appropriate interest and discount rates. For further information on the notes receivables, which are included in both other current assets and notes receivable in the consolidated balance sheets, see Note 3.



The fair value of the Company's 2010 and 2012 Senior Notes are classified as Level 2 as the significant inputs are observable in an active market. At September 30, 2014 and December 31, 2013, the 2010 Senior Notes had an approximate fair value of

20

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Table of Contents

\$271.9 million and \$261.3 million, respectively. At September 30, 2014 and December 31, 2013, the 2012 Senior Notes had an approximate fair value of \$427.0 million and \$416.0 million, respectively.

Fair values estimated are made at a specific point in time, are subjective in nature and involve uncertainties and matters of significant judgment. Settlement of such fair value amounts may not be possible and may not be a prudent management decision.

#### 11. Income Taxes

The effective income tax rates for income from continuing operations were 29.6% and 28.9% for the three months ended September 30, 2014 and 2013, respectively. The effective income tax rates for income from continuing operations were 30.2% and 28.8% for the nine months ended September 30, 2014 and 2013, respectively. The effective income tax rate for discontinued operations was 37.1% for the three and nine months ended September 30, 2014 and 2013.

The effective income tax rate for continuing operations for the three and nine months ended September 30, 2014 and 2013 were lower than the U.S federal income tax rate of 35% due to the recurring impact of foreign operations, partially offset by state income taxes. The effective income tax rates for the three and nine months ended September 30, 2014 were further reduced by the settlement of unrecognized tax positions. Additionally, the effective income tax rate for the nine months ended September 30, 2013 was also reduced by settlements of unrecognized tax positions and legislation retroactively extending the U.S. controlled foreign corporation look-through rules.

#### 12. Share-Based Compensation and Capital Stock

##### Stock Options

No stock options were granted during the three month periods ended September 30, 2014 and 2013. The Company granted 0.7 million and 0.2 million options to certain employees of the Company at a fair value of \$5.7 million and \$1.7 million for the nine months ended September 30, 2014 and 2013, 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:

	2014 Grants	2013 Grants	
Risk-free interest rate	1.56	% 0.73	%
Expected volatility	25.01	% 38.14	%
Expected life of stock option	4.5 years	4.5 years	
Dividend yield	1.62	% 2.01	%
Requisite service period	4 years	4 years	
Contractual life	7 years	7 years	
Weighted average fair value of options granted	\$8.82	\$9.89	

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, 2014 was \$41.4 million and \$32.1 million, respectively. The total intrinsic value of options exercised during the three months ended September 30, 2014 and 2013 was approximately \$3.1 million and \$0.5 million, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2014 and 2013 was approximately \$4.4 million and \$3.4 million, respectively.

The Company received approximately \$3.4 million and \$0.7 million in proceeds from the exercise of 131,808 and 29,008 employee stock options during the three months ended September 30, 2014 and 2013, respectively. The

Company received approximately \$5.0 million and \$6.7 million in proceeds from the exercise of 190,557 and 263,073 employee stock options during the nine month periods ended September 30, 2014 and 2013, 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,	
	2014	2013	2014	2013
Restricted share grants	2,853	7,646	149,908	223,045
Weighted average grant date fair value per share	\$52.59	\$39.24	\$46.58	\$37.65
Aggregate grant date fair value (\$000)	\$150	\$300	\$6,983	\$8,397
Restricted shares forfeited	13,922	25	18,218	27,953
Vesting service period of shares granted	36 months	36 months	12 - 48 months	12 - 48 months
Grant date fair value of shares vested (\$000)	\$2,076	\$94	\$10,280	\$8,569

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 non-employee 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 fair value is measured by the market price of the Company's common stock on the date of the grant. 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 generally between 0% and 200% of the initial target. If minimum performance targets are not attained then no awards will vest under the terms of the various PVRSU agreements. Compensation expense related to these awards is recognized over the requisite service period based on the Company's estimate of the achievement of the various performance targets. The Company has currently estimated that between 0% and 150% of the various award targets will be achieved. Compensation expense is recognized ratably over the requisite service period only on those PVRSUs that ultimately vest.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Performance vested restricted stock units granted at target	—	—	24,678	58,902
Weighted average grant date fair value per share	\$—	\$—	\$45.59	\$36.76
Aggregate grant date fair value (\$000)	\$—	\$—	\$1,125	\$2,165
Stock units forfeited	3,900	—	3,900	—
Requisite service period	—	—	36 months	22-36 months

During the three months ended September 30, 2014 and 2013, no PVRSU grants vested. During the nine months ended September 30, 2014, a total of 28,886 PVRSU grants vested at a fair value of \$1.4 million. These PVRSU grants were initially granted at a target of 18,635 units. However, since the Company achieved 155% of the targeted performance conditions contained in the stock awards granted in prior periods, an additional 10,251 shares were earned and issued.

During the nine months ended September 30, 2013, a total of 39,816 PVRSU grants vested at a fair value of \$1.3 million. These PVRSU grants were initially granted at a target of 30,624 units. However, since the Company achieved 130% of the targeted performance conditions contained in the stock awards granted in prior periods, an additional 9,192 shares were earned and issued.



Table of Contents

A summary of stock-based award activity as of September 30, 2014 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, 2014	1,661,952	\$26.44		563,345	\$36.64	216,342	\$37.34
Granted	651,757	\$45.59		149,908	\$46.58	24,678	\$45.59
Performance based leveraging <sup>(1)</sup>	—	\$—		—	\$—	10,251	\$41.25
Exercised/Vested	(190,557 )	\$26.16		(214,818 )	\$35.91	(28,886 )	\$41.25
Expired	—	\$—		—	\$—	—	\$—
Forfeited	(15,990 )	\$31.33		(18,218 )	\$38.50	(3,900 )	\$36.76
Outstanding at September 30, 2014	2,107,162	\$32.35	3.7	480,217	\$40.01	218,485	\$37.95
Options exercisable at September 30, 2014	1,194,906	\$25.15	2.0				

<sup>(1)</sup>PVRSU units outstanding have been increased by 10,251 units due to the Company exceeding the targeted performance conditions contained in PVRSUs granted in prior periods during the nine months ended September 30, 2014.

The components of the Company's pretax share-based compensation expense and associated income tax benefits are as follows for the three and nine months ended September 30, 2014 and 2013:

(in millions)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Stock options	\$0.6	\$0.3	\$1.7	\$1.3
Restricted stock	1.7	2.1	5.5	5.7
Performance vested restricted stock units	0.8	0.5	0.7	1.7
Total	\$3.1	\$2.9	\$7.9	\$8.7
Income tax benefits	\$1.1	\$1.1	\$2.9	\$3.2

During the nine months ended September 30, 2014, the Company revised its estimate of the projected achievement of various performance conditions that affect the number of PVRSUs that will ultimately vest. As a result, previously recognized share-based compensation costs related to these PVRSUs has been decreased by \$0.9 million for the nine months ended September 30, 2014.

**Dividends**

The Company currently pays a quarterly dividend on its common stock of \$0.185 per share, however the declaration of future dividends are subject to the discretion of the board of directors. During the three and nine months ended September 30, 2014, the Company's board of directors declared dividends totaling \$0.185 and \$0.56 per share or approximately \$10.8 million and \$32.4 million in the aggregate, respectively.

In addition, during the nine months ended September 30, 2014, the Company recorded dividends totaling \$0.4 million related to previously declared dividends that were contingent upon the vesting of performance vested restricted stock units. No dividends on performance vested restricted units were paid during the three months ended September 30, 2014.



Table of Contents

Share Repurchases and Redemptions

The Company purchased 0.4 million shares of common stock under the share repurchase program at a total cost of \$18.4 million during the three and nine months ended September 30, 2014. These shares were purchased from family members of the Company's largest shareholder at their fair market value.

During the three and nine months ended September 30, 2014, the Company redeemed 15,834 and 110,579 shares of common stock at a total cost of approximately \$0.8 million and \$5.3 million, respectively, from employees to satisfy the option exercise price and statutory minimum tax-withholding requirements related to the exercising of stock options and vesting of performance vested restricted stock units and restricted stock grants. These redemptions were outside the share repurchase program.

Other

Effective January 1, 2014, the Company reduced its reported number of common shares outstanding by 0.3 million shares to address a reconciling item with the Company's share transfer agent.



Table of Contents

## 13. Earnings Per Share

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

(In thousands, except per share amounts)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Computation of Basic Earnings Per Share:				
Numerator:				
Net income from continuing operations	\$39,416	\$38,573	\$96,164	\$89,973
Net income (loss) from discontinued operations	(51	) 143	1,711	293
Net income	39,365	38,716	97,875	90,266
Income allocated to participating securities	(343	) (377	) (867	) (901
Net income available to common shareholders	\$39,022	\$38,339	\$97,008	\$89,365
Denominator:				
Weighted average common shares outstanding – basic	57,932	57,978	57,878	57,884
Basic earnings per share - Continuing operations	\$0.67	\$0.66	\$1.65	\$1.54
Basic earnings per share - Discontinued operations	—	—	0.03	—
	\$0.67	\$0.66	\$1.68	\$1.54
Computation of Diluted Earnings Per Share:				
Numerator:				
Net income from continuing operations	\$39,416	\$38,573	\$96,164	\$89,973
Net income from discontinued operations	(51	) 143	1,711	293
Net income	39,365	38,716	97,875	90,266
Income allocated to participating securities	(340	) (375	) (862	) (898
Net income available to common shareholders	\$39,025	\$38,341	\$97,013	\$89,368
Denominator:				
Weighted average common shares outstanding – basic	57,932	57,978	57,878	57,884
Diluted effect of stock options and PVRsUs	524	394	503	383
Weighted average common shares outstanding – diluted	58,456	58,372	58,381	58,267
Diluted earnings per share - Continuing operations	\$0.67	\$0.65	\$1.63	\$1.53
Diluted earnings per share - Discontinued operations	—	0.01	0.03	—
	\$0.67	\$0.66	\$1.66	\$1.53

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, 2014 and 2013, the Company had 2.1 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 months ended September 30, 2014 and 2013, the Company did not exclude any anti-dilutive stock options from the diluted EPS calculation.

PVRsUs are also included in the diluted earnings per share calculation when the performance conditions have been met at the reporting date. However, at September 30, 2014 and 2013, PVRsUs totaling 218,485 and 198,394, respectively, were excluded from the computation since the performance conditions had not been met.



Table of Contents

14. Condensed Consolidating Financial Statements

The Company's 2010 and 2012 Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations, by certain of the Company's 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.

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Three Months Ended September 30, 2014  
(Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>REVENUES:</b>					
Royalty fees	\$79,326	\$28,799	\$10,829	\$(32,863 )	\$86,091
Initial franchise and relicensing fees	4,125	—	174	—	4,299
Procurement services	5,215	—	280	—	5,495
Marketing and reservation	104,093	106,438	4,981	(99,859 )	115,653
Other	3,500	2	128	—	3,630
Total revenues	196,259	135,239	16,392	(132,722 )	215,168
<b>OPERATING EXPENSES:</b>					
Selling, general and administrative	33,301	26,251	3,547	(32,863 )	30,236
Marketing and reservation	109,086	102,108	4,318	(99,859 )	115,653
Depreciation and amortization	765	1,383	145	—	2,293
Total operating expenses	143,152	129,742	8,010	(132,722 )	148,182
Operating income	53,107	5,497	8,382	—	66,986
<b>OTHER INCOME AND EXPENSES, NET:</b>					
Interest expense	10,485	1	9	—	10,495
Equity in earnings of consolidated subsidiaries	(10,760 )	554	—	10,206	—
Other items, net	(263 )	410	386	—	533
Total other income and expenses, net	(538 )	965	395	10,206	11,028
Income from continuing operations before income taxes	53,645	4,532	7,987	(10,206 )	55,958
Income taxes	14,280	2,562	(300 )	—	16,542
Income from continuing operations, net of income taxes	39,365	1,970	8,287	(10,206 )	39,416
Net income (loss) from discontinued operations, net of income taxes	—	(51 )	—	—	(51 )
Net income	\$39,365	\$1,919	\$8,287	\$(10,206 )	\$39,365

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Three Months Ended September 30, 2013  
(Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>REVENUES:</b>					
Royalty fees	\$72,915	\$25,161	\$11,362	\$(29,978)	) \$79,460
Initial franchise and relicensing fees	4,419	—	231	—	4,650
Procurement services	4,375	—	333	—	4,708
Marketing and reservation	112,354	96,672	5,807	(90,024)	) 124,809
Other	2,778	—	313	—	3,091
Total revenues	196,841	121,833	18,046	(120,002)	) 216,718
<b>OPERATING EXPENSES:</b>					
Selling, general and administrative	30,498	22,417	3,472	(29,978)	) 26,409
Marketing and reservation	117,480	92,784	4,569	(90,024)	) 124,809
Depreciation and amortization	828	1,222	222	—	2,272
Total operating expenses	148,806	116,423	8,263	(120,002)	) 153,490
Operating income	48,035	5,410	9,783	—	63,228
<b>OTHER INCOME AND EXPENSES, NET:</b>					
Interest expense	10,691	61	5	—	10,757
Equity in earnings of consolidated subsidiaries	(13,031)	) —	—	13,031	—
Other items, net	(577)	) (697)	) (526)	) —	(1,800)
Total other income and expenses, net	(2,917)	) (636)	) (521)	) 13,031	8,957
Income from continuing operations before income taxes	50,952	6,046	10,304	(13,031)	) 54,271
Income taxes	12,236	3,017	445	—	15,698
Income from continuing operations, net of income taxes	38,716	3,029	9,859	(13,031)	) 38,573
Income from discontinued operations, net of income taxes	—	143	—	—	143
Net income	\$38,716	\$3,172	\$9,859	\$(13,031)	) \$38,716

