

CHOICE HOTELS INTERNATIONAL INC /DE  
Form 10-Q  
August 11, 2014  
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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 June 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<br>(State or other jurisdiction of<br>incorporation or organization)<br>1 CHOICE HOTELS CIRCLE, SUITE 400<br>ROCKVILLE, MD 20850<br>(Address of principal executive offices)<br>(Zip Code)<br>(301) 592-5000<br>(Registrant's telephone number, including area code) | 52-1209792<br>(I.R.S. Employer<br>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 <input checked="" type="checkbox"/> | Accelerated filer <input type="checkbox"/>         |
| Non-accelerated filer <input type="checkbox"/>              | Smaller reporting company <input type="checkbox"/> |

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

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| CLASS                                    | SHARES OUTSTANDING AT JUNE 30, 2014 |
|--|-------------------------------------|
| Common Stock, Par Value \$0.01 per share | 58,433,234                          |

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

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

|  | Three Months Ended |            | Six Months Ended |            |
|--|--------------------|------------|------------------|------------|
|  | June 30,           |            | June 30,         |            |
|  | 2014               | 2013       | 2014             | 2013       |
| REVENUES:  |                    | (Restated) |                  | (Restated) |
| Royalty fees   | \$77,670           | \$72,638   | \$136,210        | \$128,746  |
| Initial franchise and relicensing fees                   | 4,722              | 4,416      | 8,462            | 8,193      |
| Procurement services                                     | 8,020              | 7,546      | 12,798           | 11,496     |
| Marketing and reservation                                | 103,766            | 104,072    | 193,372          | 186,395    |
| Other  | 3,486              | 2,258      | 6,558            | 4,271      |
| Total revenues   | 197,664            | 190,930    | 357,400          | 339,101    |
| OPERATING EXPENSES:                                      |                    |            |                  |            |
| Selling, general and administrative                      | 31,413             | 29,731     | 58,093           | 56,399     |
| Depreciation and amortization                            | 2,332              | 2,388      | 4,610            | 4,429      |
| Marketing and reservation                                | 103,766            | 104,072    | 193,372          | 186,395    |
| Total operating expenses                                 | 137,511            | 136,191    | 256,075          | 247,223    |
| Operating income   | 60,153             | 54,739     | 101,325          | 91,878     |
| OTHER INCOME AND EXPENSES, NET:                          |                    |            |                  |            |
| Interest expense   | 10,710             | 10,807     | 20,881           | 21,577     |
| Interest income  | (347)              | (659)      | (850)            | (1,303)    |
| Other (gains) and losses                                 | (474)              | 147        | (533)            | (563)      |
| Equity in net (income) loss of affiliates                | 30                 | (60)       | 65               | 81         |
| Total other income and expenses, net                     | 9,919              | 10,235     | 19,563           | 19,792     |
| Income from continuing operations before income taxes    | 50,234             | 44,504     | 81,762           | 72,086     |
| Income taxes   | 14,955             | 12,880     | 25,014           | 20,686     |
| Income from continuing operations, net of income taxes   | 35,279             | 31,624     | 56,748           | 51,400     |
| Income from discontinued operations, net of income taxes | 121                | 183        | 1,762            | 150        |
| Net income   | \$35,400           | \$31,807   | \$58,510         | \$51,550   |
| Basic earnings per share                                 |                    |            |                  |            |
| Continuing operations                                    | \$0.61             | \$0.54     | \$0.97           | \$0.88     |
| Discontinued operations                                  | —                  | —          | 0.03             | —          |
|  | \$0.61             | \$0.54     | \$1.00           | \$0.88     |
| Diluted earnings per share                               |                    |            |                  |            |
| Continuing operations                                    | \$0.60             | \$0.54     | \$0.96           | \$0.88     |
| Discontinued operations                                  | —                  | —          | 0.03             | —          |
|  | \$0.60             | \$0.54     | \$0.99           | \$0.88     |

|                                   |         |         |        |        |
|-----------------------------------|---------|---------|--------|--------|
| Cash dividends declared per share | \$0.185 | \$0.185 | \$0.37 | \$0.37 |
|-----------------------------------|---------|---------|--------|--------|

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

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(UNAUDITED, IN THOUSANDS)

|  | Three Months Ended |            | Six Months Ended |            |
|--|--------------------|------------|------------------|------------|
|  | June 30            |            | June 30          |            |
|  | 2014               | 2013       | 2014             | 2013       |
| Net income                                     | \$35,400           | \$31,807   | \$58,510         | \$51,550   |
| Other comprehensive income (loss), net of tax: |                    | (Restated) |                  | (Restated) |
| Amortization of loss on cash flow hedge        | 216                | 216        | 431              | 431        |
| Foreign currency translation adjustment        | 509                | (2,082     | ) 1,030          | (2,327     |
| Other comprehensive income (loss), net of tax  | 725                | (1,866     | ) 1,461          | (1,896     |
| Comprehensive income                           | \$36,125           | \$29,941   | \$59,971         | \$49,654   |

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

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

|  | June 30,<br>2014 | December 31,<br>2013 |
|--|------------------|----------------------|
| <b>ASSETS</b>  |                  |                      |
| Current assets   |                  |                      |
| Cash and cash equivalents  | \$211,542        | \$167,795            |
| Receivables (net of allowance for doubtful accounts of \$13,188 and \$12,187, respectively)  | 119,763          | 82,385               |
| Deferred income taxes  | 29,733           | 26,684               |
| Investments, employee benefit plans, at fair value   | 176              | 400                  |
| Other current assets   | 23,789           | 29,710               |
| Total current assets   | 385,003          | 306,974              |
| Property and equipment, at cost, net   | 58,238           | 67,852               |
| Goodwill   | 65,813           | 65,813               |
| Franchise rights and other identifiable intangibles, net   | 8,389            | 9,953                |
| Advances, marketing and reservation activities   | —                | 5,844                |
| Notes receivable, net of allowances  | 34,492           | 31,872               |
| Investments, employee benefit plans, at fair value   | 17,270           | 15,950               |
| Deferred income taxes  | 1,121            | —                    |
| Other assets   | 58,116           | 52,164               |
| Total assets   | \$628,442        | \$556,422            |
| <b>LIABILITIES AND SHAREHOLDERS' DEFICIT</b>   |                  |                      |
| Current liabilities  |                  |                      |
| Accounts payable   | \$50,892         | \$41,663             |
| Accrued expenses   | 52,398           | 56,625               |
| Deferred revenue   | 67,365           | 61,188               |
| Current portion of long-term debt  | 11,970           | 10,088               |
| Deferred compensation and retirement plan obligations  | 579              | 2,492                |
| Income taxes payable   | 17,459           | 2,282                |
| Total current liabilities  | 200,663          | 174,338              |
| Long-term debt   | 777,536          | 783,471              |
| Deferred compensation and retirement plan obligations  | 23,260           | 22,527               |
| Deferred income taxes  | —                | 5,149                |
| Other liabilities  | 39,493           | 23,808               |
| Total liabilities  | 1,040,952        | 1,009,293            |
| Commitments and Contingencies  |                  |                      |
| Common stock, \$0.01 par value, 160,000,000 shares authorized; 95,065,638 shares issued at June 30, 2014 and December 31, 2013 and 58,433,234 and 58,638,863 shares outstanding at June 30, 2014 and December 31, 2013, respectively | 584              | 586                  |
| Additional paid-in-capital   | 118,976          | 117,768              |
| Accumulated other comprehensive loss   | (4,756           | ) (6,217 )           |
| Treasury stock (36,632,404 and 36,426,775 shares at June 30, 2014 and December 31, 2013, respectively), at cost  | (916,893         | ) (918,031 )         |
| Retained earnings  | 389,579          | 353,023              |
| Total shareholders' deficit  | (412,510         | ) (452,871 )         |
| Total liabilities and shareholders' deficit  | \$628,442        | \$556,422            |

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

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

|   | Six Months Ended |            |   |
|---|------------------|------------|---|
|   | June 30          |            |   |
|   | 2014             | 2013       |   |
|   |                  | (Restated) |   |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                  |            |   |
| Net income  | \$58,510         | \$51,550   |   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |            |   |
| Depreciation and amortization   | 4,610            | 4,695      |   |
| Gain on sale of assets  | (2,849           | ) —        |   |
| Provision for bad debts, net  | 1,383            | 1,753      |   |
| Non-cash stock compensation and other charges                                     | 4,711            | 5,566      |   |
| Non-cash interest and other (income) loss   | 719              | 967        |   |
| Deferred income taxes   | (9,273           | ) 8,236    |   |
| Dividends received from equity method investments                                 | 546              | 535        |   |
| Equity in net loss of affiliates  | 65               | 81         |   |
| Changes in assets and liabilities:  |                  |            |   |
| Receivables   | (39,518          | ) (40,349  | ) |
| Advances to/from marketing and reservation activities, net                        | 31,522           | 5,631      |   |
| Forgivable notes receivable, net  | (6,692           | ) (3,595   | ) |
| Accounts payable  | 8,316            | 9,893      |   |
| Accrued expenses  | (5,247           | ) (18,463  | ) |
| Income taxes payable/receivable   | 15,198           | 1,198      |   |
| Deferred revenue  | 6,231            | (3,318     | ) |
| Other assets  | (1,102           | ) (1,664   | ) |
| Other liabilities   | (1,298           | ) 7,271    |   |
| Net cash provided by operating activities   | 65,832           | 29,987     |   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                  |            |   |
| Investment in property and equipment  | (7,314           | ) (22,035  | ) |
| Proceeds from sales of assets   | 12,216           | —          |   |
| Equity method investments   | (6,946           | ) (1,851   | ) |
| Purchases of investments, employee benefit plans                                  | (1,220           | ) (1,580   | ) |
| Proceeds from sales of investments, employee benefit plans                        | 641              | 3,934      |   |
| Issuance of mezzanine and other notes receivable                                  | (2,223           | ) —        |   |
| Collections of mezzanine and other notes receivable                               | 9,743            | 201        |   |
| Other items, net  | (296             | ) (304     | ) |
| Net cash provided (used) in investing activities                                  | 4,601            | (21,635    | ) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                  |            |   |
| Net borrowings pursuant to revolving credit facility                              | —                | 15,200     |   |
| Principal payments on long-term debt  | (4,112           | ) (4,095   | ) |
| Proceeds from the issuance of long-term debt                                      | 26               | —          |   |
| Purchases of treasury stock   | (4,544           | ) (3,651   | ) |
| Dividends paid  | (21,957          | ) (11,261  | ) |
| Excess tax benefits from stock-based compensation                                 | 1,319            | 1,146      |   |
| Proceeds from exercise of stock options   | 1,547            | 5,973      |   |
| Net cash provided (used) by financing activities                                  | (27,721          | ) 3,312    |   |
| Net change in cash and cash equivalents   | 42,712           | 11,664     |   |

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|   |           |           |   |
|---|-----------|-----------|---|
| Effect of foreign exchange rate changes on cash and cash equivalents                    | 1,035     | (2,051    | ) |
| Cash and cash equivalents at beginning of period  | 167,795   | 134,177   |   |
| Cash and cash equivalents at end of period  | \$211,542 | \$143,790 |   |
| Supplemental disclosure of cash flow information:                                       |           |           |   |
| Cash payments during the period for:  |           |           |   |
| Income taxes, net of refunds  | \$19,594  | \$11,652  |   |
| Interest  | \$20,595  | \$22,033  |   |
| Non-cash investing and financing activities:  |           |           |   |
| Dividends declared but not paid   | \$10,810  | \$10,766  |   |
| Issuance of common stock pursuant to share based compensation plans                     | \$8,024   | \$9,395   |   |
| Investment in property and equipment acquired in accounts payable                       | \$688     | \$6,096   |   |
| The accompanying notes are an integral part of these consolidated financial statements. |           |           |   |

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

1. Company Information and Significant Accounting Policies

The accompanying unaudited consolidated financial statements of Choice Hotels International, Inc. and subsidiaries (together the "Company") have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). 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 Form 10-K, filed with the SEC on March 3, 2014 (the "10-K") as well as the information provided below under the heading "Revision to Prior Annual Financial Statements and Restatement of Prior Interim Financial Statements". The Company intends to amend its 10-K as soon as administratively practical to revise its previously issued audited financial statements and amend its report on internal control over financial reporting. 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.

Revision to Prior Annual Financial Statements and Restatement of Prior Interim Financial Statements

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, during the current period, 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 GAAP, was material to interim periods due to the seasonality of the Company's business. 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.

In accordance with Accounting Standards Codification ("ASC") 250 (SEC's Staff Accounting Bulletin 99, "Materiality"), the Company assessed the materiality of the misapplication of GAAP and concluded that the restatement of revenues was not material to any of its previously issued annual financial statements but was material to certain interim periods. In accordance with the accounting guidance in ASC 250 (SEC Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements"), the Company will restate its previously issued interim financial statements for the periods ended March 31, 2014 and 2013 and September 30, 2013 and 2012 through the filing of amended quarterly filings on Form 10-Q and has restated the interim financial periods for June 30, 2013 in this interim financial report. In addition, the Company will revise its previously issued audited financial statements for the years ended December 31, 2011, 2012, and 2013 to correct the presentation of revenues and amend its report on internal control over financial reporting.

The following tables present the effect of this and other immaterial errors for the financial statement line items impacted in the affected periods included within this interim financial report. In addition, these amounts have been adjusted to reflect the Company's discontinued operations reported in the first quarter of 2014.