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Nine Months Ended September 30, 2014  
(Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>REVENUES:</b>					
Royalty fees	\$203,411	\$89,773	\$33,711	\$(104,594 )	\$222,301
Initial franchise and relicensing fees	12,144	—	617	—	12,761
Procurement services	17,688	—	605	—	18,293
Marketing and reservation	275,203	274,638	14,150	(254,966 )	309,025
Other	9,798	3	387	—	10,188
Total revenues	518,244	364,414	49,470	(359,560 )	572,568
<b>OPERATING EXPENSES:</b>					
Selling, general and administrative	101,012	81,845	10,066	(104,594 )	88,329
Marketing and reservation	286,903	263,710	13,378	(254,966 )	309,025
Depreciation and amortization	2,272	4,117	514	—	6,903
Total operating expenses	390,187	349,672	23,958	(359,560 )	404,257
Operating income	128,057	14,742	25,512	—	168,311
<b>OTHER INCOME AND EXPENSES, NET:</b>					
Interest expense	31,356	3	17	—	31,376
Equity in earnings of consolidated subsidiaries	(34,874 )	604	—	34,270	—
Other items, net	(988 )	(107 )	310	—	(785 )
Total other income and expenses, net	(4,506 )	500	327	34,270	30,591
Income from continuing operations before income taxes	132,563	14,242	25,185	(34,270 )	137,720
Income taxes	34,688	6,746	122	—	41,556
Income from continuing operations, net of income taxes	97,875	7,496	25,063	(34,270 )	96,164
Income from discontinued operations, net of income taxes	—	1,711	—	—	1,711
Net income	\$97,875	\$9,207	\$25,063	\$(34,270 )	\$97,875

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Nine Months Ended September 30, 2013  
(Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>REVENUES:</b>					
Royalty fees	\$ 189,559	\$ 84,477	\$ 31,940	\$(97,770)	) \$ 208,206
Initial franchise and relicensing fees	12,074	—	769	—	12,843
Procurement services	15,559	—	645	—	16,204
Marketing and reservation	275,780	267,404	15,391	(247,371)	) 311,204
Other	6,581	—	781	—	7,362
Total revenues	499,553	351,881	49,526	(345,141)	) 555,819
<b>OPERATING EXPENSES:</b>					
Selling, general and administrative	94,903	75,799	9,876	(97,770)	) 82,808
Marketing and reservation	287,436	257,197	13,942	(247,371)	) 311,204
Depreciation and amortization	2,301	3,775	625	—	6,701
Total operating expenses	384,640	336,771	24,443	(345,141)	) 400,713
Operating income	114,913	15,110	25,083	—	155,106
<b>OTHER INCOME AND EXPENSES, NET:</b>					
Interest expense	32,210	111	13	—	32,334
Equity in earnings of consolidated subsidiaries	(34,691)	) —	—	34,691	—
Other items, net	(1,689)	) (1,261)	) (635)	) —	(3,585)
Total other income and expenses, net	(4,170)	) (1,150)	) (622)	) 34,691	28,749
Income from continuing operations before income taxes	119,083	16,260	25,705	(34,691)	) 126,357
Income taxes	28,817	7,317	250	—	36,384
Income from continuing operations, net of income taxes	90,266	8,943	25,455	(34,691)	) 89,973
Income from discontinued operations, net of income taxes	—	293	—	—	293
Net income	\$ 90,266	\$ 9,236	\$ 25,455	\$(34,691)	) \$ 90,266





Table of Contents

Choice Hotels International, Inc.  
 Condensed Consolidating Statement of Comprehensive Income  
 For the Three Months Ended September 30, 2014  
 (Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net income	\$39,365	\$1,919	\$8,287	\$(10,206 )	\$39,365
Other comprehensive income (loss), net of tax:					
Amortization of loss on cash flow hedge <sup>215</sup>	—	—	—	—	215
Foreign currency translation adjustment	(1,387 )	—	(1,387 )	1,387	(1,387 )
Other comprehensive income (loss), net of tax	(1,172 )	—	(1,387 )	1,387	(1,172 )
Comprehensive income	\$38,193	\$1,919	\$6,900	\$(8,819 )	\$38,193

Table of Contents

Choice Hotels International, Inc.  
 Condensed Consolidating Statement of Comprehensive Income  
 For the Three Months Ended September 30, 2013  
 (Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net income	\$38,716	\$3,172	\$9,859	\$(13,031)	) \$38,716
Other comprehensive income (loss), net of tax:					
Amortization of loss on cash flow hedge	215	—	—	—	215
Foreign currency translation adjustment	524	—	524	(524)	) 524
Other comprehensive income (loss), net of tax	739	—	524	(524)	) 739
Comprehensive income	\$39,455	\$3,172	\$10,383	\$(13,555)	) \$39,455

32

Table of Contents

Choice Hotels International, Inc.  
 Condensed Consolidating Statement of Comprehensive Income  
 For the Nine Months Ended September 30, 2014  
 (Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net income	\$97,875	\$9,207	\$25,063	\$(34,270 )	\$97,875
Other comprehensive income (loss), net of tax:					
Amortization of loss on cash flow hedge	646	—	—	—	646
Foreign currency translation adjustment	(357 )	—	(357 )	357	(357 )
Other comprehensive income (loss), net of tax	289	—	(357 )	357	289
Comprehensive income	\$98,164	\$9,207	\$24,706	\$(33,913 )	\$98,164

33

Table of Contents

Choice Hotels International, Inc.  
 Condensed Consolidating Statement of Comprehensive Income  
 For the Nine Months Ended September 30, 2013  
 (Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net income	\$90,266	\$9,236	\$25,455	\$(34,691 )	\$90,266
Other comprehensive income (loss), net of tax:					
Amortization of loss on cash flow hedge	646	—	—	—	646
Foreign currency translation adjustment	(1,803 )	—	(1,803 )	1,803	(1,803 )
Other comprehensive income (loss), net of tax	(1,157 )	—	(1,803 )	1,803	(1,157 )
Comprehensive income	\$89,109	\$9,236	\$23,652	\$(32,888 )	\$89,109

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Balance Sheet  
As of September 30, 2014  
(Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>ASSETS</b>					
Cash and cash equivalents	\$63,757	\$63	\$180,572	\$—	\$244,392
Receivables, net	98,712	1,188	9,848	—	109,748
Other current assets	17,398	37,938	1,975	(6,025)	) 51,286
Total current assets	179,867	39,189	192,395	(6,025)	) 405,426
Property and equipment, at cost, net	20,377	37,122	882	—	58,381
Goodwill	60,620	5,193	—	—	65,813
Franchise rights and other identifiable intangibles, net	4,927	1,632	957	—	7,516
Notes receivable, net of allowances	11,948	21,649	1,448	—	35,045
Investments, employee benefit plans, at fair value	—	16,845	—	—	16,845
Investment in affiliates	413,865	30,579	—	(444,444)	) —
Advances to affiliates	12,284	231,454	10,382	(254,120)	) —
Deferred income taxes	2,569	11,006	923	—	14,498
Other assets	7,763	19,080	33,820	—	60,663
Total assets	\$714,220	\$413,749	\$240,807	\$(704,589)	) \$664,187
<b>LIABILITIES AND SHAREHOLDERS' DEFICIT</b>					
Accounts payable	\$11,454	\$49,383	\$3,273	\$—	\$64,110
Accrued expenses	19,158	25,338	2,285	—	46,781
Deferred revenue	6,938	58,206	695	—	65,839
Current portion of long-term debt	11,250	713	4	—	11,967
Deferred compensation and retirement plan obligations	—	620	—	—	620
Other current liabilities	—	16,165	—	(6,025)	) 10,140
Total current liabilities	48,800	150,425	6,257	(6,025)	) 199,457
Long-term debt	770,556	4,149	51	—	774,756
Deferred compensation and retirement plan obligations	—	23,109	9	—	23,118
Advances from affiliates	246,193	371	7,556	(254,120)	) —
Other liabilities	45,686	17,364	821	—	63,871
Total liabilities	1,111,235	195,418	14,694	(260,145)	) 1,061,202
Total shareholders' (deficit) equity	(397,015)	) 218,331	226,113	(444,444)	) (397,015)
Total liabilities and shareholders' deficit	\$714,220	\$413,749	\$240,807	\$(704,589)	) \$664,187

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Balance Sheet  
As of December 31, 2013  
(in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>ASSETS</b>					
Cash and cash equivalents	\$9,785	\$569	\$157,441	\$—	\$167,795
Receivables, net	72,219	1,475	8,691	—	82,385
Other current assets	26,395	34,987	752	(5,340)	56,794
Total current assets	108,399	37,031	166,884	(5,340)	306,974
Property and equipment, at cost, net	11,087	55,963	802	—	67,852
Goodwill	60,620	5,193	—	—	65,813
Franchise rights and other identifiable intangibles, net	6,553	2,096	1,304	—	9,953
Advances, marketing and reservation activities	5,844	—	—	—	5,844
Notes receivable, net of allowances	13,257	17,158	1,457	—	31,872
Investments, employee benefit plans, at fair value	—	15,950	—	—	15,950
Investment in affiliates	376,712	28,312	—	(405,024)	—
Advances to affiliates	14,198	189,833	10,896	(214,927)	—
Deferred income taxes	—	10,710	871	(11,581)	—
Other assets	8,955	13,184	30,025	—	52,164
Total assets	\$605,625	\$375,430	\$212,239	\$(636,872)	\$556,422
<b>LIABILITIES AND SHAREHOLDERS' DEFICIT</b>					
Accounts payable	\$6,276	\$30,778	\$4,609	\$—	\$41,663
Accrued expenses	28,215	26,503	1,907	—	56,625
Deferred revenue	7,065	53,414	709	—	61,188
Current portion of long-term debt	9,375	702	11	—	10,088
Deferred compensation and retirement plan obligations	—	2,492	—	—	2,492
Other current liabilities	—	7,401	221	(5,340)	2,282
Total current liabilities	50,931	121,290	7,457	(5,340)	174,338
Long-term debt	778,946	4,507	18	—	783,471
Deferred compensation and retirement plan obligations	—	22,520	7	—	22,527
Advances from affiliates	206,931	362	7,634	(214,927)	—
Other liabilities	21,688	18,216	634	(11,581)	28,957
Total liabilities	1,058,496	166,895	15,750	(231,848)	1,009,293
Total shareholders' (deficit) equity	(452,871)	208,535	196,489	(405,024)	(452,871)
Total liabilities and shareholders' deficit	\$605,625	\$375,430	\$212,239	\$(636,872)	\$556,422

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Cash Flows  
For the Nine Months Ended September 30, 2014  
(Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net cash provided by operating activities	\$ 111,851	\$ 2,866	\$ 24,318	\$(657 )	\$ 138,378
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>					
Investment in property and equipment	(5,138 )	(6,378 )	(370 )	—	(11,886 )
Proceeds from sales of assets	27	15,585	—	—	15,612
Equity method investments	—	(8,800 )	(5,562 )	—	(14,362 )
Purchases of investments, employee benefit plans	—	(1,520 )	—	—	(1,520 )
Proceeds from sales of investments, employee benefit plans	—	966	—	—	966
Issuance of mezzanine and other notes receivable	(3,340 )	—	—	—	(3,340 )
Collections of mezzanine and other notes receivable	9,832	—	—	—	9,832
Advances to and investments in affiliates	(1,000 )	(4,740 )	—	5,740	—
Other items, net	(446 )	(146 )	—	—	(592 )
Net cash provided (used) in investing activities	(65 )	(5,033 )	(5,932 )	5,740	(5,290 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>					
Principal payments on long-term debt	(6,563 )	(523 )	(24 )	—	(7,110 )
Proceeds from the issuance of long-term debt	—	176	50	—	226
Proceeds from contributions from affiliates	—	—	5,740	(5,740 )	—
Purchases of treasury stock	(23,757 )	—	—	—	(23,757 )
Dividends paid	(32,767 )	—	(657 )	657	(32,767 )
Excess tax benefits from stock-based compensation	289	2,008	—	—	2,297
Proceeds from exercise of stock options	4,984	—	—	—	4,984
Net cash provided (used) by financing activities	(57,814 )	1,661	5,109	(5,083 )	(56,127 )
Net change in cash and cash equivalents	53,972	(506 )	23,495	—	76,961
Effect of foreign exchange rate changes on cash and cash equivalents	—	—	(364 )	—	(364 )
Cash and cash equivalents at beginning of period	9,785	569	157,441	—	167,795
Cash and cash equivalents at end of period	\$ 63,757	\$ 63	\$ 180,572	\$—	\$ 244,392

Table of Contents

Choice Hotels International, Inc.  
Condensed Consolidating Statement of Cash Flows  
For the Nine Months Ended September 30, 2013  
(Unaudited, in thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net cash provided (used) by operating activities	\$60,070	\$20,198	\$26,221	\$—	\$106,489
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>					
Investment in property and equipment	(4,083 )	(23,662 )	(177 )	—	(27,922 )
Equity method investments	—	(1,481 )	(2,280 )	—	(3,761 )
Purchases of investments, employee benefit plans	—	(1,845 )	—	—	(1,845 )
Proceeds from sales of investments, employee benefit plans	—	4,052	—	—	4,052
Collections of mezzanine and other notes receivable	224	—	—	—	224
Advances to and investments in affiliates	(1,000 )	(1,280 )	—	2,280	—
Other items, net	(578 )	—	—	—	(578 )
Net cash provided (used) in investing activities	(5,437 )	(24,216 )	(2,457 )	2,280	(29,830 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>					
Net repayments pursuant to revolving credit facility	(27,500 )	—	—	—	(27,500 )
Proceeds from issuance of long-term debt	—	3,360	—	—	3,360
Principal payments on long-term debt	(5,625 )	(502 )	(31 )	—	(6,158 )
Purchase of treasury stock	(3,684 )	—	—	—	(3,684 )
Dividends paid	(22,026 )	—	—	—	(22,026 )
Excess tax benefits from stock-based compensation	26	1,190	—	—	1,216
Proceeds from contributions from affiliates	—	—	2,280	(2,280 )	—
Proceeds from exercise of stock options	6,677	—	—	—	6,677
Net cash provided (used) by financing activities	(52,132 )	4,048	2,249	(2,280 )	(48,115 )
Net change in cash and cash equivalents	2,501	30	26,013	—	28,544
Effect of foreign exchange rate changes on cash and cash equivalents	—	—	(1,583 )	—	(1,583 )
Cash and cash equivalents at beginning of period	8,420	407	125,350	—	134,177
Cash and cash equivalents at end of period	\$10,921	\$437	\$149,780	\$—	\$161,138





Table of Contents

## 15. Reportable Segment Information

**Franchising:** Franchising includes the Company's hotel franchising operations consisting of its eleven brands. The eleven brands are aggregated within this segment considering their similar economic characteristics, types of customers, distribution channels and regulatory business environments. Revenues from the franchising business include royalty fees, initial franchise and relicensing fees, marketing and reservation system fees, procurement services revenue and other franchising related 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.