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## Consolidated Statements of Income

|  | Three Months Ended June 30, 2013         |                            |            |                | Six Months Ended June 30, 2013 |                            |            |                |
|--|--|----------------------------|------------|----------------|--------------------------------|----------------------------|------------|----------------|
|  | As<br>Previously<br>Reported             | Discontinued<br>Operations | Adjustment | As<br>Restated | As<br>Previously<br>Reported   | Discontinued<br>Operations | Adjustment | As<br>Restated |
|  | (in thousands, except per share amounts) |                            |            |                |                                |                            |            |                |
| Royalty fees   | \$68,379                                 | \$—                        | \$4,259    | \$72,638       | \$118,115                      | \$—                        | \$10,631   | \$128,746      |
| Marketing and reservation revenues                     | 99,645                                   | —                          | 4,427      | 104,072        | 176,085                        | —                          | 10,310     | 186,395        |
| Hotel operations                                       | 1,334                                    | (1,334)                    | ) —        | —              | 2,290                          | (2,290)                    | ) —        | —              |
| Total revenues   | 183,578                                  | (1,334)                    | ) 8,686    | 190,930        | 320,450                        | (2,290)                    | ) 20,941   | 339,101        |
| Selling, general and administrative                    | 30,180                                   | —                          | (449)      | ) 29,731       | 57,096                         | —                          | (697)      | ) 56,399       |
| Depreciation and amortization                          | 2,520                                    | (132)                      | ) —        | 2,388          | 4,695                          | (266)                      | ) —        | 4,429          |
| Marketing and reservation expenses                     | 99,645                                   | —                          | 4,427      | 104,072        | 176,085                        | —                          | 10,310     | 186,395        |
| Hotel operations                                       | 911                                      | (911)                      | ) —        | —              | 1,786                          | (1,786)                    | ) —        | —              |
| Total operating expenses                               | 133,256                                  | (1,043)                    | ) 3,978    | 136,191        | 239,662                        | (2,052)                    | ) 9,613    | 247,223        |
| Operating income                                       | 50,322                                   | (291)                      | ) 4,708    | 54,739         | 80,788                         | (238)                      | ) 11,328   | 91,878         |
| Income from continuing operations before income taxes  | 40,087                                   | (291)                      | ) 4,708    | 44,504         | 60,996                         | (238)                      | ) 11,328   | 72,086         |
| Income taxes   | 11,853                                   | (108)                      | ) 1,135    | 12,880         | 17,239                         | (88)                       | ) 3,535    | 20,686         |
| Income from continuing operations, net of income taxes | 28,234                                   | (183)                      | ) 3,573    | 31,624         | 43,757                         | (150)                      | ) 7,793    | 51,400         |
| Basic earnings per share, continuing operations        | \$0.48                                   | \$—                        | \$0.06     | \$0.54         | \$0.75                         | \$—                        | \$0.13     | \$0.88         |
| Diluted earnings per share, continuing operations      | \$0.48                                   | \$—                        | \$0.06     | \$0.54         | \$0.74                         | \$—                        | \$0.14     | \$0.88         |

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|  | Six Months Ended June 30, 2013 |            |             |
|--|--------------------------------|------------|-------------|
|  | As                             |            | As          |
|  | Previously                     | Adjustment | As          |
|  | Reported                       |            | Restated    |
| Consolidated Statement of Cash Flows                       | (in thousands)                 |            |             |
| Net income   | \$43,757                       | \$7,793    | \$51,550    |
| Provision for bad debts, net                               | 1,420                          | 333        | 1,753       |
| Non-cash stock compensation and other charges              | 5,581                          | (15        | ) 5,566     |
| Deferred income taxes                                      | 4,169                          | 4,067      | 8,236       |
| Change in assets and liabilities                           |                                |            |             |
| Receivables  | (21,156                        | ) (19,193  | ) (40,349 ) |
| Advances to/from marketing and reservation activities, net | (2,945                         | ) 8,576    | 5,631       |
| Income taxes payable/receivable                            | 1,729                          | (531       | ) 1,198     |
| Net cash provided by operating activities                  | 28,957                         | 1,030      | 29,987      |
| Investment in property and equipment                       | (21,005                        | ) (1,030   | ) (22,035 ) |
| Net cash used in investing activities                      | (20,605                        | ) (1,030   | ) (21,635 ) |

|  | As of December 31, 2013 |            |            |
|--|-------------------------|------------|------------|
|  | As                      |            | As         |
|  | Previously              | Adjustment | Revised    |
|  | Reported                |            | As         |
| Consolidated Balance Sheet                     | (in thousands)          |            |            |
| Receivables                                    | \$53,521                | \$28,864   | \$82,385   |
| Deferred income taxes                          | 7,220                   | 19,464     | 26,684     |
| Total current assets                           | 258,646                 | 48,328     | 306,974    |
| Property and equipment, at cost, net           | 66,092                  | 1,760      | 67,852     |
| Advances, marketing and reservation activities | 19,127                  | (13,283    | ) 5,844    |
| Deferred income taxes                          | 20,282                  | (20,282    | ) —        |
| Total assets                                   | 539,899                 | 16,523     | 556,422    |
| Deferred income taxes                          | —                       | 5,149      | 5,149      |
| Total liabilities                              | 1,004,144               | 5,149      | 1,009,293  |
| Retained earnings                              | 341,649                 | 11,374     | 353,023    |
| Total shareholders' deficit                    | (464,245                | ) 11,374   | (452,871 ) |

The following tables present the effect of this and other immaterial errors for the financial statement line items impacted in the Company's quarterly reports on Form 10-Q which will be amended for the interim periods ended March 31, 2014 and September 30, 2013 and corresponding prior year periods. These amended reports will be filed with the SEC as soon as administratively possible. In addition, these amounts have been adjusted to reflect the Company's discontinued operations reported in the first quarter of 2014.

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## Consolidated Statements of Income

|  | Three Months Ended March 31, 2014        |            |             | Three Months Ended March 31, 2013 |            |             |
|--|--|------------|-------------|-----------------------------------|------------|-------------|
|  | As Previously Reported                   | Adjustment | As Restated | As Previously Reported            | Adjustment | As Restated |
|  | (in thousands, except per share amounts) |            |             |                                   |            |             |
| Royalty fees   | \$51,681                                 | \$6,859    | \$58,540    | \$49,736                          | \$6,372    | \$56,108    |
| Marketing and reservation revenues                     | 84,012                                   | 5,594      | 89,606      | 76,440                            | 5,883      | 82,323      |
| Total revenues   | 147,283                                  | 12,453     | 159,736     | 135,916                           | 12,255     | 148,171     |
| Selling, general and administrative                    | 26,463                                   | 217        | 26,680      | 26,916                            | (248 )     | 26,668      |
| Depreciation and amortization                          | 2,122                                    | 156        | 2,278       | 2,041                             | —          | 2,041       |
| Marketing and reservation expenses                     | 84,012                                   | 5,594      | 89,606      | 76,440                            | 5,883      | 82,323      |
| Total operating expenses                               | 112,597                                  | 5,967      | 118,564     | 105,397                           | 5,635      | 111,032     |
| Operating income                                       | 34,686                                   | 6,486      | 41,172      | 30,519                            | 6,620      | 37,139      |
| Income from continuing operations before income taxes  | 25,042                                   | 6,486      | 31,528      | 20,962                            | 6,620      | 27,582      |
| Income taxes   | 7,711                                    | 2,348      | 10,059      | 5,406                             | 2,400      | 7,806       |
| Income from continuing operations, net of income taxes | 17,331                                   | 4,138      | 21,469      | 15,556                            | 4,220      | 19,776      |
| Basic earnings per share, continuing operations        | \$0.30                                   | \$0.07     | \$0.37      | \$0.27                            | \$0.07     | \$0.34      |
| Diluted earnings per share, continuing operations      | \$0.29                                   | \$0.07     | \$0.36      | \$0.26                            | \$0.08     | \$0.34      |
|  | Three Months Ended March 31, 2014        |            |             | Three Months Ended March 31, 2013 |            |             |
|  | As Previously Reported                   | Adjustment | As Restated | As Previously Reported            | Adjustment | As Restated |
|  | (in thousands)                           |            |             |                                   |            |             |
| Net cash provided by operating activities              | \$5,264                                  | \$—        | \$5,264     | \$145                             | \$450      | \$595       |
| Investment in property and equipment                   | (3,015 )                                 | —          | (3,015 )    | (13,645 )                         | (450 )     | (14,095 )   |
| Net cash provided (used) by investing activities       | 1,027                                    | —          | 1,027       | (12,087 )                         | (450 )     | (12,537 )   |

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|   | As of March 31, 2014                     |              |             |            |                                      |              |            |           |
|---|--|--------------|-------------|------------|--------------------------------------|--------------|------------|-----------|
|   | As Previously                            | Adjustment   | As Restated |            |                                      |              |            |           |
|   | Reported                                 |              |             |            |                                      |              |            |           |
|   | (in thousands)                           |              |             |            |                                      |              |            |           |
| Consolidated Balance Sheet                            |  |              |             |            |                                      |              |            |           |
| Receivables   | \$59,241                                 | \$40,906     | \$100,147   |            |                                      |              |            |           |
| Deferred income taxes                                 | 7,220                                    | 21,202       | 28,422      |            |                                      |              |            |           |
| Total current assets                                  | 277,714                                  | 62,108       | 339,822     |            |                                      |              |            |           |
| Property and equipment, at cost, net                  | 56,664                                   | 1,604        | 58,268      |            |                                      |              |            |           |
| Advances, marketing and reservation activities        | 18,856                                   | (18,696      | ) 160       |            |                                      |              |            |           |
| Deferred income taxes                                 | 20,321                                   | (20,321      | ) —         |            |                                      |              |            |           |
| Total assets  | 554,900                                  | 24,695       | 579,595     |            |                                      |              |            |           |
| Deferred income taxes                                 | —  | 9,196        | 9,196       |            |                                      |              |            |           |
| Total liabilities                                     | 1,009,533                                | 9,196        | 1,018,729   |            |                                      |              |            |           |
| Retained earnings                                     | 349,458                                  | 15,511       | 364,969     |            |                                      |              |            |           |
| Total shareholders' deficit                           | (454,633                                 | ) 15,499     | (439,134    |            | )                                    |              |            |           |
| Consolidated Statements of Income                     |  |              |             |            |                                      |              |            |           |
|   | Three Months Ended September 30, 2013    |              |             |            | Nine Months Ended September 30, 2013 |              |            |           |
|   | As                                       | Discontinued | Adjustment  | As         | As                                   | Discontinued | Adjustment | As        |
|   | Previously                               | Operations   |             | Restated   | Previously                           | Operations   |            | Restated  |
|   | Reported                                 |              |             |            | Reported                             |              |            |           |
|   | (in thousands, except per share amounts) |              |             |            |                                      |              |            |           |
| Royalty fees  | \$83,107                                 | \$—          | \$(3,647    | ) \$79,460 | \$201,222                            | \$—          | \$6,984    | \$208,206 |
| Marketing and reservation revenues                    | 126,296                                  | —            | (1,487      | ) 124,809  | 302,381                              | —            | 8,823      | 311,204   |
| Hotel operations                                      | 1,310                                    | (1,310       | ) —         | —          | 3,600                                | (3,600       | ) —        | —         |
| Total revenues  | 223,162                                  | (1,310       | ) (5,134    | ) 216,718  | 543,612                              | (3,600       | ) 15,807   | 555,819   |
| Selling, general and administrative                   | 26,982                                   | —            | (573        | ) 26,409   | 84,078                               | —            | (1,270     | ) 82,808  |
| Depreciation and amortization                         | 2,379                                    | (127         | ) 20        | 2,272      | 7,074                                | (393         | ) 20       | 6,701     |
| Marketing and reservation expenses                    | 126,296                                  | —            | (1,487      | ) 124,809  | 302,381                              | —            | 8,823      | 311,204   |
| Hotel operations                                      | 956                                      | (956         | ) —         | —          | 2,742                                | (2,742       | ) —        | —         |
| Total operating expenses                              | 156,613                                  | (1,083       | ) (2,040    | ) 153,490  | 396,275                              | (3,135       | ) 7,573    | 400,713   |
| Operating income                                      | 66,549                                   | (227         | ) (3,094    | ) 63,228   | 147,337                              | (465         | ) 8,234    | 155,106   |
| Income from continuing operations before income taxes | 57,592                                   | (227         | ) (3,094    | ) 54,271   | 118,588                              | (465         | ) 8,234    | 126,357   |
| Income taxes  | 16,080                                   | (84          | ) (298      | ) 15,698   | 33,319                               | (172         | ) 3,237    | 36,384    |
| Income from continuing                                | 41,512                                   | (143         | ) (2,796    | ) 38,573   | 85,269                               | (293         | ) 4,997    | 89,973    |



operations, net of  
income taxes

|  |        |       |           |          |        |     |        |        |
|--|--------|-------|-----------|----------|--------|-----|--------|--------|
| Basic earnings per<br>share, continuing<br>operations      | \$0.71 | \$—   | \$(0.05)  | ) \$0.66 | \$1.46 | \$— | \$0.08 | \$1.54 |
| Diluted earnings<br>per share,<br>continuing<br>operations | \$0.70 | (0.01 | ) \$(0.04 | ) \$0.65 | \$1.45 | \$— | \$0.08 | \$1.53 |

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|  | Three Months Ended September 30, 2012    |                         |                                      |             | Nine Months Ended September 30, 2012 |                         |            |             |
|--|--|-------------------------|--------------------------------------|-------------|--------------------------------------|-------------------------|------------|-------------|
|  | As Previously Filed                      | Discontinued Operations | Adjustment                           | As Restated | As Previously Filed                  | Discontinued Operations | Adjustment | As Restated |
|  | (in thousands, except per share amounts) |                         |                                      |             |                                      |                         |            |             |
| Royalty fees   | \$80,845                                 | \$—                     | \$ (2,807 )                          | \$78,038    | \$194,762                            | \$—                     | \$ 8,225   | \$202,987   |
| Marketing and reservation revenues                     | 119,062                                  | —                       | (1,097 )                             | 117,965     | 284,624                              | —                       | 9,721      | 294,345     |
| Hotel operations                                       | 1,238                                    | (1,238 )                | —                                    | —           | 3,440                                | (3,440 )                | —          | —           |
| Total revenues   | 210,413                                  | (1,238 )                | (3,904 )                             | 205,271     | 513,203                              | (3,440 )                | 17,946     | 527,709     |
| Selling, general and administrative                    | 23,170                                   | —                       | (98 )                                | 23,072      | 72,073                               | —                       | 249        | 72,322      |
| Depreciation and amortization                          | 1,995                                    | (135 )                  | —                                    | 1,860       | 5,989                                | (401 )                  | —          | 5,588       |
| Marketing and reservation expenses                     | 119,062                                  | —                       | (1,097 )                             | 117,965     | 284,624                              | —                       | 9,721      | 294,345     |
| Hotel operations                                       | 933                                      | (933 )                  | —                                    | —           | 2,609                                | (2,609 )                | —          | —           |
| Total operating expenses                               | 145,160                                  | (1,068 )                | (1,195 )                             | 142,897     | 365,295                              | (3,010 )                | 9,970      | 372,255     |
| Operating income                                       | 65,253                                   | (170 )                  | (2,709 )                             | 62,374      | 147,908                              | (430 )                  | 7,976      | 155,454     |
| Income from continuing operations before income taxes  | 55,668                                   | (170 )                  | (2,709 )                             | 52,789      | 133,840                              | (430 )                  | 7,976      | 141,386     |
| Income taxes   | 11,291                                   | (63 )                   | (1,076 )                             | 10,152      | 37,604                               | (160 )                  | 3,303      | 40,747      |
| Income from continuing operations, net of income taxes | 44,377                                   | (107 )                  | (1,633 )                             | 42,637      | 96,236                               | (270 )                  | 4,673      | 100,639     |
| Basic earnings per share, continuing operations        | \$0.77                                   | \$—                     | \$ (0.03 )                           | \$0.74      | \$1.66                               | \$ (0.01 )              | \$ 0.08    | \$1.73      |
| Diluted earnings per share, continuing operations      | \$0.76                                   | \$—                     | \$ (0.03 )                           | \$0.73      | \$1.65                               | \$—                     | \$ 0.08    | \$1.73      |
|  |  |                         | Nine Months Ended September 30, 2013 |             |                                      |                         |            |             |
| Consolidated Statement of Cash Flows                   |  |                         | As Previously Filed                  | Adjustment  | As Restated                          |                         |            |             |
|  |  |                         | (in thousands)                       |             |                                      |                         |            |             |
|  |  |                         | \$105,009                            | \$1,480     | \$106,489                            |                         |            |             |