**SkyTouch Technology:** SkyTouch Technology ("SkyTouch") is a division of the Company that develops and markets cloud-based technology products to hoteliers not under franchise agreements with the Company.

The Company evaluates its segments based primarily on the results of the segment without allocating corporate expenses, income taxes or indirect general and administrative expenses. Equity in earnings or losses from franchising related joint ventures is allocated to the Company's franchising segment. Corporate and other expenses consist primarily of overhead selling, general and administrative costs such as finance, legal, human resources and other general administrative expenses that are not allocated to the Company's two segments. As described in Note 4, certain interest expenses related to the Company's marketing and reservation activities are allocated to the franchising segment. The Company does not allocate the remaining interest expense, interest income, other gains and losses or income taxes to its segments.

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

(In thousands)	Three Months Ended September 30, 2014				Three Months Ended September 30, 2013			
	Franchising	SkyTouch Technology	Corporate & Other	Consolidated	Franchising	SkyTouch Technology	Corporate & Other	Consolidated
Revenues	\$ 215,076	\$ 92	\$ —	\$ 215,168	\$ 216,705	\$ 13	\$ —	\$ 216,718
Operating income (loss)	\$ 82,525	\$ (4,928 )	\$ (10,611 )	\$ 66,986	\$ 75,773	\$ (2,841 )	\$ (9,704 )	\$ 63,228
Income (loss) from continuing operations before income taxes	\$ 81,946	\$ (4,928 )	\$ (21,060 )	\$ 55,958	\$ 76,114	\$ (2,841 )	\$ (19,002 )	\$ 54,271

(In thousands)	Nine Months Ended September 30, 2014				Nine Months Ended September 30, 2013			
	Franchising	SkyTouch Technology	Corporate & Other	Consolidated	Franchising	SkyTouch Technology	Corporate & Other	Consolidated
Revenues	\$ 572,355	\$ 213	\$ —	\$ 572,568	\$ 555,806	\$ 13	\$ —	\$ 555,819
Operating income (loss)	\$ 211,946	\$ (12,794 )	\$ (30,841 )	\$ 168,311	\$ 194,026	\$ (7,307 )	\$ (31,613 )	\$ 155,106
Income (loss) from continuing operations before income taxes	\$ 211,368	\$ (12,794 )	\$ (60,854 )	\$ 137,720	\$ 194,358	\$ (7,307 )	\$ (60,694 )	\$ 126,357

taxes

16. Commitments and Contingencies

The Company is not a party to any litigation other than litigation in the ordinary course of business. The Company's management and legal counsel do not expect that the ultimate outcome of any of its currently ongoing legal proceedings,

39

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## Table of Contents

individually or collectively, will have a material adverse effect on the Company's financial position, results of operations or cash flows.

### Contingencies

On October 9, 2012, the Company entered into a limited payment guaranty with regards to a VIE's \$18.0 million bank loan for the construction of a hotel franchised under one of the Company's brands in the United States. Under the terms of the limited guaranty, the Company has agreed to guarantee 25% of the outstanding principal balance for a maximum exposure of \$4.5 million and accrued and unpaid interest, as well as any unpaid expenses incurred by the lender. The limited guaranty shall remain in effect until the maximum amount guaranteed by the Company is paid in full. In addition to the limited guaranty, the Company entered into an agreement in which the Company guarantees the completion of the construction of the hotel and an environmental indemnity agreement which indemnifies the lending institution from and against any damages relating to or arising out of possible environmental contamination issues with regards to the property.

On November 15, 2013, the Company entered into a limited payment guaranty with regards to a VIE's \$46.2 million bank loan for the construction of a hotel franchised under one of the Company's brands in the United States. Under the terms of the limited guaranty, the Company has agreed to unconditionally guarantee and become surety for the full and timely payment of the guaranteed outstanding principal balance, as well as any unpaid expenses incurred by the lender. The guarantee is limited to 25% of the outstanding principal balance of the \$46.2 million loan due at any time for a maximum exposure of \$11.6 million. The limited guaranty shall remain in effect until the maximum amount guaranteed by the Company is repaid in full. The maturity date of the VIE's loan is May 2017. In conjunction with this guaranty, the Company has entered into a reimbursement and guaranty agreement with certain individuals that requires them to reimburse the Company in an amount equal to 75% of any payments made by the Company under this limited payment guaranty.

### Commitments

The Company has the following commitments outstanding at September 30, 2014:

The Company occasionally provides financing in the form of forgivable promissory notes or cash incentives to franchisees for property improvements, hotel development efforts and other purposes. At September 30, 2014, the Company had commitments to extend an additional \$16.3 million for these purposes provided certain conditions are met by its franchisees, of which \$6.6 million is expected to be advanced in the next twelve months.

The Company committed to make additional capital contributions totaling \$2.2 million to existing joint ventures related to the construction of various hotels to be operated under the Company's Cambria Suites brand. These commitments are expected to be funded in the next twelve months.

The Company has a property improvement incentive program for its domestic Comfort Inn and Comfort Suites hotels to incent hotel owners to renovate their properties to accelerate improvement of the brand's product quality and consistency, guest satisfaction and brand performance. The Company has committed to provide financing in the form of forgivable promissory notes to qualifying domestic hotels for a portion of their Company approved and completed property improvement expenses. Financing will be provided upon the completion and Company certification of the renovations. At September 30, 2014, the Company expects future commitments of between \$20.9 million and \$24.1 million for this purpose, provided certain conditions are met by its franchisees. These commitments are expected to be funded in the next twelve months.

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

40

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Table of Contents

respect to certain of the aforementioned indemnities, such as indemnifications of landlords against third party claims for the use of real estate property leased by the Company, the Company maintains insurance coverage that mitigates potential liability.

## 17. Discontinued Operations

In the first quarter of 2014, the Company's management approved a plan to sell the three Company-owned hotels operated under the MainStay Suites brand and completed the disposal of these hotels at June 30, 2014. The Company determined that this disposal transaction met the definition of a discontinued operation since the operations and cash flows of this component has been eliminated from the on-going operations of the Company and the Company will not have significant continuing involvement in the operations of the hotels after the disposal transaction.

The operations related to these three Company-owned hotels were reported as a component of "Corporate and Other" for segment reporting purposes. The results of operations for the three and nine months ended September 30, 2014 and the Company's financial position as of September 30, 2014 presented in these Consolidated Financial Statements reflect these three Company-owned hotels as discontinued operations. The results of operations for the three and nine months ended September 30, 2013 presented in the Consolidated Financial Statements have been reclassified to account for these operations as discontinued. Summarized financial information related to the discontinued operations is as follows:

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2014	2013	2014	2013
	(in thousands)			
Revenues				
Hotel operations	\$—	\$ 1,310	\$ 801	\$ 3,600
Total revenues	—	1,310	801	3,600
Expenses				
Hotel operations	52	956	884	2,742
Depreciation and amortization	—	127	—	393
Total operating expenses	52	1,083	884	3,135
Operating income (loss)	(52)	) 227	(83)	) 465
Gain (loss) on disposal of discontinued operations	(30)	) —	2,803	—
Income (loss) from discontinued operations before income taxes	(82)	) 227	2,720	465
Income taxes	(31)	) 84	1,009	172
Income (loss) from discontinued operations	\$ (51)	) \$ 143	\$ 1,711	\$ 293

	As of September 30, 2014	As of December 31, 2013
	(in thousands)	
Cash	\$44	\$550
Receivables, net	1	106
Other current assets	100	223
Income taxes receivable	—	20

Total current assets	145	899
Property and equipment, at cost, net	—	8,816
Total assets	\$ 145	\$ 9,715
Accounts payable	\$ 26	\$ 425
Accrued expenses	10	10
Income taxes payable	1,009	—
Total liabilities	\$ 1,045	\$ 435
Net assets (liabilities) of discontinued operations	\$ (900	) \$ 9,280

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to help the reader understand the consolidated financial condition and results of operations of Choice Hotels International, Inc. and its subsidiaries (together the "Company") contained in this report. 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 primarily a hotel franchisor with franchise agreements representing 6,386 hotels open and 516 hotels under construction, awaiting conversion or approved for development as of September 30, 2014, with 507,314 rooms and 41,096 rooms, respectively, in 50 states, the District of Columbia and over 35 countries and territories outside the United States. Our brand names include Comfort Inn®, Comfort Suites®, Quality®, Clarion®, Ascend Hotel Collection®, Sleep Inn®, Econo Lodge®, Rodeway Inn®, MainStay Suites®, Suburban Extended Stay Hotel®, and Cambria Suites® (collectively, the "Choice brands").

The Company's domestic franchising operations are conducted through direct franchising relationships while its international franchise operations are conducted through a combination of direct franchising and master franchising relationships. Master franchising relationships are governed by master franchising agreements which generally provide the master franchisee with the right to use our brands and sub-license the use of our brands in a specific geographic region, usually for a fee.

Our business strategy is to conduct direct franchising in those international markets where both franchising is an accepted business model and we believe our brands can achieve significant scale. We elect to enter into master franchise agreements in those markets where direct franchising is currently not a prevalent or viable business model. When entering into master franchising relationships, we strive to select partners that have professional hotel and asset management capabilities together with the financial capacity to invest in building the Choice brands in their respective markets. Master franchising relationships typically provide lower revenues to the Company as the master franchisees are responsible for managing certain necessary services (such as training, quality assurance, reservations and marketing) to support the franchised hotels in the master franchise area and therefore retain a larger percentage of the hotel franchise fees to cover their expenses. In certain circumstances, the Company has and may continue to make equity investments in our master franchisees.

As a result of our use of master franchising relationships and international market conditions, total revenues from international franchising operations comprised 7% of our total revenues for the nine months ended September 30, 2014, while representing approximately 18% of hotels open at September 30, 2014. Therefore, our description of the franchise system is primarily focused on the domestic operations.

## Table of Contents

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 and other sources. The hotel industry is seasonal in nature. For most hotels, demand is lower in December through February 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 reflect the industry's seasonality and historically have been lower in the first and fourth quarter than in the second or third 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, based on its current domestic portfolio of hotels under franchise, a 1% change in revenue per available room ("RevPAR") or rooms under franchise would increase or decrease annual domestic royalty revenues by approximately \$2.6 million and a 1 basis point change in the Company's effective royalty rate would increase or decrease annual domestic royalties by approximately \$0.6 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. The Company's hotel franchising business 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 in the various hotel lodging price categories; 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 of our established brands 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 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 and property management systems, 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 and increases the desirability of our brands to hotel owners and developers, which ultimately increases franchise fees earned by the Company.

Our Company articulates its mission as a commitment to our franchisees' profitability by providing our franchisees 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 owners.

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

**Profitable Growth.** 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 over time. 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 is intended to ensure 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

Table of Contents

that generates high financial returns and use our excess cash flow to increase returns to our shareholders primarily through share repurchases, dividends or investing in growth opportunities.

Historically, we have returned value to our shareholders through share repurchases and dividends. In 1998, our board of directors instituted a share repurchase program which has generated substantial value for our shareholders. Since the program's inception through September 30, 2014, we have repurchased 45.7 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 \$1.1 billion.

Considering the effect of the two-for-one stock split, the Company has repurchased 78.7 million shares at an average price of \$14.06 per share. The Company purchased 0.4 million shares of common stock under the share repurchase program at a total cost of \$18.4 million during the three and nine months ended September 30, 2014. These shares were purchased from family members of the Company's largest shareholder at their fair market value. At September 30, 2014, we had approximately 1.1 million shares remaining under the current share repurchase authorization. We currently believe that our cash flows from operations will support our ability to complete the current repurchase authorization. Upon completion of the current authorization, our board of directors will evaluate the advisability of additional share repurchases.

The Company commenced paying quarterly dividends in 2004 and in 2012 the Company elected to pay a special cash dividend totaling approximately \$600 million. The Company currently maintains the payment of a quarterly dividend on its common shares outstanding of \$0.185 per share, however the declaration of future dividends are subject to the discretion of the board of directors. During the nine months ended September 30, 2014, we paid cash dividends totaling approximately \$32.8 million. We expect to continue to pay dividends in the future, subject to declaration by our board of directors as well as future business performance, economic conditions, changes in income tax regulations and other factors. Based on the present dividend rate and outstanding share count, we expect that aggregate annual regular dividends for 2014 would be approximately \$43.5 million.