Net cash provided by operating  
activities

|                                       |         |          |             |
|---------------------------------------|---------|----------|-------------|
| Investment in property and equipment  | (26,442 | ) (1,480 | ) (27,922 ) |
| Net cash used in investing activities | (28,350 | ) (1,480 | ) (29,830 ) |

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|  | As of September 30, 2013 |            |             | As of December 31, 2012 |            |            |   |
|--|--------------------------|------------|-------------|-------------------------|------------|------------|---|
|  | As Previously Reported   | Adjustment | As Restated | As Previously Reported  | Adjustment | As Revised |   |
| Consolidated Balance Sheets                    | (in thousands)           |            |             |                         |            |            |   |
| Receivables                                    | \$62,605                 | \$40,282   | \$102,887   | \$52,270                | \$27,729   | \$79,999   |   |
| Income taxes receivable                        | —                        | —          | —           | 2,732                   | (531       | ) 2,201    |   |
| Deferred income taxes                          | 4,136                    | 23,231     | 27,367      | 4,136                   | 22,062     | 26,198     |   |
| Total current assets                           | 258,267                  | 63,513     | 321,780     | 233,470                 | 49,260     | 282,730    |   |
| Property and equipment, at cost, net           | 65,540                   | 1,460      | 67,000      | 51,651                  | —          | 51,651     |   |
| Advances, marketing and reservation activities | 32,564                   | (18,494    | ) 14,070    | 42,179                  | (12,712    | ) 29,467   |   |
| Deferred income taxes                          | 19,496                   | (19,496    | ) —         | 15,418                  | (15,418    | ) —        |   |
| Total assets                                   | 555,709                  | 26,983     | 582,692     | 510,772                 | 21,130     | 531,902    |   |
| Deferred income taxes                          | —                        | 11,722     | 11,722      | —                       | 10,864     | 10,864     |   |
| Total liabilities                              | 1,040,433                | 11,722     | 1,052,155   | 1,059,676               | 10,864     | 1,070,540  |   |
| Retained earnings                              | 325,005                  | 15,264     | 340,269     | 272,260                 | 10,266     | 282,526    |   |
| Total shareholders' deficit                    | (484,724                 | ) 15,261   | (469,463    | ) (548,904              | ) 10,266   | (538,638   | ) |

The following tables present the effect of this and other immaterial errors for the financial statement line items impacted for the years ended December 31, 2011, 2012, and 2013 which will be revised prospectively in future annual filings. In addition, these amounts have been adjusted to reflect the Company's discontinued operations reported in the first quarter of 2014.

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## Consolidated Statements of Income

|  | Year Ended December 31, 2013             |                            |            |               | Year Ended December 31, 2012 |                            |            |               |
|--|--|----------------------------|------------|---------------|------------------------------|----------------------------|------------|---------------|
|  | As<br>Previously<br>Reported             | Discontinued<br>Operations | Adjustment | As<br>Revised | As<br>Previously<br>Reported | Discontinued<br>Operations | Adjustment | As<br>Revised |
|  | (in thousands, except per share amounts) |                            |            |               |                              |                            |            |               |
| Royalty fees   | \$267,229                                | \$—                        | \$583      | \$267,812     | \$260,782                    | \$—                        | \$898      | \$261,680     |
| Marketing and reservation revenues                     | 403,099                                  | —                          | 4,534      | 407,633       | 384,784                      | —                          | 4,894      | 389,678       |
| Hotel operations                                       | 4,774                                    | (4,774 )                   | —          | —             | 4,573                        | (4,573 )                   | —          | —             |
| Total revenues   | 724,307                                  | (4,774 )                   | 5,117      | 724,650       | 691,509                      | (4,573 )                   | 5,792      | 692,728       |
| Selling, general and administrative                    | 113,567                                  | —                          | (1,854 )   | 111,713       | 101,852                      | —                          | 27         | 101,879       |
| Depreciation and amortization                          | 9,469                                    | (526 )                     | 113        | 9,056         | 8,226                        | (535 )                     | —          | 7,691         |
| Marketing and reservation expenses                     | 403,099                                  | —                          | 4,534      | 407,633       | 384,784                      | —                          | 4,894      | 389,678       |
| Hotel operations                                       | 3,678                                    | (3,678 )                   | —          | —             | 3,505                        | (3,505 )                   | —          | —             |
| Total operating expenses                               | 529,813                                  | (4,204 )                   | 2,793      | 528,402       | 498,367                      | (4,040 )                   | 4,921      | 499,248       |
| Operating income                                       | 194,494                                  | (570 )                     | 2,324      | 196,248       | 193,142                      | (533 )                     | 871        | 193,480       |
| Income from continuing operations before income taxes  | 156,918                                  | (570 )                     | 2,324      | 158,672       | 169,168                      | (533 )                     | 871        | 169,506       |
| Income taxes   | 44,317                                   | (211 )                     | 1,216      | 45,322        | 48,481                       | (198 )                     | (55 )      | 48,228        |
| Income from continuing operations, net of income taxes | 112,601                                  | (359 )                     | 1,108      | 113,350       | 120,687                      | (335 )                     | 926        | 121,278       |
| Basic earnings per share, continuing operations        | \$1.92                                   | \$—                        | \$0.02     | \$1.94        | \$2.08                       | \$—                        | \$0.01     | \$2.09        |
| Diluted earnings per share, continuing operations      | \$1.91                                   | \$(0.01 )                  | \$0.02     | \$1.92        | \$2.07                       | \$(0.01 )                  | \$0.02     | \$2.08        |

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|   | Year Ended December 31, 2011             |                            |            | As        |
|---|--|----------------------------|------------|-----------|
|   | As Previously<br>Reported                | Discontinued<br>Operations | Adjustment | Revised   |
|   | (in thousands, except per share amounts) |                            |            |           |
| Royalty fees  | \$245,426                                | \$—                        | \$1,049    | \$246,475 |
| Marketing and reservation<br>revenues                     | 349,036                                  | —                          | 5,116      | 354,152   |
| Hotel operations  | 4,356                                    | (4,356)                    | ) —        | —         |
| Total revenues  | 638,793                                  | (4,356)                    | ) 6,165    | 640,602   |
| Selling, general and<br>administrative                    | 106,404                                  | —                          | 32         | 106,436   |
| Depreciation and amortization                             | 8,024                                    | (527)                      | ) —        | 7,497     |
| Marketing and reservation<br>expenses                     | 349,036                                  | —                          | 5,116      | 354,152   |
| Hotel operations  | 3,466                                    | (3,466)                    | ) —        | —         |
| Total operating expenses                                  | 466,930                                  | (3,993)                    | ) 5,148    | 468,085   |
| Operating income  | 171,863                                  | (363)                      | ) 1,017    | 172,517   |
| Income from continuing<br>operations before income taxes  | 158,057                                  | (363)                      | ) 1,017    | 158,711   |
| Income taxes  | 47,661                                   | (135)                      | ) 352      | 47,878    |
| Income from continuing<br>operations, net of income taxes | 110,396                                  | (228)                      | ) 665      | 110,833   |
| Basic earnings per share,<br>continuing operations        | \$1.86                                   | \$(0.01)                   | ) \$0.01   | \$1.86    |
| Diluted earnings per share,<br>continuing operations      | \$1.85                                   | \$(0.01)                   | ) \$0.02   | \$1.86    |

|  | Year Ended December 31, 2013 |            |            |
|--|------------------------------|------------|------------|
|  | As Previously<br>Reported    | Adjustment | As Revised |
|  | (in thousands)               |            |            |
| Consolidated Statement of Cash<br>Flows      |                              |            |            |
| Net cash provided by operating<br>activities | \$152,040                    | \$1,873    | \$153,913  |
| Investment in property and<br>equipment      | (31,524)                     | ) (1,873)  | ) (33,397) |
| Net cash used in investing activities        | (27,549)                     | ) (1,873)  | ) (29,422) |

**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 restated 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 June 30, 2014 and December 31, 2013, \$3.3 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.

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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 June 30, 2014, the Company maintains cash balances of \$172.5 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 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

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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:

|  | June 30, 2014  | December 31,<br>2013 |
|--|----------------|----------------------|
|  | (In thousands) |                      |
| Notes receivable, net of allowances (See Note 3) | \$6,182        | \$12,816             |
| Prepaid expenses                                 | 14,534         | 13,746               |
| Other current assets                             | 3,073          | 3,148                |
| Total  | \$23,789       | \$29,710             |

## 3. Notes Receivable and Allowance for Losses

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

The 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  | June 30, 2014<br>(In thousands)   |   |          | December 31, 2013<br>(In thousands) |   |          |
|---|-----------------------------------|---|----------|-------------------------------------|---|----------|
|   | Forgivable<br>Notes<br>Receivable | Mezzanine<br>& Other<br>Notes<br>Receivable | Total    | Forgivable<br>Notes<br>Receivable   | Mezzanine<br>& Other<br>Notes<br>Receivable | Total    |
| Senior  | \$—                               | \$10,150                                    | \$10,150 | \$—                                 | \$18,052                                    | \$18,052 |
| Subordinated  | —                                 | 13,770                                      | 13,770   | —                                   | 14,152                                      | 14,152   |
| Unsecured   | 25,048                            | 4,131                                       | 29,179   | 20,625                              | 3,405                                       | 24,030   |
| Total notes receivable  | 25,048                            | 28,051                                      | 53,099   | 20,625                              | 35,609                                      | 56,234   |
| Allowance for losses on non-impaired loans                                | 2,477                             | 1,600                                       | 4,077    | 1,650                               | 1,607                                       | 3,257    |
| Allowance for losses on receivables specifically evaluated for impairment | —                                 | 8,348                                       | 8,348    | —                                   | 8,289                                       | 8,289    |
| Total loan reserves   | 2,477                             | 9,948                                       | 12,425   | 1,650                               | 9,896                                       | 11,546   |
| Net carrying value  | \$22,571                          | \$18,103                                    | \$40,674 | \$18,975                            | \$25,713                                    | \$44,688 |

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|                        |          |          |          |          |          |          |
|------------------------|----------|----------|----------|----------|----------|----------|
| Current portion, net   | \$126    | \$6,056  | \$6,182  | \$361    | \$12,455 | \$12,816 |
| Long-term portion, net | 22,445   | 12,047   | 34,492   | 18,614   | 13,258   | 31,872   |
| Total                  | \$22,571 | \$18,103 | \$40,674 | \$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.

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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 six months ended June 30, 2014:

|                      | Forgivable<br>Notes<br>Receivable<br>(In thousands) | Mezzanine<br>& Other Notes<br>Receivable |
|----------------------|---|--|
| Beginning balance    | \$1,650   | \$9,896                                  |
| Provisions           | 1,129   | 102                                      |
| Recoveries           | (9  | ) (50                                    |
| Write-offs           | (95   | ) —                                      |
| Other <sup>(1)</sup> | (198  | ) —                                      |
| Ending balance       | \$2,477   | \$9,948                                  |

(1) Consists of default rate assumption changes

Forgivable Notes Receivable

As of June 30, 2014 and December 31, 2013, the unamortized balance of the Company's forgivable notes receivable totaled \$25.0 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 June 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 June 30, 2014 and 2013 was \$1.2 million and \$1.0 million, respectively. Amortization expense for the six months ended June 30, 2014 and 2013 was \$2.4 million and \$2.0 million, respectively.

Past due balances of forgivable notes receivable are as follows:

|                         | 30-89 days<br>Past Due | > 90 days<br>Past Due | Total<br>Past Due | Current  | Total<br>Notes<br>Receivable |
|-------------------------|------------------------|-----------------------|-------------------|----------|------------------------------|
| (In thousands)          |                        |                       |                   |          |                              |
| As of June 30, 2014     |                        |                       |                   |          |                              |
| Forgivable Notes        | \$—                    | \$1,347               | \$1,347           | \$23,701 | \$25,048                     |
|                         | \$—                    | \$1,347               | \$1,347           | \$23,701 | \$25,048                     |
| 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 June 30, 2014 and December 31, 2013, respectively. The Company recorded allowance for credit losses on these impaired loans at June 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 six months ended June 30, 2014 and 2013, the average mezzanine and other notes receivable on non-accrual status was approximately \$12.2 million and \$12.9 million, respectively. The Company recognized approximately \$22 thousand and \$76 thousand of interest income on impaired loans during the three and six months ended June 30, 2014, respectively, on the cash basis. The Company recognized approximately \$73 thousand and \$139 thousand of interest on impaired loans during the three and six months ended June 30, 2013. The Company provided loan reserves on non-impaired loans totaling \$1.6 million at both June 30, 2014 and December 31, 2013.

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

|                         | 30-89 days<br>Past Due | > 90 days<br>Past Due | Total<br>Past Due | Current  | Total<br>Notes<br>Receivable |
|-------------------------|------------------------|-----------------------|-------------------|----------|------------------------------|
| (In thousands)          |                        |                       |                   |          |                              |
| As of June 30, 2014     |                        |                       |                   |          |                              |
| Senior                  | \$—                    | \$—                   | \$—               | \$10,150 | \$10,150                     |
| Subordinated            | 1,368                  | 9,629                 | 10,997            | 2,773    | 13,770                       |
| Unsecured               | —                      | 47                    | 47                | 4,084    | 4,131                        |
|                         | \$1,368                | \$9,676               | \$11,044          | \$17,007 | \$28,051                     |
| 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                     |

**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 three months ended June 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 uncollectable amounts. The Company's accretable yield at acquisition was \$1.8 million or 7.36% and a reconciliation of the accretable yield for the six months ended June 30, 2014 is as follows:

|   | Accretable<br>Yield<br>(In thousands) |
|---|---------------------------------------|
| Beginning balance                             | \$582                                 |
| Additions                                     | —                                     |
| Accretion                                     | (143 )                                |
| Disposals                                     | (439 )                                |
| Reclassifications from<br>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 are 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 June 30, 2014, cumulative marketing and reservation system fees collected exceeded expenses by \$15.9 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 six months ended June 30, 2014 was \$4.3 million and \$8.0 million, respectively. Depreciation and amortization expense attributable to marketing and reservation activities for the three and six months ended June 30, 2013 was \$4.1 million and \$8.1 million, respectively. Interest expense attributable to marketing and reservation activities for the three and six months ended June 30, 2014 was \$0.3 million and \$1.0 million, respectively. Interest expense attributable to marketing and reservation activities for the three and six months ended June 30, 2013 was \$0.9 million and \$1.8 million, respectively.

#### 5. Other Assets

Other assets consist of the following:

|                              | June 30, 2014  | December 31,<br>2013 |
|------------------------------|----------------|----------------------|
|                              | (In thousands) |                      |
| Equity method investments    | \$38,594       | \$32,257             |
| Deferred financing fees, net | 8,295          | 8,954                |
| Land                         | 10,234         | 10,097               |
| Other assets                 | 993            | 856                  |
| Total                        | \$58,116       | \$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 \$34.8 million and \$28.9 million at June 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. As a result, the Company's investment in these entities is accounted for under the equity method. For the three and six months ended June 30, 2014, the Company recognized losses totaling \$22 thousand and \$66 thousand, respectively from these investments. For the three and six months ended June 30, 2013, the Company recognized losses totaling \$7 thousand and \$72 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 17 "Commitments and Contingencies" of these financial statements.

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## 6. Deferred Revenue

Deferred revenue consists of the following:

|   | June 30,<br>2014 | December 31,<br>2013 |
|---|------------------|----------------------|
|   | (In thousands)   |                      |
| Loyalty programs                        | \$60,427         | \$53,875             |
| Initial, relicensing and franchise fees | 4,477            | 5,354                |
| Procurement service fees                | 1,254            | 1,504                |
| Other                                   | 1,207            | 455                  |
| Total                                   | \$67,365         | \$61,188             |

## 7. Debt

Debt consists of the following at:

|  | June 30, 2014  | December 31,<br>2013 |
|--|----------------|----------------------|
|  | (In thousands) |                      |
| \$400 million senior unsecured notes with an effective interest rate of 5.94% at June 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 June 30, 2014 and December 31, 2013  | 249,604        | 249,572              |
| \$350 million senior secured credit facility with an effective interest rate of 2.15% and 2.17% at June 30, 2014 and December 31, 2013, respectively | 135,000        | 138,750              |
| Economic development loans with an effective interest rate of 3.00% at June 30, 2014 and December 31, 2013   | 3,360          | 3,360                |
| Capital lease obligations due 2016 with an effective interest rate of 3.18% at June 30, 2014 and December 31, 2013                                   | 1,499          | 1,848                |
| Other notes payable  | 43             | 29                   |
| Total debt   | \$789,506      | \$793,559            |
| Less current portion   | 11,970         | 10,088               |
| Total long-term debt   | \$777,536      | \$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

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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 4.0 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 June 30, 2014, the Company was in

compliance with all financial covenants under the Credit Facility.

At June 30, 2014, the Company had \$135.0 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.

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## 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 headquarter relocation and tenant improvement costs in consideration of the employment of permanent, full-time employees within the jurisdictions. At June 30, 2014, the Company had been advanced approximately \$3.4 million pursuant to these agreements and expects to receive the remaining \$1 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 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 June 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 six months ended June 30, 2014:

|   | Loss on<br>Cash Flow<br>Hedge<br>(In thousands) | Foreign<br>Currency<br>Items | Total       |
|---|---|------------------------------|-------------|
| Beginning balance, December 31, 2013                                    | \$ (5,745 )                                     | \$ (472 )                    | \$ (6,217 ) |
| Other comprehensive income (loss) before reclassification               | —   | 1,030                        | 1,030       |
| Amounts reclassified from accumulated other comprehensive income (loss) | 431   | —                            | 431         |
| Net current period other comprehensive income (loss)                    | 431   | 1,030                        | 1,461       |
| Ending balance, June 30, 2014   | \$ (5,314 )                                     | \$ 558                       | \$ (4,756 ) |

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

| Component               | Amount Reclassified from<br>Accumulated Other<br>Comprehensive Income(Loss) |                                      | Affected Line Item in<br>the Consolidated<br>Statement of Net<br>Income |
|-------------------------|---|--------------------------------------|---|
|                         | Three Months<br>Ended June<br>30, 2014<br>(In thousands)                    | Six Months<br>Ended June<br>30, 2014 |   |
| Loss on cash flow hedge |   |                                      |   |

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|                        |       |       |                       |
|------------------------|-------|-------|-----------------------|
| Interest rate contract | \$216 | \$431 | Interest expense      |
|                        | —     | —     | Tax (expense) benefit |
|                        | \$216 | \$431 | Net of tax            |

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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 \$9.7 million and \$11.3 million, as of June 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 June 30, 2014 and 2013 was \$0.2 million and \$0.1 million, respectively. Compensation expense recorded in SG&A related to the EDCP for the six months ended June 30, 2014 and 2013 was \$0.4 million and \$0.4 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 June 30, 2014 and December 31, 2013, respectively, and are recorded at their fair value, based on quoted market prices. At June 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 June 30, 2014 and 2013 of approximately \$109 thousand and (\$36) thousand, respectively. The Company recorded investment gains related to the EDCP during the six months ended June 30, 2014 and 2013 of approximately \$139 thousand and \$87 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 June 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 June 30, 2014 and December 31, 2013, the Company had recorded a deferred compensation liability of \$14.2 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 June 30, 2014 and 2013 was \$0.4 million and \$(0.2) million, respectively. The net increase in compensation expense recorded in SG&A related to the Non-Qualified Plan for the six months ended June 30, 2014 and 2013 was \$0.2 million and \$0.7 million, respectively.

The diversified investments held in the trusts were \$13.0 million and \$12.3 million as of June 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 June 30, 2014 and 2013 of

approximately \$0.3 million and (\$0.1) million, respectively. The Company recorded investment gains related to the Non-Qualified Plan during the six months ended June 30, 2014 and 2013 of approximately \$0.4 million and \$0.5 million, respectively. In addition, the Non-Qualified Plan held shares of the Company's common stock with a market value of \$1.2 million and \$1.4 million at June 30, 2014 and December 31, 2013, respectively, which are recorded as a component of shareholders' deficit.

#### 10. Fair Value Measurements

The Company estimates the fair value of its financial instruments utilizing a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. The following summarizes the three levels of inputs, as well as the assets that the Company values using those levels of inputs.

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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 six months ended June 30, 2014.

As of June 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   | Level 1  | Level 2  | Level 3 |
| Assets  | (In thousands)                                  |          |          |         |
| As of June 30, 2014                                       |   |          |          |         |
| Money market funds, included in cash and cash equivalents | \$50,001  | \$—      | \$50,001 | \$—     |
| Mutual funds <sup>(1)</sup>                               | 15,810  | 15,810   | —        | —       |
| Money market funds <sup>(1)</sup>                         | 1,636   | —        | 1,636    | —       |
|   | \$67,447  | \$15,810 | \$51,637 | \$—     |
| 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 inputs. 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 June 30, 2014 and December 31, 2013, the 2010 Senior Notes had an approximate fair value of \$271.3 million and \$261.3 million, respectively. At June 30, 2014 and December 31, 2013, the 2012 Senior Notes had an approximate fair value of \$434.0 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.

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## 11. Income Taxes

The effective income tax rates for income from continuing operations were 29.8% and 28.9% for the three months ended June 30, 2014 and restated June 30, 2013, respectively. The effective income tax rates for income from continuing operations were 30.6% and 28.7% for the six months ended June 30, 2014 and and restated June 30, 2013, respectively. The effective income tax rate for discontinued operations was 37.1% for the three and six months ended June 30, 2014 and restated June 30, 2013.

The effective income tax rate for continuing operations for the three and six months ended June 30, 2014 and restated June 30, 2013 was 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 restated three and six months ended June 30, 2013 reflect the release of a valuation allowance on local country tax refunds received by a foreign subsidiary. The effective income tax rate for the restated six months ended June 30, 2013 was further 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 June 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 six months ended June 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 June 30, 2014 was \$34.1 million and \$29.0 million, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2014 and 2013 was approximately \$1.3 million and \$2.9 million, respectively. There were no options exercised during the three months ended June 30, 2014. The total intrinsic value of options exercised during the three months ended June 30, 2013 was approximately \$0.6 million.

The Company received approximately \$1.5 million and \$6.0 million in proceeds from the exercise of 58,749 and 234,065 employee stock options during the six month periods ended June 30, 2014 and 2013, respectively. The Company received approximately \$0.6 million in proceeds from the exercise of 29,742 employee stock options during the three months ended June 30, 2013.

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## Restricted Stock

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

|  | Three Months Ended |                   | Six Months Ended  |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | June 30            |                   | June 30           |                   |
|  | 2014               | 2013              | 2014              | 2013              |
| Restricted share grants                          | 17,262             | 20,858            | 147,055           | 215,399           |
| Weighted average grant date fair value per share | \$44.62            | \$45.32           | \$46.46           | \$37.59           |
| Aggregate grant date fair value (\$000)          | \$770              | \$945             | \$6,833           | 8,097             |
| Restricted shares forfeited                      | 2,964              | 6,429             | 4,296             | 27,928            |
| Vesting service period of shares granted         | 12 - 36<br>months  | 12 - 48<br>months | 12 - 48<br>months | 12 - 48<br>months |
| Grant date fair value of shares vested (\$000)   | \$935              | \$660             | \$8,203           | \$7,659           |

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 |      | Six Months Ended |                 |
|---|--------------------|------|------------------|-----------------|
|   | June 30            |      | June 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                                       | —                  | —    | —                | —               |
| Requisite service period                                    | —                  | —    | 36 months        | 22-36<br>months |

During the three months ended June 30, 2014 and 2013, no PVRSU grants vested. During the six months ended June 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 six months ended June 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.



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A summary of stock-based award activity as of June 30, 2014 and changes during the six 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                         |   | 147,055          | \$46.46                                | 24,678                                    | \$45.59                                |
| Performance based leveraging <sup>(1)</sup> | —             | \$—                             |   | —                | \$—                                    | 10,251                                    | \$41.25                                |
| Exercised/Vested                            | (58,749 )     | \$26.33                         |   | (172,997 )       | \$37.04                                | (28,886 )                                 | \$41.25                                |
| Expired                                     | —             | \$—                             |   | —                | \$—                                    | —   | \$—                                    |
| Forfeited                                   | —             | \$—                             |   | (4,296 )         | \$39.18                                | —   | \$—                                    |
| Outstanding at June 30, 2014                | 2,254,960     | \$31.98                         | 3.7   | 533,107          | \$39.20                                | 222,385                                   | \$37.93                                |
| Options exercisable at June 30, 2014        | 1,326,714     | \$25.24                         | 2.1   |                  |  |   |  |

<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 six months ended June 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 six months ended June 30, 2014 and 2013:

| (in millions)                             | Three Months Ended |       | Six Months Ended |       |
|---|--------------------|-------|------------------|-------|
|   | June 30            |       | June 30          |       |
|   | 2014               | 2013  | 2014             | 2013  |
| Stock options                             | \$0.7              | \$0.5 | \$1.1            | \$1.0 |
| Restricted stock                          | 1.9                | 1.8   | 3.8              | 3.6   |
| Performance vested restricted stock units | (0.8 )             | 0.6   | (0.1 )           | 1.2   |
| Total                                     | \$1.8              | \$2.9 | \$4.8            | \$5.8 |
| Income tax benefits                       | \$0.7              | \$1.1 | \$1.8            | \$2.1 |

During the three and six months ended June 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 \$1.2 million and \$1.0 million for the three and six months ended June 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 six months ended June 30, 2014, the Company's board of directors declared dividends totaling \$0.185 and \$0.37 per share or approximately \$10.8 million and \$21.6 million in the aggregate, respectively.

In addition, during the six months ended June 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 June 30, 2014.

Share Repurchases and Redemptions

No shares of common stock were purchased by the Company under the share repurchase program during the three and six months ended June 30, 2014.

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During the three and six months ended June 30, 2014, the Company redeemed 302 and 94,745 shares of common stock at a total cost of approximately \$13 thousand and \$4.5 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.

## 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 |                    | Six Months Ended |                    |
|--|--------------------|--------------------|------------------|--------------------|
|  | June 30,<br>2014   | 2013<br>(Restated) | June 30,<br>2014 | 2013<br>(Restated) |
| Computation of Basic Earnings Per Share:             |                    |                    |                  |                    |
| Numerator:   |                    |                    |                  |                    |
| Net income from continuing operations                | \$35,279           | \$31,624           | \$56,748         | \$51,400           |
| Net income from discontinued operations              | 121                | 183                | 1,762            | 150                |
| Net income   | 35,400             | 31,807             | 58,510           | 51,550             |
| Income allocated to participating securities         | (324 )             | (310 )             | (523 )           | (521 )             |
| Net income available to common shareholders          | \$35,076           | \$31,497           | \$57,987         | \$51,029           |
| Denominator:   |                    |                    |                  |                    |
| Weighted average common shares outstanding – basic   | 57,893             | 57,953             | 57,850           | 57,837             |
| Basic earnings per share - Continuing operations     | \$0.61             | \$0.54             | \$0.97           | \$0.88             |
| Basic earnings per share - Discontinued operations   | —                  | —                  | 0.03             | —                  |
|  | \$0.61             | \$0.54             | \$1.00           | \$0.88             |
| Computation of Diluted Earnings Per Share:           |                    |                    |                  |                    |
| Numerator:   |                    |                    |                  |                    |
| Net income from continuing operations                | \$35,279           | \$31,624           | \$56,748         | \$51,400           |
| Net income from discontinued operations              | 121                | 183                | 1,762            | 150                |
| Net income   | 35,400             | 31,807             | 58,510           | 51,550             |
| Income allocated to participating securities         | (322 )             | (309 )             | (521 )           | (519 )             |
| Net income available to common shareholders          | \$35,078           | \$31,498           | \$57,989         | \$51,031           |
| Denominator:   |                    |                    |                  |                    |
| Weighted average common shares outstanding – basic   | 57,893             | 57,953             | 57,850           | 57,837             |
| Diluted effect of stock options and PVRsUs           | 492                | 386                | 491              | 376                |
| Weighted average common shares outstanding – diluted | 58,385             | 58,339             | 58,341           | 58,213             |
| Diluted earnings per share - Continuing operations   | \$0.60             | \$0.54             | \$0.96           | \$0.88             |
| Diluted earnings per share - Discontinued operations | —                  | —                  | 0.03             | —                  |
|  | \$0.60             | \$0.54             | \$0.99           | \$0.88             |

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





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shown above excludes the income attributable to the unvested restricted share awards from the numerator and excludes the dilutive impact of those awards from the denominator.