The Company also allocates capital to exploring growth opportunities in business areas that are adjacent or complementary to our core hotel franchising business, which leverage our core competencies and are additive to our franchising business model. The timing and amount of these investments are subject to market and other conditions and include the following:

Our board of directors authorized a program which permits us to offer financing, investment and guaranty support to qualified franchisees as well as allows us to acquire and resell real estate to incent franchise development for certain brands in strategic markets. Recent market conditions have resulted in increased opportunities to incentivize development under this program and as a result over the next several years we expect to deploy capital pursuant to this program opportunistically to promote growth of our emerging brands. The amount and timing of the investment in this program will be dependent on market and other conditions. Our current expectation is that our annual investment in this program will range from \$20 million to \$40 million per year and we generally expect to recycle these investments within a five year period.

In March 2013, the Company announced the launch of a new division, SkyTouch Technology ("SkyTouch"), which develops and markets cloud-based technology products for the hotel industry. In conjunction with the establishment of this new division, the Company expects to incur costs in excess of revenues earned as it further develops SkyTouch's product offerings and invests in sales and marketing. During the year ended December 31, 2014, the Company expects to incur selling, general and administrative ("SG&A") expenses in excess of revenues by approximately \$18 million. Notwithstanding investments in SkyTouch and other alternative growth strategies, the Company expects to continue to return value to its shareholders over time through a combination of share repurchases and dividends, subject to the discretion of our board of directors as well as to business performance, economic conditions, changes in income tax regulations and other factors.

We believe these investments and strategic priorities, 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. These measurements are primarily driven by the operations of our franchise system and therefore our analysis of the Company's operations is primarily focused on the size, performance and

potential growth of the franchise system as well as our variable overhead costs.

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 typically utilize cash in ways that management believes provide the greatest returns to our shareholders which include share repurchases and dividends.

However, we may determine to utilize cash for acquisitions and other investments in the future. We believe the Company's cash flow from

Table of Contents

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.

#### Non-GAAP Financial Statement Measurements

The Company utilizes certain measures which do not conform to generally accepted accounting principles accepted 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. 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 reasons for reporting these non-GAAP measures.

**Franchising Revenues:** The Company utilizes franchising revenues, which exclude revenues from marketing and reservation system activities and the SkyTouch division, rather than total revenues when analyzing the performance of the business. Marketing and reservation activities are excluded from franchising revenues since the Company is contractually required by its franchise agreements to use the 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 liability in 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 incurred in excess of fees collected for marketing and reservation activities are deferred and recorded as an asset in the Company's financial statements and recovered in future periods. SkyTouch is a division of the Company that develops and markets cloud-based technology products, including inventory management, pricing and connectivity to third party channels, to hoteliers not under franchise agreements with the Company. SkyTouch operations are excluded from franchising revenues since those operations do not reflect the Company's core franchising business but represent an adjacent, complimentary line of 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, (in thousands)		Nine Months Ended September 30,	
	2014	2013	2014	2013
Franchising Revenues:				
Total Revenues	\$215,168	\$216,718	\$572,568	\$555,819
Adjustments:				
Marketing and reservation system revenues	(115,653 )	(124,809 )	(309,025 )	(311,204 )
SkyTouch division	(92 )	(13 )	(213 )	(13 )
Franchising Revenues	\$99,423	\$91,896	\$263,330	\$244,602

**Adjusted EBITDA:** We also utilize adjusted earnings before interest, taxes, depreciation and amortization ("Adjusted EBITDA") to analyze our results which reflects earnings from continuing operations excluding the impact of interest expense, interest income, provision for income taxes, depreciation and amortization, other (gains) and losses and equity earnings of unconsolidated affiliates. We consider Adjusted EBITDA to be an indicator of operating performance because we use it to measure our ability to service debt, fund capital expenditures, and expand our business. We also use Adjusted EBITDA, as do analysts, lenders, investors and others, to evaluate companies because it excludes certain items that can vary widely across different industries or among companies within the same industry. For example, interest expense can be dependent on a company's capital structure, debt levels and credit ratings. Accordingly, the impact of interest expense on earnings can vary significantly among companies. The tax positions of companies can also vary because of their differing abilities to take advantage of tax benefits and because of the tax policies of the jurisdictions in which they operate. As a result, effective tax rates and provision for income taxes can vary considerably among companies. Adjusted EBITDA also excludes depreciation and amortization

because companies utilize productive assets of different ages and use different methods of both acquiring and depreciating productive assets. These differences can result in considerable variability in the relative costs of productive assets and the depreciation and amortization expense among companies. Additionally, Adjusted EBITDA is also utilized as a performance indicator as it excludes equity in earnings of unconsolidated affiliates and other (gains) and losses which primarily

44

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Table of Contents

reflect the performance of investments held in the Company's non-qualified retirement, savings and investment plans which can vary widely from period to period based on market conditions.

## Calculation of Adjusted EBITDA

	Three Months Ended September 30, (in thousands)		Nine Months Ended September 30,	
	2014	2013	2014	2013
Adjusted EBITDA:				
Income from continuing operations, net of income taxes	\$ 39,416	\$ 38,573	\$ 96,164	\$ 89,973
Income taxes	16,542	15,698	41,556	36,384
Interest expense	10,495	10,757	31,376	32,334
Interest income	(355)	(676)	(1,205)	(1,979)
Other (gains) and losses	375	(703)	(158)	(1,266)
Equity in net (income) loss of affiliates	513	(421)	578	(340)
Depreciation and amortization	2,293	2,272	6,903	6,701
Adjusted EBITDA	\$ 69,279	\$ 65,500	\$ 175,214	\$ 161,807

## Operations Review

## Comparison of Operating Results for the Three-Month Periods Ended September 30, 2014 and 2013

Summarized financial results for the three months ended September 30, 2014 and 2013 are as follows:

(in thousands)	2014	2013
REVENUES:		
Royalty fees	\$ 86,091	\$ 79,460
Initial franchise and relicensing fees	4,299	4,650
Procurement services	5,495	4,708
Marketing and reservation	115,653	124,809
Other	3,630	3,091
Total revenues	215,168	216,718
OPERATING EXPENSES:		
Selling, general and administrative	30,236	26,409
Depreciation and amortization	2,293	2,272
Marketing and reservation	115,653	124,809
Total operating expenses	148,182	153,490
Operating income	66,986	63,228
OTHER INCOME AND EXPENSES, NET:		
Interest expense	10,495	10,757
Interest income	(355)	(676)
Other (gains) and losses	375	(703)
Equity in net (income) loss of affiliates	513	(421)
Total other income and expenses, net	11,028	8,957
Income from continuing operations before income taxes	55,958	54,271
Income taxes	16,542	15,698
Income from continuing operations, net of income taxes	39,416	38,573
Income (loss) from discontinued operations, net of income taxes	(51)	143
Net income	\$ 39,365	\$ 38,716



Table of Contents

## Results of Operations

The Company recorded income from continuing operations before income taxes of \$56.0 million for the three month period ended September 30, 2014, a \$1.7 million, or 3% increase from the same period of the prior year. The increase in income from continuing operations primarily reflects a \$3.8 million increase in operating income partially offset by a decline in other (gains) and losses resulting from a \$0.7 million appreciation in the fair value of investments held in the Company's non-qualified employee benefit plans during the three months ended September 30, 2013 compared to a \$0.4 million loss in the current year period.

Operating income increased \$3.8 million as the Company's franchising revenues increased by \$7.5 million or 8% partially offset by a \$3.8 million or 14% increase in SG&A expenses. Adjusted EBITDA for the three months ended September 30, 2014 increased \$3.8 million or 6% to \$69.3 million. The key drivers of these fluctuations are described in more detail below.

Franchising Revenues: Franchising revenues were \$99.4 million for the three months ended September 30, 2014 compared to \$91.9 million for the three months ended September 30, 2013, an increase of 8%. The increase in franchising revenues is primarily due to a \$6.6 million or 8% increase in royalty revenues, a \$0.8 million or 17% increase in procurement services revenue, and a \$0.5 million increase in other revenues, offset by a \$0.4 million or 8% decline in initial and relicensing fees.

## Royalty Fees

Domestic royalty fees for the three months ended September 30, 2014 increased \$6.6 million to \$79.5 million, an increase of 9% compared to the three months ended September 30, 2013. The increase in royalties is attributable to a combination of factors including an 8.8% increase in RevPAR and a 0.9% increase in the number of domestic franchised hotel rooms open. These increases were partially offset by a 4 basis point decline in the effective royalty rate from 4.28% to 4.24%. System-wide RevPAR increased due to a combination of a 3.4% increase in average daily rates and a 320 basis point increase in occupancy rates.

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

	For the Three Months Ended September 30, 2014			For the Three Months Ended September 30, 2013			Change			
	Average Daily Rate	Occupancy	RevPAR	Average Daily Rate	Occupancy	RevPAR	Average Daily Rate	Occupancy	RevPAR	
Comfort Inn	\$92.33	72.0	% \$66.44	\$88.73	68.4	% \$60.73	4.1	% 360	bps 9.4	%
Comfort Suites	94.13	72.1	% 67.86	90.22	68.1	% 61.48	4.3	% 400	bps 10.4	%
Sleep	80.95	68.4	% 55.35	77.72	63.9	% 49.66	4.2	% 450	bps 11.5	%
Quality	77.05	63.3	% 48.78	75.14	59.9	% 45.02	2.5	% 340	bps 8.4	%
Clarion	83.40	61.8	% 51.49	80.42	57.6	% 46.35	3.7	% 420	bps 11.1	%
Econo Lodge	63.31	59.0	% 37.33	61.18	56.0	% 34.27	3.5	% 300	bps 8.9	%
Rodeway	62.71	62.8	% 39.35	60.41	58.7	% 35.48	3.8	% 410	bps 10.9	%
MainStay	78.58	77.3	% 60.70	75.99	73.0	% 55.51	3.4	% 430	bps 9.3	%
Suburban	46.78	74.6	% 34.88	43.45	72.1	% 31.32	7.7	% 250	bps 11.4	%
Ascend Hotel Collection	127.43	61.0	% 77.68	124.86	69.7	% 87.07	2.1	% (870)	bps (10.8)	)%
Total*	\$82.12	66.5	% \$54.64	\$79.39	63.3	% \$50.22	3.4	% 320	bps 8.8	%

\*Operating statistics exclude Cambria Suites since the operating statistics are not representative of a stabilized brand which the Company defines as having at least 25 units open and operating for a twelve month period.

The number of domestic rooms on-line increased by 3,746 rooms or 0.9% to 400,409 as of September 30, 2014 from 396,663 as of September 30, 2013. The total number of domestic hotels on-line increased by 1.6% to 5,218 as of September 30, 2014 from 5,134 as of September 30, 2013.





Table of Contents

A summary of domestic hotels and rooms on-line at September 30, 2014 and 2013 by brand is as follows:

	September 30, 2014		September 30, 2013		Variance		%	%	%	
	Hotels	Rooms	Hotels	Rooms	Hotels	Rooms				
Comfort Inn	1,266	98,119	1,312	102,586	(46 )	(4,467 )	(3.5 )	%	(4.4 )	%
Comfort Suites	593	45,873	590	45,519	3	354	0.5	%	0.8	%
Sleep	374	27,065	378	27,351	(4 )	(286 )	(1.1 )	%	(1.0 )	%
Quality	1,262	103,358	1,193	98,788	69	4,570	5.8	%	4.6	%
Clarion	183	26,182	188	26,885	(5 )	(703 )	(2.7 )	%	(2.6 )	%
Econo Lodge	846	52,304	821	50,230	25	2,074	3.0	%	4.1	%
Rodeway	460	25,235	434	24,660	26	575	6.0	%	2.3	%
MainStay	42	3,304	43	3,331	(1 )	(27 )	(2.3 )	%	(0.8 )	%
Suburban	64	7,164	63	7,213	1	(49 )	1.6	%	(0.7 )	%
Ascend Hotel Collection	107	9,271	94	8,006	13	1,265	13.8	%	15.8	%
Cambria Suites	21	2,534	18	2,094	3	440	16.7	%	21.0	%
Total Domestic Franchises	5,218	400,409	5,134	396,663	84	3,746	1.6	%	0.9	%

Domestic hotels open and operating increased by 6 hotels during the three months ended September 30, 2014 compared to a net increase of 16 domestic hotels open and operating during the three months ended September 30, 2013. Gross domestic franchise additions decreased from 75 for the three months ended September 30, 2013 to 67 for the same period of 2014. New construction hotels represented 8 of the gross domestic additions during the three months ended September 30, 2014 as compared to 7 new construction hotel openings in the same period of the prior year. Gross domestic additions for conversion hotels during the three months ended September 30, 2014 decreased by 9 units to 59 from 68 for the three months ended September 30, 2013. The decline in conversion hotel gross openings primarily reflects the variability in the timing of hotel openings from period to period.

Net domestic franchise terminations increased slightly from 59 in the three months ended September 30, 2013 to 61 for the three months ended September 30, 2014.

International rooms open and operating increased 0.9% to 106,905 as of September 30, 2014 from 106,000 as of September 30, 2013 contributing to an increase in international royalties of \$0.1 million or 1%. International royalties for the three months ended September 30, 2014 totaled \$6.6 million. The total number of international hotels declined 0.1% from 1,169 as of September 30, 2013 to 1,168 as of September 30, 2014.