At June 30, 2014 and 2013, the Company had 2.3 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 months ended June 30, 2014, the Company excluded 0.7 million of anti-dilutive stock options from the diluted EPS calculation. For the six months ended June 30, 2014 and the three and six months ended June 30, 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 June 30, 2014 and 2013, PVRSUs totaling 222,385 and 198,394, respectively, were excluded from the computation since the performance conditions had not been met.

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.

The condensed consolidating financial statements have been restated for the three and six months ended June 30, 2013 and the consolidated balance sheet as of December 31, 2013 has been revised from previously issued interim and annual financial statements to reflect the correction of an error discussed in Note 1 under the heading "Revision to Prior Annual Financial Statements and Restatement of Prior Interim Financial Statements" and other immaterial errors. In addition, the condensed consolidating statements of income for the three and six months ended June 30, 2013 have been reclassified to account for discontinued operations as discussed in Note 17, "Discontinued Operations".

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

|  | Parent    | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-----------|---------------------------|-------------------------------|--------------|--------------|
| <b>REVENUES:</b>   |           |                           |                               |              |              |
| Royalty fees   | \$71,090  | \$36,759                  | \$12,360                      | \$(42,539 )  | \$77,670     |
| Initial franchise and relicensing fees                   | 4,435     | —                         | 287                           | —            | 4,722        |
| Procurement services                                     | 7,842     | —                         | 178                           | —            | 8,020        |
| Marketing and reservation                                | 92,289    | 94,301                    | 5,034                         | (87,858 )    | 103,766      |
| Other  | 3,342     | 1                         | 143                           | —            | 3,486        |
| Total revenues   | 178,998   | 131,061                   | 18,002                        | (130,397 )   | 197,664      |
| <b>OPERATING EXPENSES:</b>                               |           |                           |                               |              |              |
| Selling, general and administrative                      | 37,137    | 33,503                    | 3,312                         | (42,539 )    | 31,413       |
| Marketing and reservation                                | 96,232    | 90,658                    | 4,734                         | (87,858 )    | 103,766      |
| Depreciation and amortization                            | 756       | 1,416                     | 160                           | —            | 2,332        |
| Total operating expenses                                 | 134,125   | 125,577                   | 8,206                         | (130,397 )   | 137,511      |
| Operating income   | 44,873    | 5,484                     | 9,796                         | —            | 60,153       |
| <b>OTHER INCOME AND EXPENSES,<br/>NET:</b>               |           |                           |                               |              |              |
| Interest expense   | 10,703    | 1                         | 6                             | —            | 10,710       |
| Equity in earnings of consolidated subsidiaries          | (13,188 ) | (11 )                     | —                             | 13,199       | —            |
| Other items, net   | (297 )    | (450 )                    | (44 )                         | —            | (791 )       |
| Total other income and expenses, net                     | (2,782 )  | (460 )                    | (38 )                         | 13,199       | 9,919        |
| Income from continuing operations before income taxes    | 47,655    | 5,944                     | 9,834                         | (13,199 )    | 50,234       |
| Income taxes   | 12,255    | 2,380                     | 320                           | —            | 14,955       |
| Income from continuing operations, net of income taxes   | 35,400    | 3,564                     | 9,514                         | (13,199 )    | 35,279       |
| Income from discontinued operations, net of income taxes | —         | 121                       | —                             | —            | 121          |
| Net income   | \$35,400  | \$3,685                   | \$9,514                       | \$(13,199 )  | \$35,400     |

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

|  | Parent<br>(Restated) | Guarantor<br>Subsidiaries<br>(Restated) | Non-Guarantor<br>Subsidiaries<br>(Restated) | Eliminations<br>(Restated) | Consolidated<br>(Restated) |
|--|----------------------|---|---|----------------------------|----------------------------|
| <b>REVENUES:</b>   |                      |   |   |                            |                            |
| Royalty fees   | \$66,228             | \$35,111                                | \$11,191                                    | \$(39,892)                 | ) \$72,638                 |
| Initial franchise and relicensing fees                   | 4,087                | —                                       | 329   | —                          | 4,416                      |
| Procurement services                                     | 7,384                | —                                       | 162   | —                          | 7,546                      |
| Marketing and reservation                                | 92,381               | 94,569                                  | 5,037                                       | (87,915)                   | ) 104,072                  |
| Other  | 2,015                | —                                       | 243   | —                          | 2,258                      |
| Total revenues   | 172,095              | 129,680                                 | 16,962                                      | (127,807)                  | ) 190,930                  |
| <b>OPERATING EXPENSES:</b>                               |                      |   |   |                            |                            |
| Selling, general and administrative                      | 35,121               | 31,394                                  | 3,108                                       | (39,892)                   | ) 29,731                   |
| Marketing and reservation                                | 96,364               | 91,251                                  | 4,372                                       | (87,915)                   | ) 104,072                  |
| Depreciation and amortization                            | 759                  | 1,426                                   | 203   | —                          | 2,388                      |
| Total operating expenses                                 | 132,244              | 124,071                                 | 7,683                                       | (127,807)                  | ) 136,191                  |
| Operating income   | 39,851               | 5,609                                   | 9,279                                       | —                          | 54,739                     |
| <b>OTHER INCOME AND EXPENSES,<br/>NET:</b>               |                      |   |   |                            |                            |
| Interest expense   | 10,783               | 17                                      | 7   | —                          | 10,807                     |
| Equity in earnings of consolidated subsidiaries          | (13,215)             | ) —                                     | —   | 13,215                     | —                          |
| Other items, net   | (564)                | ) 147                                   | (155)                                       | ) —                        | (572)                      |
| Total other income and expenses, net                     | (2,996)              | ) 164                                   | (148)                                       | ) 13,215                   | 10,235                     |
| Income from continuing operations before income tax      | 42,847               | 5,445                                   | 9,427                                       | (13,215)                   | ) 44,504                   |
| Income taxes   | 11,040               | 2,222                                   | (382)                                       | ) —                        | 12,880                     |
| Income from continuing operations, net of income taxes   | 31,807               | 3,223                                   | 9,809                                       | (13,215)                   | ) 31,624                   |
| Income from discontinued operations, net of income taxes | —                    | 183                                     | —   | —                          | 183                        |
| Net income   | \$31,807             | \$3,406                                 | \$9,809                                     | \$(13,215)                 | ) \$31,807                 |

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

|  | Parent    | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-----------|---------------------------|-------------------------------|--------------|--------------|
| <b>REVENUES:</b>   |           |                           |                               |              |              |
| Royalty fees   | \$124,085 | \$60,974                  | \$22,882                      | \$(71,731)   | ) \$136,210  |
| Initial franchise and relicensing fees                   | 8,019     | —                         | 443                           | —            | 8,462        |
| Procurement services                                     | 12,473    | —                         | 325                           | —            | 12,798       |
| Marketing and reservation                                | 171,110   | 168,200                   | 9,169                         | (155,107)    | ) 193,372    |
| Other  | 6,298     | 1                         | 259                           | —            | 6,558        |
| Total revenues   | 321,985   | 229,175                   | 33,078                        | (226,838)    | ) 357,400    |
| <b>OPERATING EXPENSES:</b>                               |           |                           |                               |              |              |
| Selling, general and administrative                      | 67,711    | 55,594                    | 6,519                         | (71,731)     | ) 58,093     |
| Marketing and reservation                                | 177,817   | 161,602                   | 9,060                         | (155,107)    | ) 193,372    |
| Depreciation and amortization                            | 1,507     | 2,734                     | 369                           | —            | 4,610        |
| Total operating expenses                                 | 247,035   | 219,930                   | 15,948                        | (226,838)    | ) 256,075    |
| Operating income   | 74,950    | 9,245                     | 17,130                        | —            | 101,325      |
| <b>OTHER INCOME AND EXPENSES,<br/>NET:</b>               |           |                           |                               |              |              |
| Interest expense   | 20,871    | 2                         | 8                             | —            | 20,881       |
| Equity in earnings of consolidated subsidiaries          | (24,114)  | ) 50                      | —                             | 24,064       | —            |
| Other items, net   | (725)     | ) (517)                   | ) (76)                        | )            | (1,318)      |
| Total other income and expenses, net                     | (3,968)   | ) (465)                   | ) (68)                        | ) 24,064     | 19,563       |
| Income from continuing operations before income taxes    | 78,918    | 9,710                     | 17,198                        | (24,064)     | ) 81,762     |
| Income taxes   | 20,408    | 4,184                     | 422                           | —            | 25,014       |
| Income from continuing operations, net of income taxes   | 58,510    | 5,526                     | 16,776                        | (24,064)     | ) 56,748     |
| Income from discontinued operations, net of income taxes | —         | 1,762                     | —                             | —            | 1,762        |
| Net income   | \$58,510  | \$7,288                   | \$16,776                      | \$(24,064)   | ) \$58,510   |

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

|   | Parent<br>(Restated) | Guarantor<br>Subsidiaries<br>(Restated) | Non-Guarantor<br>Subsidiaries<br>(Restated) | Eliminations<br>(Restated) | Consolidated<br>(Restated) |
|---|----------------------|---|---|----------------------------|----------------------------|
| <b>REVENUES:</b>  |                      |   |   |                            |                            |
| Royalty fees  | \$ 116,644           | \$ 59,316                               | \$ 20,578                                   | \$(67,792)                 | ) \$ 128,746               |
| Initial franchise and relicensing<br>fees                   | 7,655                | —                                       | 538   | —                          | 8,193                      |
| Procurement services  | 11,184               | —                                       | 312   | —                          | 11,496                     |
| Marketing and reservation                                   | 163,426              | 170,732                                 | 9,584                                       | (157,347)                  | ) 186,395                  |
| Other   | 3,803                | —                                       | 468   | —                          | 4,271                      |
| Total revenues  | 302,712              | 230,048                                 | 31,480                                      | (225,139)                  | ) 339,101                  |
| <b>OPERATING EXPENSES:</b>                                  |                      |   |   |                            |                            |
| Selling, general and administrative                         | 64,405               | 53,382                                  | 6,404                                       | (67,792)                   | ) 56,399                   |
| Marketing and reservation                                   | 169,956              | 164,413                                 | 9,373                                       | (157,347)                  | ) 186,395                  |
| Depreciation and amortization                               | 1,473                | 2,553                                   | 403   | —                          | 4,429                      |
| Total operating expenses                                    | 235,834              | 220,348                                 | 16,180                                      | (225,139)                  | ) 247,223                  |
| Operating income  | 66,878               | 9,700                                   | 15,300                                      | —                          | 91,878                     |
| <b>OTHER INCOME AND<br/>EXPENSES, NET:</b>                  |                      |   |   |                            |                            |
| Interest expense  | 21,519               | 50                                      | 8   | —                          | 21,577                     |
| Equity in earnings of consolidated<br>subsidiaries          | (21,660)             | ) —                                     | —   | 21,660                     | —                          |
| Other items, net  | (1,112)              | ) (564)                                 | ) (109)                                     | ) —                        | (1,785)                    |
| Total other income and expenses,<br>net                     | (1,253)              | ) (514)                                 | ) (101)                                     | ) 21,660                   | 19,792                     |
| Income from continuing<br>operations before income taxes    | 68,131               | 10,214                                  | 15,401                                      | (21,660)                   | ) 72,086                   |
| Income taxes (benefit)                                      | 16,581               | 4,300                                   | (195)                                       | ) —                        | 20,686                     |
| Income from continuing<br>operations, net of income taxes   | 51,550               | 5,914                                   | 15,596                                      | (21,660)                   | ) 51,400                   |
| Income from discontinued<br>operations, net of income taxes | —                    | 150                                     | —   | —                          | 150                        |
| Net income  | \$ 51,550            | \$ 6,064                                | \$ 15,596                                   | \$(21,660)                 | ) \$ 51,550                |



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

|   | Parent   | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|----------|---------------------------|-------------------------------|--------------|--------------|
| Net income  | \$35,400 | \$3,685                   | \$9,514                       | \$(13,199 )  | \$35,400     |
| Other comprehensive income (loss), net<br>of tax: |          |                           |                               |              |              |
| Amortization of loss on cash flow hedge           | 216      | —                         | —                             | —            | 216          |
| Foreign currency translation adjustment           | 509      | —                         | 509                           | (509 )       | 509          |
| Other comprehensive income (loss), net<br>of tax  | 725      | —                         | 509                           | (509 )       | 725          |
| Comprehensive income                              | \$36,125 | \$3,685                   | \$10,023                      | \$(13,708 )  | \$36,125     |

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

|  | Parent<br>(Restated) | Guarantor<br>Subsidiaries<br>(Restated) | Non-Guarantor<br>Subsidiaries<br>(Restated) | Eliminations<br>(Restated) | Consolidated<br>(Restated) |
|--|----------------------|---|---|----------------------------|----------------------------|
| Net income                                     | \$31,807             | \$3,406                                 | \$9,809                                     | \$(13,215 )                | \$31,807                   |
| Other comprehensive income (loss), net of tax: |                      |   |   |                            |                            |
| Amortization of loss on cash flow hedge        | 216                  | —                                       | —   | —                          | 216                        |
| Foreign currency translation adjustment        | (2,082 )             | —                                       | (2,082 )                                    | 2,082                      | (2,082 )                   |
| Other comprehensive income (loss), net of tax  | (1,866 )             | —                                       | (2,082 )                                    | 2,082                      | (1,866 )                   |
| Comprehensive income                           | \$29,941             | \$3,406                                 | \$7,727                                     | \$(11,133 )                | \$29,941                   |