#### Initial Franchise and Relicensing Fees

Domestic initial fee revenue, included in the initial franchise and relicensing fees caption on the Company's statements of income, generated from executed franchise agreements decreased \$0.7 million to \$1.9 million for the three months ended September 30, 2014 from \$2.6 million for the three months ended September 30, 2013. Domestic initial fee revenue decreased approximately 27% as there has been a 12% decline in executed franchise agreements from 129 franchise agreements, representing 10,591 rooms, executed in the third quarter of 2013 compared to 113 franchise agreements, representing 8,681 rooms executed in the third quarter of 2014 and a decline in the amount of deferred revenue recognized in third quarter of 2014 compared to the prior year related to franchise agreements containing developer 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.

During the third quarter of 2014, 31 of the executed agreements were for new construction hotel franchises representing 2,384 rooms compared to 20 contracts representing 1,397 rooms for the three months ended September 30, 2013. The increase in new construction franchise agreements primarily reflects a gradual improvement of the lending environment for hotel construction and improving lodging fundamentals including an increasing RevPAR environment and low industry supply growth which are typically catalysts for increased construction of new hotels. Conversion hotel executed franchise agreements totaled 82 representing 6,297 rooms for the three months ended September 30, 2014 compared to 109 agreements representing 9,194 rooms for the same period a year ago.

A summary of executed domestic franchise agreements by brand for the three months ended September 30, 2014 and 2013 is as follows:

47

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Table of Contents

	September 30, 2014			September 30, 2013			% Change		
	New Construction	Conversion	Total	New Construction	Conversion	Total	New Construction	Conversion	Total
Comfort Inn	6	3	9	7	17	24	(14)%	(82)%	(63)%
Comfort Suites	4	—	4	2	4	6	100%	(100)%	(33)%
Sleep	7	—	7	4	1	5	75%	(100)%	40%
Quality	—	34	34	—	32	32	NM	6%	6%
Clarion	1	4	5	1	5	6	—%	(20)%	(17)%
Econo Lodge	1	19	20	—	31	31	NM	(39)%	(35)%
Rodeway	2	17	19	1	15	16	100%	13%	19%
MainStay	5	—	5	1	—	1	400%	NM	400%
Suburban	1	—	1	1	—	1	—%	NM	—%
Ascend Hotel Collection	—	5	5	2	4	6	(100)%	25%	(17)%
Cambria Suites	4	—	4	1	—	1	300%	NM	300%
Total Domestic System	31	82	113	20	109	129	55%	(25)%	(12)%

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. Domestic relicensing revenues increased \$0.4 million or 23% from \$1.8 million for the three months ended September 30, 2013 to \$2.2 million for the three months ended September 30, 2014. The increase in revenues is due to an 18% increase in the execution of domestic relicensing and renewal contracts and an increase in the average fees per contract. Domestic relicensing and renewal contracts increased from 72 in the third quarter of 2013 to 85 for the three months ended September 30, 2014.

As of September 30, 2014, the Company had 422 franchised hotels with 32,505 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 371 hotels and 29,871 rooms at September 30, 2013. The number of new construction franchised hotels in the Company's domestic pipeline increased 20% to 261 at September 30, 2014 from 217 at September 30, 2013. The number of conversion franchised hotels in the Company's domestic pipeline increased by 7 hotels or 5% from 154 hotels at September 30, 2013 to 161 hotels at September 30, 2014. The Company had an additional 94 franchised hotels with 8,591 rooms under construction, awaiting conversion or approved for development in its international system as of September 30, 2014 compared to 84 hotels and 7,206 rooms at September 30, 2013. While the Company's hotel pipeline provides a strong platform for growth, a hotel in the pipeline does not always result in an open and operating hotel due to various factors.

Table of Contents

A summary of the domestic franchised hotels pipeline, which includes hotels under construction, awaiting conversion and approved for development, at September 30, 2014 and 2013 by brand is as follows:

	September 30, 2014			September 30, 2013			Variance		New Construction		Total		
	Conversion	New Construction	Total	Conversion	New Construction	Total	Units	%	Units	%	Units	%	
Comfort Inn	33	51	84	36	50	86	(3 )	(8 )%	1	2	%	(2 )	(2 )%
Comfort Suites	—	47	47	4	47	51	(4 )	(100 )%	—	—	%	(4 )	(8 )%
Sleep Quality	2	62	64	1	45	46	1	100 %	17	38	%	18	39 %
Clarion	34	6	40	33	3	36	1	3 %	3	100	%	4	11 %
Econo Lodge	9	3	12	7	2	9	2	29 %	1	50	%	3	33 %
Rodeway MainStay	36	3	39	33	—	33	3	9 %	3	NM		6	18 %
Suburban	31	4	35	24	1	25	7	29 %	3	300	%	10	40 %
Ascend Hotel Collection	2	39	41	—	26	26	2	NM	13	50	%	15	58 %
Cambria Suites	6	11	17	3	12	15	3	100 %	(1 )	(8 )%		2	13 %
	8	15	23	13	10	23	(5 )	(38 )%	5	50	%	—	— %
	—	20	20	—	21	21	—	NM	(1 )	(5 )%		(1 )	(5 )%
	161	261	422	154	217	371	7	5 %	44	20	%	51	14 %

Procurement Services: Revenues increased \$0.8 million or 17% from \$4.7 million for the three months ended September 30, 2013 to \$5.5 million for the three months ended September 30, 2014. The increase in revenues primarily reflects the implementation of new brand programs as well as an increased volume of business transacted with qualified vendors and strategic alliance partners.

Other Income: Revenue increased \$0.5 million from the three months ended September 30, 2013 to \$3.6 million for the three months ended September 30, 2014. The increase in other income is primarily due to income generated from additional fees implemented in late 2013 and charged to franchisees for non-compliance with the Company's rules and regulations.

Selling, General and Administrative Expenses: The cost to operate the business is reflected in SG&A on the consolidated statements of income. SG&A expenses were \$30.2 million for the three months ended September 30, 2014, an increase of \$3.8 million or 14% from the three months ended September 30, 2013.

SG&A expenses for the three months ended September 30, 2014 and 2013 include approximately \$4.8 million and \$2.7 million, respectively related to the Company's SkyTouch division. The increase in expenses related to SkyTouch primarily reflects increased investment in the division's sales and marketing efforts and product development.

Excluding the SG&A expenses for the SkyTouch division, SG&A for the three months ended September 30, 2014 increased \$1.8 million or 8% from the prior year. This increase in SG&A primarily reflects general inflationary cost increases as well as additional expenses related to an expansion of the Company's franchised hotel quality assurance program and unfavorable foreign currency exchange rate fluctuations

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 and property management systems, loyalty programs, 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 net income or loss to the Company is generated.

Total marketing and reservation system revenues declined from \$124.8 million for the three months ended September 30, 2013 to \$115.7 million for the three months ended September 30, 2014. Marketing and reservation system revenues recognized during the three months ended September 30, 2014 were impacted by the deferral of approximately \$23.9 million of revenue as the Company generated marketing and reservation system fees in excess of cumulative expenses. The Company is

Table of Contents

contractually obligated by its franchise agreements to use the marketing and reservation system fees collected for marketing and reservation activities. As a result, cumulative marketing and reservation fees not expended are deferred and recorded as a liability in the Company's financial statements and carried over to the next fiscal year and expended in accordance with the franchise agreements. Conversely, cumulative marketing and reservation expenditures incurred in excess of fees billed for marketing and reservation activities are deferred and recorded as an asset in the Company's financial statements and recovered in future periods. During the three months ended September 30, 2013, the Company's cumulative expenses exceeded cumulative marketing and reservation fees and therefore marketing and reservation fees collected in excess of current period expenses were utilized to reimburse cumulative advances. As a result, no revenues were deferred during this period.

Excluding the impact of the revenue deferred during the three month period ended September 30, 2014, marketing and reservation system revenues increased approximately 12%. The increase in revenues was primarily due to improved system fees resulting from system growth and RevPAR increases, increasing revenues from the Choice Privileges loyalty program resulting from the growth in program membership and new marketing and distribution program fees. At December 31, 2013, the Company incurred marketing and reservation system expenses in excess of cumulative marketing and reservation system fees earned of \$5.8 million. At September 30, 2014, cumulative marketing and reservation system fees billed exceeded expenses by \$39.9 million with the excess reflected as an other long-term liability in the accompanying consolidated balance sheets.

**Interest Expense:** Interest expense decreased \$0.3 million for the three months ended September 30, 2014 to \$10.5 million due to lower outstanding borrowings on the Company's revolving credit facility and term loan as well as a lower effective borrowing rate costs.

**Other (Gains) and Losses:** Other gains and losses decreased from a gain of \$0.7 million for the three months ended September 30, 2013 to a \$0.4 million loss in the same period of the current year primarily due to the fluctuations in the fair value of investments held in the Company's non-qualified employee benefit plans.

**Income Taxes:** The Company's effective income tax rates for continuing operations were 29.6% and 28.9% for the three months ended September 30, 2014 and 2013, respectively. The effective income tax rate for the three months ended September 30, 2014 and 2013 were lower than the U.S federal income tax rate of 35% due to the recurring impact of foreign operations, partially offset by state income taxes. The effective income tax rate for the three months ended September 30, 2014 was further reduced by the settlement of unrecognized tax positions.

**Discontinued Operations:** In the first quarter of 2014, the Company's management approved a plan to dispose of the three Company owned Mainstay Suites hotels. As a result, the Company has reported the operations related to these three hotels as discontinued operations beginning in the first quarter of 2014. Net loss from discontinued operations was \$0.1 million in the third quarter of 2014 compared to net income of \$0.1 million in the third quarter of 2013.

**Diluted EPS:** Diluted EPS increased 2% to \$0.67 for the three months ended September 30, 2014 from \$0.66 for the same period of the prior year. During the three months ended September 30, 2014 continuing and discontinued operations contributed \$0.67 and \$0.00, respectively, to diluted EPS. During the three months ended September 30, 2013 continuing operations and discontinued operations contributed \$0.65 and \$0.01, respectively, to diluted EPS. The increase in diluted EPS in 2014 over 2013 primarily reflects the items discussed above.

Table of Contents

## Operations Review

## Comparison of Operating Results for the Nine-Month Periods Ended September 30, 2014 and 2013

Summarized financial results for the nine months ended September 30, 2014 and 2013 are as follows:

(in thousands)	2014	2013
<b>REVENUES:</b>		
Royalty fees	\$222,301	\$208,206
Initial franchise and relicensing fees	12,761	12,843
Procurement services	18,293	16,204
Marketing and reservation	309,025	311,204
Other	10,188	7,362
Total revenues	572,568	555,819
<b>OPERATING EXPENSES:</b>		
Selling, general and administrative	88,329	82,808
Depreciation and amortization	6,903	6,701
Marketing and reservation	309,025	311,204
Total operating expenses	404,257	400,713
Operating income	168,311	155,106
<b>OTHER INCOME AND EXPENSES, NET:</b>		
Interest expense	31,376	32,334
Interest income	(1,205)	(1,979)
Other (gains) and losses	(158)	(1,266)
Equity in net (income) loss of affiliates	578	(340)
Total other income and expenses, net	30,591	28,749
Income from continuing operations before income taxes	137,720	126,357
Income taxes	41,556	36,384
Income from continuing operations, net of income taxes	96,164	89,973
Income from discontinued operations, net of income taxes	1,711	293
Net income	\$97,875	\$90,266

## Results of Operations

The Company recorded income from continuing operations before income taxes of \$137.7 million for the nine month period ended September 30, 2014, an \$11.4 million, or 9% increase from the same period of the prior year. The increase in income from continuing operations before income taxes primarily reflects a \$13.2 million increase in operating income and a \$1.0 million decline in interest expense partially offset by a \$1.1 million decrease in the Company's other gains and losses and a \$0.9 million decline in equity in net income of affiliates. The decline in other gains and losses resulted from a \$1.3 million appreciation in the fair value of investments held in the Company's non-qualified employee benefit plans during the nine months ended September 30, 2013 compared to a \$0.2 million appreciation in fair value in the current year period.

Operating income increased \$13.2 million as the Company's franchising revenues increased by \$18.7 million or 8% partially offset by SG&A expenses increasing \$5.5 million or 7%. Adjusted EBITDA for the nine months ended September 30, 2014 increased \$13.4 million or 8% to \$175.2 million. The key drivers of these fluctuations are described in more detail below.

**Franchising Revenues:** Franchising revenues were \$263.3 million for the nine months ended September 30, 2014 compared to \$244.6 million for the nine months ended September 30, 2013, an increase of 8%. The increase in franchising revenues is primarily due to a \$14.1 million or 7% increase in royalty revenues, a \$2.1 million or 13% increase in procurement services revenues and a \$2.8 million increase in other revenues.





Table of Contents

## Royalty Fees

Domestic royalty fees for the nine months ended September 30, 2014 increased \$14.2 million to \$203.9 million, an increase of 8% compared to the nine months ended September 30, 2013. The increase in royalties is attributable to a combination of factors including a 7.7% increase in RevPAR and a 0.9% increase in the number of domestic franchised hotel rooms open. These increases were partially offset by a 5 basis point decline in the effective royalty rate from 4.33% to 4.28%. System-wide RevPAR increased due to a combination of a 2.8% increase in average daily rates and a 280 basis point increase in occupancy rates.

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

	For the Nine Months Ended September 30, 2014			For the Nine Months Ended September 30, 2013			Change						
	Average		RevPAR	Average		RevPAR	Average			Occupancy	RevPAR		
	Daily Rate	Occupancy		Daily Rate	Occupancy		Daily Rate	Occupancy	RevPAR				
Comfort Inn	\$86.92	64.9	% \$56.43	\$84.14	61.9	% \$52.08	3.3	%	300	bps	8.4	%	
Comfort Suites	91.06	67.8	% 61.78	87.91	64.6	% 56.81	3.6	%	320	bps	8.7	%	
Sleep	77.75	63.7	% 49.52	75.04	60.3	% 45.24	3.6	%	340	bps	9.5	%	
Quality	72.87	57.7	% 42.05	71.21	54.8	% 39.04	2.3	%	290	bps	7.7	%	
Clarion	78.05	55.9	% 43.59	76.21	52.6	% 40.12	2.4	%	330	bps	8.6	%	
Econo Lodge	58.64	52.9	% 31.01	57.32	50.4	% 28.89	2.3	%	250	bps	7.3	%	
Rodeway	57.46	56.5	% 32.48	55.28	53.3	% 29.45	3.9	%	320	bps	10.3	%	
MainStay	75.52	72.9	% 55.03	73.25	69.4	% 50.87	3.1	%	350	bps	8.2	%	
Suburban	45.29	73.3	% 33.19	42.91	71.5	% 30.70	5.5	%	180	bps	8.1	%	
Ascend Hotel Collection	120.64	59.8	% 72.10	122.67	65.6	% 80.52	(1.7)	)%	(580)	)bps	(10.5)	)%	
Total*	\$77.80	60.9	% \$47.36	\$75.67	58.1	% \$43.98	2.8	%	280	bps	7.7	%	

\*Operating statistics exclude Cambria Suites since the operating statistics are not representative of a stabilized brand which the Company defines as having at least 25 units open and operating for a twelve month period.

Domestic hotels open and operating increased by 38 hotels during the nine months ended September 30, 2014 compared to a net increase of 51 domestic hotels open and operating during the nine months ended September 30, 2013. Gross domestic franchise additions decreased from 236 for the nine months ended September 30, 2013 to 201 for the same period of 2014. New construction hotels represented 27 of the gross domestic additions during the nine months ended September 30, 2014 as compared to 24 new construction hotel openings in the same period of the prior year. Gross domestic additions for conversion hotels during the nine months ended September 30, 2014 decreased by 38 units to 174 from 212 for the nine months ended September 30, 2013. The decline in conversion hotel gross openings primarily reflects the impact of a strategic marketing alliance entered into with a timeshare company in 2013 which added 23 hotels to our Ascend Hotel Collection brand during the nine months ended September 30, 2013. The remaining decline reflects the variability in the timing of hotel openings from period to period. The Company expects the number of new franchise units that will open during 2014 to decline slightly from 340 in 2013 to 311 hotels. The decline in projected gross openings primarily reflects fewer conversion gross openings as our 2013 openings included the large multi-unit conversion of hotels to our Ascend Hotel Collection as noted above. The number of projected new construction and conversion openings continue to be impacted by the restrictive lending environment, retention efforts implemented by other hotel brand companies and competition for existing hotels seeking a new brand affiliation. Net domestic franchise terminations declined from 185 in the nine months ended September 30, 2013 to 163 for the nine months ended September 30, 2014. The decline in net terminations primarily reflects a decrease in the number of hotels removed from our franchise system for non-compliance with Company's rules and regulations. Under certain circumstances, as an alternative to terminating a hotel from the franchise system, the Company may seek to reposition hotels that are under-performing or that no longer meet the quality and brand standards of their particular brand to

another one of the Choice brands. As a result of this strategy, during the nine months ended September 30, 2014, the Company repositioned 64 hotels to other brands. As industry supply growth continues to improve and return to historical average levels, the Company will continue to execute its strategy to replace or reposition franchised hotels that do not meet brand standards or are under-performing in their market.

Table of Contents

International rooms open and operating increased 0.9% to 106,905 as of September 30, 2014 from 106,000 as of September 30, 2013. The total number of international hotels declined 0.1% from 1,169 as of September 30, 2013 to 1,168 as of September 30, 2014. Despite the increase in open rooms, international royalties decreased by \$0.1 million or 1% from the nine months ended September 30, 2013 to \$18.4 million for the same period of 2014. The decline in royalties was primarily the result of unfavorable foreign currency fluctuations in the countries in which we operate.

**Initial Franchise and Relicensing Fees**

Domestic initial fee revenue, included in the initial franchise and relicensing fees caption on the Company's statements of income, generated from executed franchise agreements decreased \$1.1 million to \$6.2 million for the nine months ended September 30, 2014 from \$7.3 million for the nine months ended September 30, 2013. Domestic initial fee revenue decreased approximately 15% primarily due to a 6% decline in the number of new domestic executed franchise agreements and a decline in the amount of deferred revenue recognized in 2014 related to franchise agreements containing developer incentives that were executed in prior years. Revenues associated with agreements including incentives are deferred and recognized when the incentive criteria are met or the agreement is terminated, whichever comes first.

New domestic franchise agreements executed in the nine months ended September 30, 2014 totaled 297 representing 23,335 rooms compared to 315 agreements representing 25,369 rooms executed in the same period of 2013. During the nine months ended September 30, 2014, 79 of the executed agreements were for new construction hotel franchises representing 5,877 rooms compared to 44 contracts representing 3,068 rooms for the nine months ended September 30, 2013. The increase in new construction franchise agreements primarily reflects a gradual improvement of the lending environment for hotel construction and improving lodging fundamentals including an increasing RevPAR environment and low industry supply growth which are typically a catalyst for increased construction of new hotels.

Conversion hotel executed franchise agreements totaled 218 representing 17,458 rooms for the nine months ended September 30, 2014 compared to 271 agreements representing 22,301 rooms for the same period a year ago. The decline in conversion hotel franchise agreements primarily reflects the impact of a strategic marketing alliance entered into with a timeshare company in 2013 which resulted in the execution of 24 new franchise agreements for our Ascend Hotel Collection brand during the nine months ended September 30, 2013 and a decline in Comfort conversion deals as the Company has emphasized adding new units through new construction franchise agreements rather than conversions of existing product.

A summary of executed domestic franchise agreements by brand for the nine months ended September 30, 2014 and 2013 is as follows:

	Nine Months Ended September, 2014			Nine Months Ended September 30, 2013			% Change				
	New Construction	Conversion	Total	New Construction	Conversion	Total	New Construction	Conversion	Total		
Comfort Inn	16	11	27	12	35	47	33	% (69	)%	(43	)%
Comfort Suites	11	—	11	7	6	13	57	% (100	)%	(15	)%
Sleep	21	1	22	9	1	10	133	% —	%	120	%
Quality	3	82	85	1	76	77	200	% 8	%	10	%
Clarion	1	15	16	1	12	13	—	% 25	%	23	%
Econo Lodge	1	46	47	—	61	61	NM	(25	)%	(23	)%
Rodeway	3	48	51	1	39	40	200	% 23	%	28	%
MainStay	10	1	11	5	—	5	100	% NM		120	%
Suburban	2	3	5	1	1	2	100	% 200	%	150	%
Ascend Hotel Collection	6	11	17	5	40	45	20	% (73	)%	(62	)%
Cambria Suites	5	—	5	2	—	2	150	% NM		150	%

Total											
Domestic	79	218	297	44	271	315	80	%	(20	)%	(6
System											)%

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. Domestic relicensing revenues increased \$1.2 million or 24% from \$4.8 million for the nine months ended September 30, 2013 to \$6.0 million for the nine months ended September 30, 2014. The increase in revenues is due to a 19% increase in the execution of domestic relicensing and renewal contracts and an increase in the average fees per contract. Domestic relicensing and renewal

Table of Contents

contracts increased from 204 in the nine months ended September 30, 2013 to 243 for the nine months ended September 30, 2014.

Procurement Services: Revenues increased \$2.1 million or 13% from \$16.2 million for the nine months ended September 30, 2013 to \$18.3 million for the nine months ended September 30, 2014. The increase in revenues primarily reflects the implementation of new brand programs as well as an increased volume of business transacted with qualified vendors and strategic alliance partners.

Other Income: Revenue increased \$2.8 million from the nine months ended September 30, 2013 to \$10.2 million for the nine months ended September 30, 2014. The increase in other income is primarily due to income generated from additional fees implemented in late 2013 and charged to franchisees for non-compliance with the Company's rules and regulations.

Selling, General and Administrative Expenses: The cost to operate the business is reflected in SG&A on the consolidated statements of income. SG&A expenses were \$88.3 million for the nine months ended September 30, 2014, an increase of \$5.5 million or 7% from the nine months ended September 30, 2013.

SG&A expenses for the nine months ended September 30, 2014 and 2013 include approximately \$12.3 million and \$7.1 million, respectively related to the Company's SkyTouch division. The increase in expenses related to SkyTouch primarily reflects increased investment in the division's sales and marketing efforts and product development. Excluding the SG&A expenses for the SkyTouch division, SG&A for the nine months ended September 30, 2014, increased \$0.3 million from the prior year. The growth in SG&A expenses, excluding SkyTouch, was impacted by higher occupancy costs incurred in 2013 due to the relocation of the Company's corporate headquarters, prior year litigation related settlement expenses and lower procurement services expenses incurred in 2014 compared to the prior year. In addition, compensation expense recognized on deferred compensation arrangements in 2014 declined by approximately \$1.5 million compared to the prior year period. The decline in compensation expense reflects lower increases in the fair value of investments held in the Company's non-qualified employee benefit plans during the nine months ended September 30, 2014 compared to the prior year.

Marketing and Reservations: The Company's franchise agreements require the payment of franchise fees, which include marketing and reservation system fees. The fees, which are primarily based on a percentage of the franchisees' gross room revenues, are used exclusively by the Company for expenses associated with providing franchise services such as central reservation and property management systems, loyalty programs, 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 net income or loss to the Company is generated.

Total marketing and reservation system revenues decreased from \$311.2 million for the nine months ended September 30, 2013 to \$309.0 million for the nine months ended September 30, 2014. Marketing and reservation system revenues recognized during the nine months ended September 30, 2014 were impacted by the deferral of approximately \$39.9 million of revenue as the Company billed marketing and reservation system fees in excess of cumulative expenses. The Company is contractually obligated by its franchise agreements to use the marketing and reservation system fees collected for marketing and reservation activities. As a result, cumulative marketing and reservation fees not expended are deferred and recorded as a liability in the Company's financial statements and carried over to the next fiscal year and expended in accordance with the franchise agreements. Conversely, cumulative marketing and reservation expenditures incurred in excess of fees billed for marketing and reservation activities are deferred and recorded as an asset in the Company's financial statements and recovered in future periods. During the nine months ended September 30, 2013, the Company's cumulative expenses exceeded cumulative marketing and reservation fees and therefore marketing and reservation fees collected in excess of current period expenses were utilized to reimburse cumulative advances. As a result, no revenues were deferred during this period.

Excluding the impact of the revenue deferred during the nine month period ended September 30, 2014, marketing and reservation system revenues increased approximately 12%. The increase in revenues was primarily due to improved system fees resulting from system growth and RevPAR increases, increasing revenues from the Choice Privileges

loyalty program resulting from the growth in program membership and new marketing and distribution program fees. At December 31, 2013, the Company incurred marketing and reservation system expenses in excess of cumulative marketing and reservation system fees earned of \$5.8 million. At September 30, 2014, cumulative marketing and reservation system fees billed exceeded expenses by \$39.9 million with the excess reflected as an other long-term liability in the accompanying consolidated balance sheets.

## Table of Contents

**Interest Expense:** Interest expense decreased \$1.0 million for the nine months ended September 30, 2014 to \$31.4 million due to lower outstanding borrowings on the Company's revolving credit facility and term loan as well as lower effective borrowing rate costs.

**Other (Gains) and Losses:** Other gains and losses declined from a gain of \$1.3 million for the nine months ended September 30, 2014 to a \$0.2 million gain in the same period of the current year primarily due to the fluctuations in the fair value of investments held in the Company's non-qualified employee benefit plans.

**Income Taxes:** The Company's effective income tax rates for continuing operations were 30.2% and 28.8% for the nine months ended September 30, 2014 and 2013, respectively. The effective income tax rates for the nine months ended September 30, 2014 and 2013 were lower than the U.S federal income tax rate of 35% due to the recurring impact of foreign operations, partially offset by state income taxes. The effective income tax rate for the nine months ended September 30, 2014 was further reduced by the settlement of unrecognized tax positions. Additionally, the effective income tax rate for the nine months ended September 30, 2013 was also reduced by settlements of unrecognized tax positions and by legislation retroactively extending the U.S. controlled foreign corporation look-through rule.

**Discontinued Operations:** In the first quarter of 2014, the Company's management approved a plan to dispose of the three Company owned Mainstay Suites hotels. As a result, the Company has reported the operations related to these three hotels as discontinued operations beginning in the first quarter of 2014. Net income from discontinued operations was \$1.7 million in the first nine months of 2014 compared to net income of \$0.3 million in the first nine months of 2013. The increase in net income was primarily due to a \$2.8 million gain on the sale of the three hotels during the nine months ended September 30, 2014.

**Diluted EPS:** Diluted EPS increased 8% to \$1.66 for the nine months ended September 30, 2014 from \$1.53 for the same period of the prior year. During the nine months ended September 30, 2014 continuing and discontinued operations contributed \$1.63 and \$0.03, respectively, to diluted EPS. During the nine months ended September 30, 2013 continuing operations and discontinued operations contributed \$1.53 and \$0.00, respectively, to diluted EPS. The increase in diluted EPS in 2014 over 2013 primarily reflects the items discussed above.

## Liquidity and Capital Resources

### Operating Activities

During the nine months ended September 30, 2014, net cash provided by operating activities totaled \$138.4 million compared to \$106.5 million during the nine months ended September 30, 2013, an increase of \$31.9 million. The increase in cash flows from operating activities primarily reflects an increase in operating income, a \$30.5 million improvement in cash flows from marketing and reservation activities, a decline in management incentive plan compensation payments related to prior year accruals partially offset by a \$3.1 million increase in net disbursements to franchisees for property improvements and other purposes utilizing forgivable notes receivable.