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

|   | Parent   | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|----------|---------------------------|-------------------------------|--------------|--------------|
| Net income  | \$58,510 | \$7,288                   | \$16,776                      | \$(24,064 )  | \$58,510     |
| Other comprehensive income (loss), net<br>of tax: |          |                           |                               |              |              |
| Amortization of loss on cash flow hedge           | 431      | —                         | —                             | —            | 431          |
| Foreign currency translation adjustment           | 1,030    | —                         | 1,030                         | (1,030 )     | 1,030        |
| Other comprehensive income (loss), net<br>of tax  | 1,461    | —                         | 1,030                         | (1,030 )     | 1,461        |
| Comprehensive income                              | \$59,971 | \$7,288                   | \$17,806                      | \$(25,094 )  | \$59,971     |

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

|   | Parent<br>(Restated) | Guarantor<br>Subsidiaries<br>(Restated) | Non-Guarantor<br>Subsidiaries<br>(Restated) | Eliminations<br>(Restated) | Consolidated<br>(Restated) |
|---|----------------------|---|---|----------------------------|----------------------------|
| Net income  | \$51,550             | \$6,064                                 | \$15,596                                    | \$ (21,660 )               | \$51,550                   |
| Other comprehensive income (loss), net<br>of tax: |                      |   |   |                            |                            |
| Amortization of loss on cash flow hedge           | 431                  | —                                       | —   | —                          | 431                        |
| Foreign currency translation adjustment           | (2,327 )             | —                                       | (2,327 )                                    | 2,327                      | (2,327 )                   |
| Other comprehensive income (loss), net<br>of tax  | (1,896 )             | —                                       | (2,327 )                                    | 2,327                      | (1,896 )                   |
| Comprehensive income                              | \$49,654             | \$6,064                                 | \$13,269                                    | \$ (19,333 )               | \$49,654                   |

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

|   | Parent    | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|-----------|---------------------------|-------------------------------|--------------|--------------|
| <b>ASSETS</b>   |           |                           |                               |              |              |
| Cash and cash equivalents                                   | \$38,962  | \$111                     | \$172,469                     | \$—          | \$211,542    |
| Receivables, net  | 107,954   | 1,646                     | 10,163                        | —            | 119,763      |
| Other current assets  | 14,770    | 37,976                    | 1,585                         | (633)        | 53,698       |
| Total current assets  | 161,686   | 39,733                    | 184,217                       | (633)        | 385,003      |
| Property and equipment, at cost, net                        | 18,500    | 38,796                    | 942                           | —            | 58,238       |
| Goodwill  | 60,620    | 5,193                     | —                             | —            | 65,813       |
| Franchise rights and other<br>identifiable intangibles, net | 5,468     | 1,787                     | 1,134                         | —            | 8,389        |
| Notes receivable, net of allowances                         | 12,047    | 20,936                    | 1,509                         | —            | 34,492       |
| Investments, employee benefit<br>plans, at fair value       | —         | 17,270                    | —                             | —            | 17,270       |
| Investment in affiliates                                    | 403,500   | 31,233                    | —                             | (434,733)    | —            |
| Advances to affiliates                                      | 13,060    | 216,916                   | 11,338                        | (241,314)    | —            |
| Deferred income taxes                                       | —         | 9,895                     | 917                           | (9,691)      | 1,121        |
| Other assets  | 8,296     | 14,806                    | 35,014                        | —            | 58,116       |
| Total assets  | \$683,177 | \$396,565                 | \$235,071                     | \$(686,371)  | \$628,442    |
| <b>LIABILITIES AND<br/>SHAREHOLDERS' DEFICIT</b>            |           |                           |                               |              |              |
| Accounts payable  | \$7,513   | \$39,178                  | \$4,201                       | \$—          | \$50,892     |
| Accrued expenses  | 28,591    | 21,635                    | 2,172                         | —            | 52,398       |
| Deferred revenue  | 6,794     | 59,811                    | 760                           | —            | 67,365       |
| Current portion of long-term debt                           | 11,250    | 707                       | 13                            | —            | 11,970       |
| Deferred compensation and<br>retirement plan obligations    | —         | 579                       | —                             | —            | 579          |
| Other current liabilities                                   | 4,572     | 13,520                    | —                             | (633)        | 17,459       |
| Total current liabilities                                   | 58,720    | 135,430                   | 7,146                         | (633)        | 200,663      |
| Long-term debt  | 773,353   | 4,153                     | 30                            | —            | 777,536      |
| Deferred compensation &<br>retirement plan obligations      | —         | 23,250                    | 10                            | —            | 23,260       |
| Advances from affiliates                                    | 233,304   | 318                       | 7,692                         | (241,314)    | —            |
| Other liabilities   | 30,310    | 17,984                    | 890                           | (9,691)      | 39,493       |
| Total liabilities   | 1,095,687 | 181,135                   | 15,768                        | (251,638)    | 1,040,952    |
| Total shareholders' (deficit) equity                        | (412,510) | 215,430                   | 219,303                       | (434,733)    | (412,510)    |
| Total liabilities and shareholders'<br>deficit              | \$683,177 | \$396,565                 | \$235,071                     | \$(686,371)  | \$628,442    |

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

|   | Parent    | Guarantor<br>Subsidiaries | Non-Guarantor<br>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<br>identifiable intangibles, net | 6,553     | 2,096                     | 1,304                         | —            | 9,953        |
| Advances, marketing and<br>reservation activities           | 5,844     | —                         | —                             | —            | 5,844        |
| Notes receivable, net of allowances                         | 13,257    | 17,158                    | 1,457                         | —            | 31,872       |
| Investments, employee benefit<br>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<br/>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<br>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 &<br>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'<br>deficit              | \$605,625 | \$375,430                 | \$212,239                     | \$(636,872)  | \$556,422    |

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

|  | Parent    | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-----------|---------------------------|-------------------------------|--------------|--------------|
| Net cash provided (used) by operating activities                     | \$53,132  | \$(1,383 )                | \$ 14,740                     | \$(657 )     | \$ 65,832    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                         |           |                           |                               |              |              |
| Investment in property and equipment                                 | (1,797 )  | (5,235 )                  | (282 )                        | —            | (7,314 )     |
| Proceeds from sales of assets  | 27        | 12,189                    | —                             | —            | 12,216       |
| Equity method investments  | —         | (1,283 )                  | (5,663 )                      | —            | (6,946 )     |
| Purchases of investments, employee benefit plans                     | —         | (1,220 )                  | —                             | —            | (1,220 )     |
| Proceeds from sales of investments, employee benefit plans           | —         | 641                       | —                             | —            | 641          |
| Issuance of mezzanine and other notes receivable                     | (2,223 )  | —                         | —                             | —            | (2,223 )     |
| Collections of mezzanine and other notes receivable                  | 9,743     | —                         | —                             | —            | 9,743        |
| Advances to and investments in affiliates                            | (1,000 )  | (4,842 )                  | —                             | 5,842        | —            |
| Other items, net   | (296 )    | —                         | —                             | —            | (296 )       |
| Net cash provided (used) in investing activities                     | 4,454     | 250                       | (5,945 )                      | 5,842        | 4,601        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                         |           |                           |                               |              |              |
| Principal payments on long-term debt                                 | (3,750 )  | (349 )                    | (13 )                         | —            | (4,112 )     |
| Proceeds from the issuance of long-term debt                         | —         | —                         | 26                            | —            | 26           |
| Proceeds from contributions from affiliates                          | —         | —                         | 5,842                         | (5,842 )     | —            |
| Purchases of treasury stock  | (4,544 )  | —                         | —                             | —            | (4,544 )     |
| Dividends paid   | (21,957 ) | —                         | (657 )                        | 657          | (21,957 )    |
| Excess tax benefits from stock-based compensation                    | 295       | 1,024                     | —                             | —            | 1,319        |
| Proceeds from exercise of stock options                              | 1,547     | —                         | —                             | —            | 1,547        |
| Net cash provided (used) by financing activities                     | (28,409 ) | 675                       | 5,198                         | (5,185 )     | (27,721 )    |
| Net change in cash and cash equivalents                              | 29,177    | (458 )                    | 13,993                        | —            | 42,712       |
| Effect of foreign exchange rate changes on cash and cash equivalents | —         | —                         | 1,035                         | —            | 1,035        |
| Cash and cash equivalents at beginning of period                     | 9,785     | 569                       | 157,441                       | —            | 167,795      |
| Cash and cash equivalents at end of period                           | \$38,962  | \$111                     | \$ 172,469                    | \$—          | \$211,542    |

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Choice Hotels International, Inc.  
Condensed Consolidating Statement of Cash Flows  
For the Six Months Ended June 30, 2013 (Restated)  
(Unaudited, in Thousands)

|  | Parent<br>(Restated) | Guarantor<br>Subsidiaries<br>(Restated) | Non-Guarantor<br>Subsidiaries<br>(Restated) | Eliminations<br>(Restated) | Consolidated<br>(Restated) |
|--|----------------------|---|---|----------------------------|----------------------------|
| Net cash provided (used) by operating activities                     | \$ (3,139 )          | \$ 15,698                               | \$ 17,708                                   | \$ (280 )                  | \$ 29,987                  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                         |                      |   |   |                            |                            |
| Investment in property and equipment                                 | (3,775 )             | (18,135 )                               | (125 )                                      | —                          | (22,035 )                  |
| Equity method investments  | —                    | —                                       | (1,851 )                                    | —                          | (1,851 )                   |
| Purchases of investments, employee benefit plans                     | —                    | (1,580 )                                | —   | —                          | (1,580 )                   |
| Proceeds from sales of investments, employee benefit plans           | —                    | 3,934                                   | —   | —                          | 3,934                      |
| Collections of mezzanine and other notes receivable                  | 201                  | —                                       | —   | —                          | 201                        |
| Advances to and investments in affiliates                            | (1,000 )             | (850 )                                  | —   | 1,850                      | —                          |
| Other items, net   | (304 )               | —                                       | —   | —                          | (304 )                     |
| Net cash provided (used) in investing activities                     | (4,878 )             | (16,631 )                               | (1,976 )                                    | 1,850                      | (21,635 )                  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                         |                      |   |   |                            |                            |
| Net borrowings pursuant to revolving credit facility                 | 15,200               | —                                       | —   | —                          | 15,200                     |
| Principal payments on long-term debt                                 | (3,750 )             | (335 )                                  | (10 )                                       | —                          | (4,095 )                   |
| Purchases of treasury stock  | (3,651 )             | —                                       | —   | —                          | (3,651 )                   |
| Dividends paid   | (11,261 )            | —                                       | —   | —                          | (11,261 )                  |
| Excess tax benefits from stock-based compensation                    | 20                   | 1,126                                   | —   | —                          | 1,146                      |
| Proceeds from contributions from affiliates                          | —                    | —                                       | 1,850                                       | (1,850 )                   | —                          |
| Proceeds from exercise of stock options                              | 5,973                | —                                       | —   | —                          | 5,973                      |
| Net cash provided (used) by financing activities                     | 2,531                | 791                                     | 1,840                                       | (1,850 )                   | 3,312                      |
| Net change in cash and cash equivalents                              | (5,486 )             | (142 )                                  | 17,572                                      | (280 )                     | 11,664                     |
| Effect of foreign exchange rate changes on cash and cash equivalents | —                    | —                                       | (2,051 )                                    | —                          | (2,051 )                   |
| Cash and cash equivalents at beginning of period                     | 8,420                | 407                                     | 125,350                                     | —                          | 134,177                    |
| Cash and cash equivalents at end of period                           | \$ 2,934             | \$ 265                                  | \$ 140,871                                  | \$ (280 )                  | \$ 143,790                 |



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## 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. All other joint ventures are allocated to corporate & other. 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 June 30, 2014 |                     |                   |              | Three Months Ended June 30, 2013 (Restated) |                     |                   |              |
|--|----------------------------------|---------------------|-------------------|--------------|---|---------------------|-------------------|--------------|
|  | Franchising                      | SkyTouch Technology | Corporate & Other | Consolidated | Franchising                                 | SkyTouch Technology | Corporate & Other | Consolidated |
| Revenues   | \$ 197,596                       | \$ 68               | \$ —              | \$ 197,664   | \$ 190,930                                  | \$ —                | \$ —              | \$ 190,930   |
| Operating income (loss)                                      | \$ 75,211                        | \$ (4,360 )         | \$ (10,698 )      | \$ 60,153    | \$ 67,895                                   | \$ (2,661 )         | \$ (10,495 )      | \$ 54,739    |
| Income (loss) from continuing operations before income taxes | \$ 75,203                        | \$ (4,360 )         | \$ (20,609 )      | \$ 50,234    | \$ 67,963                                   | \$ (2,661 )         | \$ (20,798 )      | \$ 44,504    |

| (In thousands)                           | Six Months Ended June 30, 2014 |                     |                   |              | Six Months Ended June 30, 2013 (Restated) |                     |                   |              |
|--|--------------------------------|---------------------|-------------------|--------------|---|---------------------|-------------------|--------------|
|  | Franchising                    | SkyTouch Technology | Corporate & Other | Consolidated | Franchising                               | SkyTouch Technology | Corporate & Other | Consolidated |
| Revenues                                 | \$ 357,279                     | \$ 121              | \$ —              | \$ 357,400   | \$ 339,101                                | \$ —                | \$ —              | \$ 339,101   |
| Operating income (loss)                  | \$ 129,421                     | \$ (7,866 )         | \$ (20,230 )      | \$ 101,325   | \$ 118,253                                | \$ (4,466 )         | \$ (21,909 )      | \$ 91,878    |
| Income (loss) from continuing operations | \$ 129,422                     | \$ (7,866 )         | \$ (39,794 )      | \$ 81,762    | \$ 118,244                                | \$ (4,466 )         | \$ (41,692 )      | \$ 72,086    |



before income  
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,

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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 June 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 June 30, 2014, the Company had commitments to extend an additional \$13.3 million for these purposes provided certain conditions are met by its franchisees, of which \$6.0 million is expected to be advanced in the next twelve months.

The Company committed to make additional capital contributions totaling \$2.1 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 June 30, 2014, the Company had commitments to extended \$25.3 million for this purpose provided certain conditions are met by its franchisees. These commitments are expected to be funded in the next twelve months.

The Company has committed to loan monies totaling approximately \$3.3 million to support the construction of a hotel under the Company's Cambria Suites brand. At June 30, 2014, the Company had funded approximately \$2.2 million of this commitment and is expected to fund the remaining commitment within 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

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be required to make under these indemnities, nor is the Company able to develop an estimate of the maximum potential amount of future payments to be made under these indemnifications as the triggering events are not subject to predictability. With respect to certain of the aforementioned indemnities, such as indemnifications of landlords against third party claims for the use of real estate property leased by the Company, the Company maintains insurance coverage that mitigates potential liability.