Net cash provided by marketing and reservation activities totaled \$60.2 million during the nine months ended September 30, 2014 compared to \$29.7 million during the nine months ended September 30, 2013. The increase in cash provided by marketing and reservation activities primarily reflects improved system fees resulting from system growth and RevPAR increases, improved financial performance of the Company's loyalty programs and new advertising and distribution program fees which have grown at a faster pace than expenses. Based on the current economic conditions, the Company expects marketing and reservation activities to provide cash flows from operations ranging between \$60 million and \$65 million in 2014.

In conjunction with brand and development programs, the Company provides financing to franchisees for property improvements and other purposes in the form of forgivable notes receivable. If the franchisee remains in the system in good standing over the term of the promissory note, the Company forgives the outstanding principal balance and related interest. Since these forgivable notes are predominantly forgiven ratably over the term of the promissory note rather than repaid, the Company classifies the related issuance and collections of these notes as operating activities.

During the nine months ended September 30, 2014 and 2013, the Company's net advances for these purposes totaled \$8.8 million and \$5.7 million, respectively. The timing and amount of these cash flows is dependent on various factors including the implementation of various development and brand incentive programs, the level of franchise sales as



well as the timing of hotel openings. At September 30, 2014, the Company had commitments to extend an additional \$16.3 million for these purposes provided certain conditions are met by its franchisees, of which \$6.6 million is expected to be advanced in the next twelve months. In addition, the Company has announced a property improvement incentive program for its domestic Comfort Inn and Comfort Suites hotels to incent hotel owners to renovate their properties to accelerate improvement of the brand's product quality and consistency, guest satisfaction and brand performance. The Company has committed to provide financing in the form of

55

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## Table of Contents

forgivable promissory notes to qualifying domestic hotels for a portion of their Company approved and completed property improvement expenses. Financing will be provided upon the completion and Company certification of the renovations. At September 30, 2014, the Company expects future commitments of between \$20.9 million and \$24.1 million for this purpose, provided certain conditions are met by its franchisees. These commitments are expected to be funded in the next twelve months.

### Investing Activities

Cash utilized for investing activities totaled \$5.3 million and \$29.8 million for the nine months ended September 30, 2014 and 2013, respectively. The decline in cash utilized for investing activities for the nine months ended September 30, 2014 primarily reflects the following items:

During the nine months ended September 30, 2014 and 2013, capital expenditures totaled \$11.9 million and \$27.9 million, respectively. The decline in capital expenditures from 2013 primarily reflect tenant improvements related to the relocation of the Company's corporate headquarters incurred during the prior year.

During the nine months ended September 30, 2014, the Company realized proceeds from the sales of assets totaling \$15.6 million related to the sale of three Company owned MainStay Suites hotels, a facility previously utilized as a call center and the sale of a parcel of land related to the development of a new Cambria Suites hotel.

During the nine months ended September 30, 2014 and 2013, the Company invested \$14.4 million and \$3.8 million, respectively, in joint ventures accounted for under the equity method of accounting. The Company's investment in these joint ventures primarily relate to ventures that either support the Company's efforts to increase business delivery to its franchisees or promote growth of our emerging brands.

The Company occasionally provides financing to franchisees for hotel development efforts and other purposes in the form of mezzanine and other notes receivable. These loans bear interest and are expected to be repaid in accordance with the terms of the loan agreements. During the nine months ended September 30, 2014, the Company advanced \$3.3 million and was repaid \$9.8 million from our franchisees for these purposes.

During the nine months ended September 30, 2014 and 2013, the Company sold investments totaling \$1.0 million and \$4.1 million, respectively, and utilized the proceeds to distribute participant deferred compensation balances from the Company's non-qualified retirement plans. The decline in proceeds from the sale of investments primarily reflects the timing of employee terminations and their deferred compensation distribution elections.

Our board of directors authorized a program which permits us to offer financing, investment and guaranty support to qualified franchisees as well as to acquire and resell real estate to incent franchise development for certain brands in strategic markets. Over the next several years, we expect to continue to deploy capital opportunistically pursuant to this program to promote growth of our emerging brands. Our current expectation is that our annual investment in this program will range from \$20 million to \$40 million per year and we generally expect to recycle these investments within a five year period. However, the amount and timing of the investment in this program will be dependent on market and other conditions.

### Financing Activities

Financing cash flows relate primarily to the Company's borrowings, open market treasury stock repurchases, acquisition of shares in connection with the exercise or vesting of equity awards, and dividends.

### Debt

#### Senior Unsecured Notes due 2022

On June 27, 2012, the Company issued unsecured senior notes with a principal amount of \$400 million (the "2012 Senior Notes") at par, bearing a coupon of 5.75% with an effective rate of 5.94%. The 2012 Senior Notes will mature on July 1, 2022, with interest to be paid semi-annually on January 1<sup>st</sup> and July 1<sup>st</sup>. The Company utilized the net proceeds of this offering, after deducting underwriting discounts and commissions and other offering expenses, together with borrowings under the Company's senior credit facility, to pay a special cash dividend in 2012 totaling approximately \$600.7 million. The Company's 2012 Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations by certain of the Company's domestic subsidiaries.

The Company may redeem the 2012 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

56

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Table of Contents

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 50 basis points.

Senior Unsecured Notes due 2020

On August 25, 2010, the Company issued unsecured senior notes with a principal amount of \$250 million (the "2010 Senior Notes") at a discount of \$0.6 million, bearing a coupon of 5.70% with an effective rate of 6.19%. The 2010 Senior Notes will mature on August 28, 2020, with interest on the 2010 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 and other general corporate purposes. The Company's 2010 Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations, by certain of the Company's domestic subsidiaries.

The Company may redeem the 2010 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.

Senior Secured Credit Facility

On July 25, 2012, the Company entered into a \$350 million senior secured credit facility, comprised of a \$200 million revolving credit tranche (the "Revolver") and a \$150 million term loan tranche (the "Term Loan") with Deutsche Bank AG New York Branch, as administrative agent, Wells Fargo Bank, National Association, as administrative agent, and a syndication of lenders (the "Credit Facility"). The Credit Facility has a final maturity date of July 25, 2016, subject to an optional one-year extension, provided certain conditions are met. Up to \$25 million of the borrowings under the Revolver may be used for letters of credit, up to \$10 million of borrowings under the Revolver may be used for swing-line loans and up to \$35 million of borrowings under the Revolver may be used for alternative currency loans. The Term Loan requires quarterly amortization payments (a) during the first two years, in equal installments aggregating 5% of the original principal amount of the Term Loan per year, (b) during the second two years, in equal installments aggregating 7.5% of the original principal amount of the Term Loan per year, and (c) during the one-year extension period (if exercised), equal installments aggregating 10% of the original principal amount of the Term Loan.

The Credit Facility is unconditionally guaranteed, jointly and severally, by certain of the Company's domestic subsidiaries. The subsidiary guarantors currently include all subsidiaries that guarantee the obligations under the Company's Indenture governing the terms of its 2010 and 2012 Senior Notes.

The Credit Facility is secured by first priority pledges of (i) 100% of the ownership interests in certain domestic subsidiaries owned by the Company and the guarantors, (ii) 65% of the ownership interests in (a) the top-tier foreign holding company of the Company's foreign subsidiaries, and (b) the domestic subsidiary that owns the top-tier foreign holding company of the Company's foreign subsidiaries and (iii) all presently existing and future domestic franchise agreements (the "Franchise Agreements") between the Company and individual franchisees, but only to the extent that the Franchise Agreements may be pledged without violating any law of the relevant jurisdiction or conflicting with any existing contractual obligation of the Company or the applicable franchisee. At the time that the maximum total leverage ratio is required to be no greater than 4.00 to 1.00 (beginning of year 4 of the Credit Facility), the security interest in the Franchise Agreements will be released.

The Company may at any time prior to the final maturity date increase the amount of the Credit Facility by up to an additional \$100 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. Such additional amounts may take the form of an increased revolver or term loan.

The Company may elect to have borrowings under the Credit Facility bear interest at a rate equal to (i) LIBOR, plus a margin ranging from 200 to 425 basis points based on the Company's total leverage ratio or (ii) a base rate plus a margin ranging from 100 to 325 basis points based on the Company's total leverage ratio.

The Credit Facility requires the Company to pay a fee on the undrawn portion of the Revolver, calculated based on the average daily unused amount of the Revolver multiplied by 0.30% per annum.

The Company may reduce the Revolver commitment and/or prepay the Term Loan in whole or in part at any time without penalty, subject to reimbursement of customary breakage costs, if any. Any Term Loan prepayments made by the Company shall be applied to reduce the scheduled amortization payments in direct order of maturity.

## Table of Contents

Additionally, the Credit Facility requires that the Company and its restricted subsidiaries comply with various covenants, including with respect to restrictions on liens, incurring indebtedness, making investments, paying dividends or repurchasing stock, and effecting mergers and/or asset sales. With respect to dividends, the Company may not make any payments if there is an existing event of default or if the payment would create an event of default. In addition, if the Company's total leverage ratio exceeds 4.5 to 1.0, the Company is generally restricted from paying aggregate dividends in excess of \$50 million during any calendar year.

The Credit Facility also imposes financial maintenance covenants requiring the Company to maintain:

- a total leverage ratio of not more than 5.75 to 1.00 in year 1, 5.00 to 1.00 in year 2, 4.50 to 1.00 in year 3 and 4.00 to 1.00 thereafter,
- a maximum secured leverage ratio of not more than 2.50 to 1.00 in year 1, 2.25 to 1.00 in year 2, 2.00 to 1.00 in year 3 and 1.75 to 1.00 thereafter, and
- a minimum fixed charge coverage ratio of not less than 2.00 to 1.00 in years 1 and 2, 2.25 to 1.00 in year 3 and 2.50 to 1.00 thereafter.

At September 30, 2014, the Company maintained a total leverage ratio of approximately 3.16x, a maximum secured leverage ratio of 0.53x and a minimum fixed charge coverage ratio of approximately 6.13x. At September 30, 2014, the Company was in compliance with all financial covenants under the Credit Facility.

The Credit Facility 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 Credit Facility to be immediately due and payable.

At September 30, 2014, the Company had \$132.2 million outstanding under the Term Loan and no amounts outstanding under the Revolver. At December 31, 2013, the Company had \$138.8 million outstanding under the Term Loan and no amounts outstanding under the Revolver.

### Economic Development Loans

The Company entered into economic development agreements with various governmental entities in conjunction with the relocation of its corporate headquarters in April 2013. In accordance with these agreements, the governmental entities agreed to advance approximately \$4.4 million to the Company to offset a portion of the corporate headquarters relocation and tenant improvement costs in consideration of the employment of permanent, full-time employees within the jurisdictions. At September 30, 2014, the Company has been advanced approximately \$3.5 million pursuant to these agreements and expects to receive the remaining \$0.9 million over the next several years, subject to annual appropriations by the governmental entities. These advances bear interest at a rate of 3% per annum.

Repayment of the advances is contingent upon the Company achieving certain performance conditions. Performance conditions are measured annually on December 31<sup>st</sup> and primarily relate to maintaining certain levels of employment within the various jurisdictions. If the Company fails to meet an annual performance condition, the Company may be required to repay a portion or all of the advances including accrued interest by April 30<sup>th</sup> following the measurement date. Any outstanding advances at the expiration of the Company's 10 year corporate headquarters lease in 2023 will be forgiven in full. The advances will be included in long-term debt in Company's consolidated balance sheets until the Company determines that the future performance conditions will be met over the entire term of the agreement and the Company will not be required to repay the advances. The Company accrues interest on the portion of the advances that it expects to repay. The Company was in compliance with all current performance conditions as of September 30, 2014.

### Dividends

The Company currently maintains the payment of a quarterly dividend on its common stock outstanding of \$0.185 per share, however, the declaration of future dividends are subject to the discretion of our board of directors. The Company's quarterly dividend rate declared during the nine months ended September 30, 2014 remained unchanged from the previous quarterly declarations.

During the nine months ended September 30, 2014, the Company paid cash dividends totaling \$32.8 million. We expect to continue to pay dividends in the future, subject to the declaration of our board of directors as well as to future business performance, economic conditions, changes in income tax regulations and other factors. Based on the present dividend rate and outstanding share count, we expect that aggregate annual regular dividends for 2014 would

be approximately \$43.5 million.

58

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## Table of Contents

### Share Repurchases

The Company repurchased 0.4 million shares of its common stock under the share repurchase program at a total cost of \$18.4 million during the nine months ended September 30, 2014. These shares were purchased from family members of the Company's largest shareholder at their fair market value. Since the program's inception through September 30, 2014, we have repurchased 45.7 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 \$1.1 billion. Considering the effect of the two-for-one stock split, the Company has repurchased 78.7 million shares at an average price of \$14.06 per share. As of September 30, 2014, the Company had approximately 1.1 million shares remaining under the current share repurchase authorization.

During the nine months ended September 30, 2014, the Company redeemed 110,579 shares of common stock at a total cost of approximately \$5.3 million from employees to satisfy the option exercise price and statutory minimum tax-withholding requirements related to the exercising of stock options and vesting of performance vested restricted stock units and restricted stock grants. These redemptions were outside the share repurchase program.

### Other items

Approximately \$180.6 million of the Company's cash and cash equivalents at September 30, 2014 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 U.S. 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 U.S. income taxes on any amounts utilized domestically.

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.

### Off Balance Sheet Arrangements

On October 9, 2012, the Company entered into a limited payment guaranty with regards to a VIE's \$18.0 million bank loan for the construction of a hotel franchised under one of the Company's brands in the United States. Under the terms of the limited guaranty, the Company has agreed to guarantee 25% of the outstanding principal balance for a maximum exposure of \$4.5 million and accrued and unpaid interest, as well as any unpaid expenses incurred by the lender. The limited guaranty shall remain in effect until the maximum amount guaranteed by the Company is paid in full. In addition to the limited guaranty, the Company entered into an agreement in which the Company guarantees the completion of the construction of the hotel and an environmental indemnity agreement which indemnifies the lending institution from and against any damages relating to or arising out of possible environmental contamination issues with regards to the property.

On November 15, 2013, the Company entered into a limited payment guaranty with regards to a VIE's \$46.2 million bank loan for the construction of a hotel franchised under one of the Company's brands in the United States. Under the terms of the limited guaranty, the Company has agreed to unconditionally guarantee and become surety for the full and timely payment of the guaranteed outstanding principal balance, as well as any unpaid expenses incurred by the lender. The guarantee is limited to 25% of the outstanding principal balance of the \$46.2 million loan due at any time for a maximum exposure of \$11.6 million. The limited guaranty shall remain in effect until the maximum amount guaranteed by the Company is repaid in full. The maturity date of the VIE's loan is May 2017. In conjunction with this guaranty, the Company has entered into a reimbursement and guaranty agreement with certain individuals that requires them to reimburse the Company in an amount equal to 75% of any payments made by the Company under this limited payment guaranty.

### 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, 2013 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 realizable from our franchisees. Franchise fees are typically based on a percentage of gross room revenues or the number of hotel rooms of each franchisee. Franchise fees based on a percentage of gross room revenues are recognized in the same period that the underlying gross room revenues are earned by our franchisees. Our estimate of the allowance for uncollectible royalty fees is

59

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Table of Contents

charged to SG&A expense and our estimate of the allowance for uncollectible marketing and reservation system fees is charged to marketing and reservation expenses.

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 pro-rata over the MDA's contractual life. Fees that are contingent upon the execution of franchise agreements under the MDA are recognized upon execution of the franchise agreement.

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

Marketing and Reservation Revenues and Expenses.

The Company's franchise agreements require the payment of certain marketing and reservation system fees, which are used exclusively by the Company for expenses associated with providing franchise services such as national marketing, loyalty programs, 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 net 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 and accounting, 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 recoveries 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 deferred and recorded as a liability in the Company's balance sheet and are carried over to the next fiscal year and expended in accordance with the franchise agreements. Shortfall amounts are recorded as an asset in the Company's balance sheet, with a corresponding reduction in costs, and are similarly recovered in subsequent years. Under the terms of the franchise agreements, the Company may advance capital and incur costs as necessary for marketing and reservation activities and recover such advances through future fees. 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. When shortfall amounts are recorded as an asset, the Company may impose an assessment on its franchisees to recover the deferred costs or recover these costs over a period of time by expending fewer amounts on marketing and reservation activities than marketing and reservation system fees collected, depending on the marketing and reservation needs of the system. Our current assessment is that the credit risk associated with any cumulative cost advances for marketing and reservation system activities is mitigated due to our contractual right to recover these amounts from a large geographically dispersed group of franchisees.

The Company evaluates the recoverability of marketing and reservation costs incurred in excess of cumulative marketing and reservation system revenues earned on a periodic basis. The Company will record a reserve when, based on current information and events, it is probable that it will be unable to recover the cumulative amounts advanced for marketing and reservation activities according to the contractual terms of the franchise agreements.

These advances are considered to be unrecoverable if the 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.

## Table of Contents

We provide Choice Privileges as a marketing program to franchised hotels and collect a percentage of program members' room revenue from franchises to operate the program. Revenues are deferred in an amount equal to the estimated fair value of the future redemption obligation. The Company develops an estimate of 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.

### 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. In evaluating these assets for impairment, the Company first assesses qualitative factors to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. If we conclude that it is not more likely than not that the fair value of the reporting unit is less than its carrying value, then no further testing is required. If the conclusion is that it is more likely than not that the fair value of a reporting unit is less than its carrying value, then a two-step impairment test is performed. 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 strategic 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 collectability 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 the Company 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 collectability 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 the 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

In conjunction with brand and development programs, the Company may provide financing to franchisees for property improvements and other purposes in the form of forgivable promissory notes which bear interest at market rates. Under these promissory notes, the franchisee promises to repay the principal balance together with interest upon maturity unless certain conditions are met throughout the term of the promissory note. The principal balance and related interest are forgiven ratably over the term of the promissory note if the franchisee remains in the system in good standing. If during the term of the promissory note, the franchisee exits our franchise system or is not operating their franchise in accordance with our quality or credit standards, the Company may declare a default under the promissory note and commence collection efforts with respect to the full amount of the then-current outstanding principal and interest.

In accordance with the terms of the promissory notes, the initial principal balance and related interest are ratably reduced over the term of the loan on each anniversary date until the outstanding amounts are reduced to zero as long as the franchisee remains within the franchise system and operates in accordance with our quality and brand standards. As a result, the amounts recorded as an asset on the Company's consolidated balance sheet are also ratably reduced since the amounts forgiven no longer represent probable future economic benefits to the Company. The Company records the reduction of its recorded assets through amortization and marketing and reservation expense on its consolidated statements of income. Since these forgivable promissory notes receivable are predominately forgiven ratably over the term of the promissory note rather than repaid, the Company classifies the issuance and collection of these notes receivable as operating activities in its consolidated statement of cash flows.

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 and marketing and reservation system expenses in the accompanying consolidated statements of income in the quarter when the note is deemed uncollectible.

### 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.

## Table of Contents

With respect to uncertain income tax positions, a tax liability is now 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.

### 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, 2009. 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 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 are held in trusts 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 consolidated statements of income. In addition, the EDCP Plan holds shares of the Company's common stock which are recorded as a component of shareholders' deficit.

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. 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 diversified investments are held in trusts 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 consolidated statements of income. In addition, the Non-Qualified Plan holds shares of the Company's common stock which are recorded as a component of shareholders' deficit.

### New Accounting Standards

See Footnote No. 1 of the Notes to our Financial Statements for information related to our adoption of new accounting standards in 2014 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 the Private Securities Litigation Reform Act of 1995. Generally, our use of words such as "expect," "estimate," "believe," "anticipate," "should," "will," "forecast," "plan," "project," "assume" or similar words of futurity identify such forward-looking statements. These 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, ability to repay outstanding indebtedness, payment of dividends, and future operations, among other matters. We caution you not to place undue reliance on any such forward-looking



statements. 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,

Table of Contents

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 marketing and reservations systems and other operating systems; fluctuations in the supply and demand for hotels rooms; the level of acceptance of alternative growth strategies we may implement; cyber security and data breach risks; operating risks associated with international operations; the outcome of litigation; and our ability to effectively manage our indebtedness. These and other risk factors are discussed in detail in the Risk Factors section of the Company's Amended Form 10-K for the year ended December 31, 2013, filed with the Securities and Exchange Commission on November 3, 2014. 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 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 \$17.1 million and \$16.4 million at September 30, 2014 and

## Table of Contents

December 31, 2013, 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, 2014, the Company had \$132.2 million of variable interest rate debt instruments outstanding at an effective rate of 2.2%. A hypothetical change of 10% in the Company's effective interest rate from September 30, 2014 levels would increase or decrease annual interest expense by \$0.3 million. 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

### Management's Evaluation of Disclosure Controls and Procedures

Our management, with participation of our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") have evaluated the effectiveness of our disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"), as of the end of the period covered by this quarterly report as required by Rules 13a-15(b) or 15d-15(b) under the Exchange Act. Our management, including our CEO and CFO, does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Based upon our evaluation, our CEO and CFO have concluded that our disclosure controls and procedures were not effective as of September 30, 2014 due to the material weakness in internal control over financial reporting related to the revenue recognition methodology for royalty and certain marketing and reservation fees revenues discussed below.

Notwithstanding the material weakness as described below, management concluded that the consolidated financial statements included in this Form 10-Q present fairly, in all material respects, the financial position, results of operations and cash flows for the periods presented.

### Material Weakness Related to Revenue Recognition Methodology for Royalty and Certain Marketing and Reservation System Fee Revenues.

In connection with the preparation of the consolidated financial statements for the second quarter of 2014, the Company reviewed its accounting policies and practices, including the historical practice of reporting royalty and certain marketing and reservation fees one month in arrears as compared to when the gross room revenues (on which the fees are based) are earned by the Company's franchisees. The Company previously determined that the impact of the revenue recognition timing related to these revenues on its annual financial statements was not material and therefore reported these revenues one month in arrears despite the fact that these fees meet the definition of being earned and realizable in the same period that the underlying gross room revenues are earned by its franchisees. However, the Company reassessed the impact of reporting these revenues one month in arrears on interim periods and determined that this revenue recognition practice, which was not in accordance with generally accepted accounting principles in the United States of America ("GAAP"), was material to interim periods. Due to the seasonality of the Company's business, the impact of this change on previously reported interim revenues, operating income and earnings per share as reported in the Company's consolidated statements of income varies for individual past quarters and is generally positive in the first two quarters of the year and negative in the final two quarters of the year. As a result, the Company has corrected its revenue recognition method to recognize royalty and certain marketing and reservation system fees as revenue in the same period as the gross room revenues are earned by its franchisees.

The Company has assessed the impact of the recognition of revenues for certain royalty and marketing and reservation system fees one month in arrears and concluded that the impact was not material to any of the Company's previously issued annual financial statements. However, while the recordation of revenue one month in arrears did not result in a material misstatement of our previously issued annual consolidated financial statements, it did result in material misstatements of previously reported interim results. Management has concluded there was a material weakness in

internal control over financial reporting related to the revenue recognition methodology for royalty and certain marketing and reservation system fees as discussed below.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

## Table of Contents

The Company did not design and maintain effective controls over the accuracy and completeness of royalty fees, certain marketing and reservation fees and expenses, and resulting receivables and advances, marketing and reservation activities. Specifically, the Company did not design a control to monitor and evaluate the materiality of the difference between recognizing these revenues and related expenses one-month in arrears rather than on an accrual basis as required by GAAP. This control deficiency resulted in the revision of the Company's financial statements for the years ended December 31, 2013, 2012, and 2011 and the restatement of interim financial statements for the periods ended March 31, 2014 and 2013, September 30, 2013 and 2012, and June 30, 2013. Additionally, this control deficiency could result in further misstatements of the aforementioned accounts and disclosures that would result in a material misstatement of the annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, the Company has determined that this control deficiency constitutes a material weakness.

### Changes in internal control over financial reporting

Except as disclosed below under "Remediation of Material Weaknesses", there have been no changes in our internal control over financial reporting that occurred during the most recent quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### Remediation of Material Weakness

In response to this material weakness, the Company has developed and is executing a plan with the oversight of the Audit Committee of the Board of Directors to remediate this material weakness. Our plan to remediate this material weakness during the year ending December 31, 2014 includes updating the revenue recognition practice to ensure the accounting for royalty and certain marketing and reservation system fees is in compliance with GAAP. The restatement of our financial statements was reflected on the following reports:

- Amended 2014 first quarter report on Form 10-Q, including restated financial statements;
- Amended 2013 third quarter report on Form 10-Q, including restated financial statements;
- Amended 2013 annual report on Form 10-K including revised financial statements for years ended 2011, 2012 and 2013;
- 2014 second quarter reports on Form 10-Q, including restated second quarter 2013 financial statements.

Management will continue to monitor the effectiveness of this and other processes, procedures and controls and will make any further changes deemed appropriate.

The material weakness noted above cannot be considered remediated until the applicable remedial controls operate for a sufficient period of time and management has concluded, through testing, that these controls are operating effectively. The required testing for remediation will occur prior the Company completing its assessment of internal controls for the year ending December 31, 2014.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

The Company is not a party to any litigation other than litigation in the ordinary course of business. The Company's management and legal counsel do not expect that the ultimate outcome of any of its currently ongoing legal proceedings, individually or collectively, will have a material adverse effect on the Company's financial position, results of operations or cash flows.

### ITEM 1A. RISK FACTORS

There have been no material changes in our risk factors from those disclosed in Part I, Item 1A to our Amended Annual Report on Form 10-K for the fiscal year ended December 31, 2013 filed on November 3, 2014. 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 Amended Annual Report on Form 10-K for the year ended December 31, 2013, which could materially affect our business, financial condition or future results. The risks described in our Amended 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, 2014:

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, 2014	—	\$—	—	1,418,991
February 28, 2014	85,280	47.85	—	1,418,991
March 31, 2014	9,163	49.10	—	1,418,991
April 30, 2014	302	44.65	—	1,418,991
May 31, 2014	—	—	—	1,418,991
June 30, 2014	—	—	—	1,418,991
July 31, 2014	—	—	—	1,418,991
August 31, 2014	8,744	47.12	—	1,418,991
September 30, 2014	363,072	51.79	355,982	1,063,009
Total	466,561	\$50.92	355,982	1,063,009

(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, 2014, the Company redeemed 110,579 shares of common stock from employees to satisfy the option price and minimum tax-withholding requirements related to the exercising of options and vesting of restricted stock and performance vested restricted stock unit grants. These redemptions were not part of the board repurchase authorization.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 4. MINE SAFETY DISCLOSURES

None.

## 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)	Amendment to the Restated Certificate of Incorporation of Choice Hotels International, Inc.
3.03(c)	Amended and Restated Bylaws of Choice Hotels International, Inc.
31.1*	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
31.2*	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
32*	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350
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

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\* Filed herewith

- (a) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc.'s Registration Statement on Form S-4, filed August 31, 1998 (Reg. No. 333-62543).
- (b) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc.'s Current Report on Form 8-K filed May 1, 2013.
- (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 February 16, 2010.





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 7, 2014

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