## 17. 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 and will be 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 six months ended June 30, 2014 and the Company's financial position as of June 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 six months ended June 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 June 30, |          | Six Months Ended June 30, |          |
|---|-----------------------------|----------|---------------------------|----------|
|   | 2014                        | 2013     | 2014                      | 2013     |
|   | (In thousands)              |          |                           |          |
| Revenues  |                             |          |                           |          |
| Hotel operations  | \$ 111                      | \$ 1,334 | \$ 801                    | \$ 2,290 |
| Total revenues  | 111                         | 1,334    | 801                       | 2,290    |
| Expenses  |                             |          |                           |          |
| Hotel operations  | 170                         | 911      | 832                       | 1,786    |
| Depreciation and amortization                           | —                           | 132      | —                         | 266      |
| Total operating expenses                                | 170                         | 1,043    | 832                       | 2,052    |
| Operating income (loss)                                 | (59                         | ) 291    | (31                       | ) 238    |
| Gain on disposal of discontinued operations             | 252                         | —        | 2,833                     | —        |
| Income from discontinued operations before income taxes | 193                         | 291      | 2,802                     | 238      |
| Income taxes  | 72                          | 108      | 1,040                     | 88       |
| Income from discontinued operations                     | \$ 121                      | \$ 183   | \$ 1,762                  | \$ 150   |

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|  | As of June<br>30, 2014 | As of<br>December 31,<br>2013 |
|--|------------------------|-------------------------------|
|  | (In thousands)         |                               |
| Cash   | \$ 89                  | \$ 550                        |
| Receivables, net                                       | 8                      | 106                           |
| Other current assets                                   | 109                    | 223                           |
| Income taxes receivable                                | —                      | 20                            |
| Total current assets                                   | 206                    | 899                           |
| Property and equipment, at cost, net                   | —                      | 8,816                         |
| Total assets   | \$ 206                 | \$ 9,715                      |
| Accounts payable                                       | \$ 9                   | \$ 425                        |
| Accrued expenses                                       | 10                     | 10                            |
| Income taxes payable                                   | 1,040                  | —                             |
| Total liabilities                                      | \$ 1,059               | \$ 435                        |
| Net assets (liabilities) of<br>discontinued operations | \$ (853                | ) \$ 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.

As described in Note 1 to our consolidated financial statements under the heading "Revision to Financial Statements", the Company has corrected its revenue recognition method for its royalty and certain marketing and reservation system fee revenues. As a result, the Company now recognizes royalty and marketing and reservation system fee revenue in the same period that the gross room revenues are earned by the Company's franchisees, not one month in arrears. As a result, the Company has revised certain operating statistics in MD&A from previously reported amounts.

### Overview

We are a primarily a hotel franchisor with franchise agreements representing 6,372 hotels open and 516 hotels under construction, awaiting conversion or approved for development as of June 30, 2014, with 506,523 rooms and 40,946 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 8% of our total revenues for the six months ended June 30, 2014, while representing

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approximately 18% of hotels open at June 30, 2014. Therefore, our description of the franchise system is primarily focused on the domestic operations.

Our Company generates revenues, income and cash flows primarily from initial, relicensing and continuing royalty fees attributable to our franchise agreements. Revenues are also generated from 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 and operating income 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.



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Currently, our business does not require significant capital to operate and grow. Therefore, we can maintain a capital structure that generates high financial returns and use our excess cash flow to increase returns to our shareholders 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 June 30, 2014, we have repurchased 45.3 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 78.3 million shares at an average price of \$13.89 per share. At June 30, 2014, we had approximately 1.4 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 six months ended June 30, 2014, we paid cash dividends totaling approximately \$22.0 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 \$43.6 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 \$20 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 operations and available financing capacity is sufficient to meet the expected future operating, investing and financing needs of the business.

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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 June 30, |                    | Six Months Ended June 30, |                    |
|---|-----------------------------|--------------------|---------------------------|--------------------|
|   | (in thousands)              |                    |                           |                    |
|   | 2014                        | 2013<br>(Restated) | 2014                      | 2013<br>(Restated) |
| Franchising Revenues:                     |                             |                    |                           |                    |
| Total Revenues                            | \$197,664                   | 190,930            | \$357,400                 | \$339,101          |
| Adjustments:                              |                             |                    |                           |                    |
| Marketing and reservation system revenues | (103,766 )                  | (104,072 )         | (193,372 )                | (186,395 )         |
| SkyTouch division                         | (68 )                       | —                  | (121 )                    | —                  |
| Franchising Revenues                      | \$93,830                    | \$86,858           | \$163,907                 | \$152,706          |

**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

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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 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 June<br>30,<br>(in thousands)<br>2014 |                    | Six Months Ended June<br>30,<br>2013 |                    |
|--|--|--------------------|--------------------------------------|--------------------|
|  | 2014   | 2013<br>(Restated) | 2014                                 | 2013<br>(Restated) |
| Adjusted EBITDA:                                       |  |                    |                                      |                    |
| Income from continuing operations, net of income taxes | \$ 35,279  | \$ 31,624          | \$ 56,748                            | \$ 51,400          |
| Income taxes   | 14,955   | 12,880             | 25,014                               | 20,686             |
| Interest expense                                       | 10,710   | 10,807             | 20,881                               | 21,577             |
| Interest income  | (347 )   | (659 )             | (850 )                               | (1,303 )           |
| Other (gains) and losses                               | (474 )   | 147                | (533 )                               | (563 )             |
| Equity in net (income) loss of affiliates              | 30   | (60 )              | 65                                   | 81                 |
| Depreciation and amortization                          | 2,332  | 2,388              | 4,610                                | 4,429              |
| Adjusted EBITDA  | \$ 62,485  | \$ 57,127          | \$ 105,935                           | \$ 96,307          |

## Operations Review

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

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

| (in thousands)   | 2014      | 2013<br>(Restated) |
|--|-----------|--------------------|
| <b>REVENUES:</b>   |           |                    |
| Royalty fees   | \$ 77,670 | \$ 72,638          |
| Initial franchise and relicensing fees                   | 4,722     | 4,416              |
| Procurement services                                     | 8,020     | 7,546              |
| Marketing and reservation                                | 103,766   | 104,072            |
| Other  | 3,486     | 2,258              |
| Total revenues   | 197,664   | 190,930            |
| <b>OPERATING EXPENSES:</b>                               |           |                    |
| Selling, general and administrative                      | 31,413    | 29,731             |
| Depreciation and amortization                            | 2,332     | 2,388              |
| Marketing and reservation                                | 103,766   | 104,072            |
| Total operating expenses                                 | 137,511   | 136,191            |
| Operating income   | 60,153    | 54,739             |
| <b>OTHER INCOME AND EXPENSES, NET:</b>                   |           |                    |
| Interest expense   | 10,710    | 10,807             |
| Interest income  | (347 )    | (659 )             |
| Other (gains) and losses                                 | (474 )    | 147                |
| Equity in net (income) loss of affiliates                | 30        | (60 )              |
| Total other income and expenses, net                     | 9,919     | 10,235             |
| Income from continuing operations before income taxes    | 50,234    | 44,504             |
| Income taxes   | 14,955    | 12,880             |
| Income from continuing operations, net of income taxes   | 35,279    | 31,624             |
| Income from discontinued operations, net of income taxes | 121       | 183                |

Net income \$35,400 \$31,807

### Results of Operations

The Company recorded income from continuing operations before income taxes of \$50.2 million for the three month period ended June 30, 2014, a \$5.7 million, or 13% increase from the same period of the prior year. The increase in income from continuing operations primarily reflects a \$5.4 million increase in operating income.

Operating income increased \$5.4 million as the Company's franchising revenues increased by \$7.0 million or 8% partially offset by a \$1.7 million or 6% increase in SG&A expenses. Adjusted EBITDA for the three months ended June 30, 2014 increased \$5.4 million or 9% to \$62.5 million. The key drivers of these fluctuations are described in more detail below.

**Franchising Revenues:** Franchising revenues were \$93.8 million for the three months ended June 30, 2014 compared to \$86.9 million for the three months ended June 30, 2013, an increase of 8%. The increase in franchising revenues is primarily due to a \$5.0 million or 7% increase in royalty revenues and a \$1.2 million increase in other revenues.

#### Royalty Fees

Domestic royalty fees for the three months ended June 30, 2014 increased \$5.0 million to \$71.2 million, an increase of 7% compared to the three months ended June 30, 2013. The increase in royalties is attributable to a combination of factors including a 7.6% increase in RevPAR and a 0.9% increase in the number of domestic franchised hotel rooms open. These increases were partially offset by a 6 basis point decline in the effective royalty rate from 4.34% to 4.28%. System-wide RevPAR increased due to a combination of a 2.9% 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 Three Months Ended<br>June 30, 2014 |           |           | For the Three Months Ended<br>June 30, 2013 (Restated) |           |           | Change                   |            |        |       |      |  |  |
|----------------------------|---|-----------|-----------|--|-----------|-----------|--------------------------|------------|--------|-------|------|--|--|
|                            | Average<br>Daily<br>Rate                    | Occupancy | RevPAR    | Average<br>Daily<br>Rate                               | Occupancy | RevPAR    | Average<br>Daily<br>Rate | Occupancy  | RevPAR |       |      |  |  |
| Comfort Inn                | \$87.16                                     | 67.6      | % \$58.94 | \$84.31  | 64.4      | % \$54.33 | 3.4                      | % 320      | bps    | 8.5   | %    |  |  |
| Comfort Suites             | 91.46                                       | 70.4      | % 64.36   | 88.11  | 67.2      | % 59.19   | 3.8                      | % 320      | bps    | 8.7   | %    |  |  |
| Sleep                      | 78.40                                       | 66.9      | % 52.42   | 75.57  | 63.5      | % 47.94   | 3.7                      | % 340      | bps    | 9.3   | %    |  |  |
| Quality                    | 72.61                                       | 59.8      | % 43.38   | 70.96  | 56.9      | % 40.39   | 2.3                      | % 290      | bps    | 7.4   | %    |  |  |
| Clarion                    | 78.36                                       | 57.0      | % 44.68   | 76.39  | 53.9      | % 41.19   | 2.6                      | % 310      | bps    | 8.5   | %    |  |  |
| Econo Lodge                | 58.12                                       | 54.9      | % 31.90   | 56.99  | 52.0      | % 29.65   | 2.0                      | % 290      | bps    | 7.6   | %    |  |  |
| Rodeway                    | 56.56                                       | 56.7      | % 32.05   | 54.52  | 54.0      | % 29.42   | 3.7                      | % 270      | bps    | 8.9   | %    |  |  |
| MainStay                   | 76.33                                       | 76.3      | % 58.25   | 73.00  | 72.7      | % 53.04   | 4.6                      | % 360      | bps    | 9.8   | %    |  |  |
| Suburban                   | 45.72                                       | 75.0      | % 34.27   | 43.07  | 73.0      | % 31.45   | 6.2                      | % 200      | bps    | 9.0   | %    |  |  |
| Ascend Hotel<br>Collection | 122.07                                      | 60.1      | % 73.32   | 124.08   | 64.9      | % 80.50   | (1.6)                    | )(%) (480) | )bps   | (8.9) | )(%) |  |  |
| Total*                     | \$77.92                                     | 63.0      | % \$49.08 | \$75.74  | 60.2      | % \$45.61 | 2.9                      | % 280      | bps    | 7.6   | %    |  |  |

\*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 3,632 rooms or 0.9% to 400,854 as of June 30, 2014 from 397,222 as of June 30, 2013. The total number of domestic hotels on-line increased by 1.8% to 5,212 as of June 30, 2014 from 5,118 as of June 30, 2013.

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

|                           | June 30, 2014 |         | June 30, 2013 |         | Variance |          |        | % | %      | % |
|---------------------------|---------------|---------|---------------|---------|----------|----------|--------|---|--------|---|
|                           | Hotels        | Rooms   | Hotels        | Rooms   | Hotels   | Rooms    |        |   |        |   |
| Comfort Inn               | 1,281         | 99,679  | 1,311         | 102,882 | (30 )    | (3,203 ) | (2.3 ) | % | (3.1 ) | % |
| Comfort Suites            | 590           | 45,664  | 587           | 45,339  | 3        | 325      | 0.5    | % | 0.7    | % |
| Sleep                     | 375           | 27,159  | 379           | 27,478  | (4 )     | (319 )   | (1.1 ) | % | (1.2 ) | % |
| Quality                   | 1,251         | 102,859 | 1,192         | 99,761  | 59       | 3,098    | 4.9    | % | 3.1    | % |
| Clarion                   | 185           | 26,501  | 191           | 27,184  | (6 )     | (683 )   | (3.1 ) | % | (2.5 ) | % |
| Econo Lodge               | 840           | 51,678  | 817           | 49,608  | 23       | 2,070    | 2.8    | % | 4.2    | % |
| Rodeway                   | 460           | 25,366  | 427           | 24,782  | 33       | 584      | 7.7    | % | 2.4    | % |
| MainStay                  | 42            | 3,304   | 43            | 3,332   | (1 )     | (28 )    | (2.3 ) | % | (0.8 ) | % |
| Suburban                  | 64            | 7,164   | 63            | 7,241   | 1        | (77 )    | 1.6    | % | (1.1 ) | % |
| Ascend Hotel Collection   | 104           | 9,076   | 90            | 7,521   | 14       | 1,555    | 15.6   | % | 20.7   | % |
| Cambria Suites            | 20            | 2,404   | 18            | 2,094   | 2        | 310      | 11.1   | % | 14.8   | % |
| Total Domestic Franchises | 5,212         | 400,854 | 5,118         | 397,222 | 94       | 3,632    | 1.8    | % | 0.9    | % |

Domestic hotels open and operating increased by 1 hotel during the three months ended June 30, 2014 compared to a net increase of 27 domestic hotels open and operating during the three months ended June 30, 2013. Gross domestic franchise additions decreased from 99 for the three months ended June 30, 2013 to 67 for the same period of 2014.

New construction hotels represented 11 of the gross domestic additions during the three months ended June 30, 2014 as compared to 9 new construction hotel openings in the same period of the prior year. Gross domestic additions for conversion hotels during the three months ended June 30, 2014 decreased by 34 units to 56 from 90 for the three months ended June 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 20 hotels to our Ascend Hotel Collection brand during the three months ended June 30, 2013. The remaining decline reflects the variability in timing of hotel openings from period to period. The Company expects the number of new franchise units that will open during 2014 to increase from 340 in 2013 to approximately 348 hotels. Although there has been an increase in the number of projected openings, 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 slightly from 72 in the three months ended June 30, 2013 to 66 for the three months ended June 30, 2014.

International rooms open and operating increased 0.9% to 105,669 as of June 30, 2014 from 104,701 as of June 30, 2013 contributing to an increase in international royalties of \$0.1 million or 1%. International royalties for the three months ended June 30, 2014 totaled \$6.5 million. The total number of international hotels declined 0.8% from 1,169 as of June 30, 2013 to 1,160 as of June 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 \$0.1 million to \$2.5 million for the three months ended June 30, 2014 from \$2.6 million for the three months ended June 30, 2013. Domestic initial fee revenue decreased approximately 6% despite a 20% increase in executed franchise agreements primarily due to a decline in the amount of deferred revenue recognized in 2014 related to franchise agreements containing developer incentives that were executed in prior years as well as an increase in the percentage of franchise agreements executed during the quarter 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.

New domestic franchise agreements executed in the three months ended June 30, 2014 totaled 125 representing 9,964 rooms compared to 104 agreements representing 8,504 rooms executed in the second quarter of 2013. During the

second quarter of 2014, 29 of the executed agreements were for new construction hotel franchises representing 2,080 rooms compared to 14 contracts representing 917 rooms for the three months ended June 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



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increased construction of new hotels. Conversion hotel executed franchise agreements totaled 96 representing 7,884 rooms for the three months ended June 30, 2014 compared to 90 agreements representing 7,587 rooms for the same period a year ago.

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

|                         | Three Months Ended June, 2014 |            |       | Three Months Ended June, 2013 |            |       | % Change         |            |       |
|-------------------------|-------------------------------|------------|-------|-------------------------------|------------|-------|------------------|------------|-------|
|                         | New Construction              | Conversion | Total | New Construction              | Conversion | Total | New Construction | Conversion | Total |
| Comfort Inn             | 7                             | 5          | 12    | 2                             | 13         | 15    | 250%             | (62)%      | (20)% |
| Comfort Suites          | 6                             | —          | 6     | 3                             | —          | 3     | 100%             | NM         | 100%  |
| Sleep                   | 10                            | 1          | 11    | 4                             | —          | 4     | 150%             | NM         | 175%  |
| Quality                 | 2                             | 38         | 40    | 1                             | 25         | 26    | 100%             | 52%        | 54%   |
| Clarion                 | —                             | 9          | 9     | —                             | 4          | 4     | NM               | 125%       | 125%  |
| Econo Lodge             | —                             | 21         | 21    | —                             | 23         | 23    | NM               | (9)%       | (9)%  |
| Rodeway                 | —                             | 16         | 16    | —                             | 15         | 15    | NM               | 7%         | 7%    |
| MainStay                | 1                             | 1          | 2     | 3                             | —          | 3     | (67)%            | NM         | (33)% |
| Suburban                | —                             | 2          | 2     | —                             | —          | —     | NM               | NM         | NM    |
| Ascend Hotel Collection | 3                             | 3          | 6     | 1                             | 10         | 11    | 200%             | (70)%      | (45)% |
| Cambria Suites          | —                             | —          | —     | —                             | —          | —     | NM               | NM         | NM    |
| Total Domestic System   | 29                            | 96         | 125   | 14                            | 90         | 104   | 107%             | 7%         | 20%   |

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 \$0.5 million or 35% from \$1.5 million for the three months ended June 30, 2013 to \$2.0 million for the three months ended June 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 contracts increased from 63 in the second quarter of 2013 to 75 for the three months ended June 30, 2014.

As of June 30, 2014, the Company had 423 franchised hotels with 32,564 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 365 hotels and 29,245 rooms at June 30, 2013. The number of new construction franchised hotels in the Company's domestic pipeline increased 12% to 247 at June 30, 2014 from 220 at June 30, 2013. The number of conversion franchised hotels in the Company's domestic pipeline increased by 31 hotels or 21% from 145 hotels at June 30, 2013 to 176 hotels at June 30, 2014. The Company had an additional 93 franchised hotels with 8,382 rooms under construction, awaiting conversion or approved for development in its international system as of June 30, 2014 compared to 83 hotels and 7,242 rooms at June 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.

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

|                           | June 30, 2014 |                  |       | June 30, 2013 |                  |       | Variance   |       |       |                  |       |       |       |       |   |
|---------------------------|---------------|------------------|-------|---------------|------------------|-------|------------|-------|-------|------------------|-------|-------|-------|-------|---|
|                           | Units         |                  | Total | Units         |                  | Total | Conversion |       |       | New Construction |       | Total |       |       |   |
|                           | Conversion    | New Construction |       | Conversion    | New Construction |       | Units      | %     | Units | %                | Units | %     |       |       |   |
| Comfort Inn               | 38            | 50               | 88    | 34            | 46               | 80    | 4          | 12    | %     | 4                | 9     | %     | 8     | 10    | % |
| Comfort Suites            | 1             | 47               | 48    | 2             | 61               | 63    | (1 )       | (50 ) | %     | (14 )            | (23 ) | %     | (15 ) | (24 ) | % |
| Sleep                     | 2             | 56               | 58    | —             | 44               | 44    | 2          | NM    |       | 12               | 27    | %     | 14    | 32    | % |
| Quality                   | 41            | 6                | 47    | 34            | 3                | 37    | 7          | 21    | %     | 3                | 100   | %     | 10    | 27    | % |
| Clarion                   | 12            | 2                | 14    | 8             | —                | 8     | 4          | 50    | %     | 2                | NM    |       | 6     | 75    | % |
| Econo Lodge               | 33            | 2                | 35    | 26            | —                | 26    | 7          | 27    | %     | 2                | NM    |       | 9     | 35    | % |
| Rodeway                   | 31            | 2                | 33    | 24            | —                | 24    | 7          | 29    | %     | 2                | NM    |       | 9     | 38    | % |
| MainStay                  | 2             | 35               | 37    | —             | 26               | 26    | 2          | NM    |       | 9                | 35    | %     | 11    | 42    | % |
| Suburban                  | 7             | 14               | 21    | 3             | 12               | 15    | 4          | 133   | %     | 2                | 17    | %     | 6     | 40    | % |
| Ascend Hotel              | 9             | 15               | 24    | 14            | 8                | 22    | (5 )       | (36 ) | %     | 7                | 88    | %     | 2     | 9     | % |
| Collection Cambria Suites | —             | 18               | 18    | —             | 20               | 20    | —          | NM    |       | (2 )             | (10 ) | %     | (2 )  | (10 ) | % |
|                           | 176           | 247              | 423   | 145           | 220              | 365   | 31         | 21    | %     | 27               | 12    | %     | 58    | 16    | % |

Other Income: Revenue increased \$1.2 million from the three months ended June 30, 2013 to \$3.5 million for the three months ended June 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 \$31.4 million for the three months ended June 30, 2014, an increase of \$1.7 million or 6% from the three months ended June 30, 2013.

SG&A expenses for the three months ended June 30, 2014 and 2013 include approximately \$4.2 million and \$2.6 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 June 30, 2014 increased \$0.1 million or less than 1% from the prior year. The low SG&A growth rate is primarily attributable to certain one time expenses incurred during the second quarter of 2013 including increased occupancy costs due to the relocation of the Company's corporate headquarters and litigation related settlements.

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 \$104.1 million for the three months ended June 30, 2013 to \$103.8 million for the three months ended June 30, 2014. Marketing and reservation system revenues recognized during the three months ended June 30, 2014 were impacted by the deferral of approximately \$15.9 million of revenue as the Company collected marketing and reservation system fees in excess of cumulative advances. 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 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 collected for marketing and reservation activities

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are deferred and recorded as an asset in the Company's financial statements and recovered in future periods. During the three months ended June 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 revenue deferred during the three month period ended June 30, 2014, revenues increased approximately 15%. 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 June 30, 2014, cumulative marketing and reservation system fees collected exceeded expenses by \$15.9 million with the excess reflected as an other long-term liabilities in the accompanying consolidated balance sheets.

Interest Expense: Interest expense decreased \$0.1 million for the three months ended June 30, 2014 to \$10.7 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 increased from a loss of \$0.1 million for the three months ended June 30, 2013 to a \$0.5 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 29.8% and 28.9% for the three months ended June 30, 2014 and restated June 30, 2013, respectively. The effective income tax rate for the three months ended June 30, 2014 and restated June 30, 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 restated three months ended June 30, 2013 also reflects the release of a valuation allowance on local country tax refunds received by our foreign subsidiary.

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## Operations Review

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

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

| (in thousands)   | 2014      | 2013       |
|--|-----------|------------|
| REVENUES:  |           | (Restated) |
| Royalty fees   | \$136,210 | \$128,746  |
| Initial franchise and relicensing fees                   | 8,462     | 8,193      |
| Procurement services                                     | 12,798    | 11,496     |
| Marketing and reservation                                | 193,372   | 186,395    |
| Other  | 6,558     | 4,271      |
| Total revenues   | 357,400   | 339,101    |
| OPERATING EXPENSES:                                      |           |            |
| Selling, general and administrative                      | 58,093    | 56,399     |
| Depreciation and amortization                            | 4,610     | 4,429      |
| Marketing and reservation                                | 193,372   | 186,395    |
| Total operating expenses                                 | 256,075   | 247,223    |
| Operating income   | 101,325   | 91,878     |
| OTHER INCOME AND EXPENSES, NET:                          |           |            |
| Interest expense   | 20,881    | 21,577     |
| Interest income  | (850)     | (1,303)    |
| Other (gains) and losses                                 | (533)     | (563)      |
| Equity in net loss of affiliates                         | 65        | 81         |
| Total other income and expenses, net                     | 19,563    | 19,792     |
| Income from continuing operations before income taxes    | 81,762    | 72,086     |
| Income taxes   | 25,014    | 20,686     |
| Income from continuing operations, net of income taxes   | 56,748    | 51,400     |
| Income from discontinued operations, net of income taxes | 1,762     | 150        |
| Net income   | \$58,510  | \$51,550   |

## Results of Operations

The Company recorded income from continuing operations of \$56.7 million for the six month period ended June 30, 2014, a \$5.3 million, or 10% increase from the same period of the prior year. The increase in income from continuing operations primarily reflects a \$9.4 million increase in operating income, a \$0.7 million, or 3% reduction in interest expense, partially offset by an increase in the Company's effective income tax rate from continuing operations from 28.7% for the six month period ended June 30, 2013 to 30.6% for the six month period ended June 30, 2014.

Operating income increased \$9.4 million as the Company's franchising revenues increased by \$11.2 million or 7% and SG&A expenses increased \$1.7 million or 3%. Adjusted EBITDA for the six months ended June 30, 2014 increased \$9.6 million or 10% to \$105.9 million. The key drivers of these fluctuations are described in more detail below.

Franchising Revenues: Franchising revenues were \$163.9 million for the six months ended June 30, 2014 compared to \$152.7 million for the six months ended June 30, 2013, an increase of 7%. The increase in franchising revenues is primarily due to a \$7.5 million or 6% increase in domestic royalty revenues, a \$1.3 million increase in procurement services revenues and a \$2.3 million increase in other revenues.

## Royalty Fees

Domestic royalty fees for the six months ended June 30, 2014 increased \$7.7 million to \$124.4 million, an increase of 7% compared to the six months ended June 30, 2013. The increase in royalties is attributable to a combination of factors including a 7.0% increase in RevPAR and a 0.9% increase in the number of domestic franchised hotel rooms open. These increases were



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partially offset by a 6 basis point decline in the effective royalty rate from 4.36% to 4.30%. System-wide RevPAR increased due to a combination of a 2.4% increase in average daily rates and a 250 basis point increase in occupancy rates.

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

|                         | For the Six Months Ended June 30, 2014 |           |           | For the Six Months Ended June 30, 2013 (Restated) |           |           | Change             |           |             |   |
|-------------------------|--|-----------|-----------|---|-----------|-----------|--------------------|-----------|-------------|---|
|                         | Average Daily Rate                     | Occupancy | RevPAR    | Average Daily Rate                                | Occupancy | RevPAR    | Average Daily Rate | Occupancy | RevPAR      |   |
| Comfort Inn             | \$83.68                                | 61.3      | % \$51.31 | \$81.41   | 58.6      | % \$47.67 | 2.8                | % 270     | bps 7.6     | % |
| Comfort Suites          | 89.35                                  | 65.7      | % 58.68   | 86.63   | 62.8      | % 54.43   | 3.1                | % 290     | bps 7.8     | % |
| Sleep                   | 75.94                                  | 61.3      | % 46.57   | 73.54   | 58.5      | % 43.00   | 3.3                | % 280     | bps 8.3     | % |
| Quality                 | 70.37                                  | 54.8      | % 38.57   | 68.89   | 52.2      | % 35.98   | 2.1                | % 260     | bps 7.2     | % |
| Clarion                 | 75.01                                  | 53.0      | % 39.75   | 73.77   | 50.1      | % 36.98   | 1.7                | % 290     | bps 7.5     | % |
| Econo Lodge             | 55.75                                  | 49.7      | % 27.72   | 54.93   | 47.4      | % 26.05   | 1.5                | % 230     | bps 6.4     | % |
| Rodeway                 | 54.19                                  | 53.2      | % 28.85   | 52.12   | 50.4      | % 26.27   | 4.0                | % 280     | bps 9.8     | % |
| MainStay                | 73.80                                  | 70.6      | % 52.11   | 71.66   | 67.5      | % 48.38   | 3.0                | % 310     | bps 7.7     | % |
| Suburban                | 44.53                                  | 72.6      | % 32.34   | 42.64   | 71.3      | % 30.39   | 4.4                | % 130     | bps 6.4     | % |
| Ascend Hotel Collection | 117.13                                 | 59.2      | % 69.30   | 121.33  | 63.4      | % 76.89   | (3.5 )%            | (420 )    | bps (9.9 )% | % |
| Total*                  | \$75.26                                | 58.0      | % \$43.63 | \$73.48   | 55.5      | % \$40.78 | 2.4                | % 250     | bps 7.0     | % |

\*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 32 hotels during the six months ended June 30, 2014 compared to a net increase of 35 domestic hotels open and operating during the six months ended June 30, 2013. Gross domestic franchise additions declined from 161 for the six months ended June 30, 2013 to 134 or the same period of 2014. New construction hotels represented 19 of the gross domestic additions during the six months ended June 30, 2014 as compared to 17 new construction hotel openings in the same period of the prior year. Gross domestic additions for conversion hotels during the six months ended June 30, 2014 decreased by 29 units to 115 from 144 for the six months ended June 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 20 hotels to our Ascend Hotel Collection brand during the six months ended June 30, 2013. The remaining decline reflects the variability in timing of hotel openings from period to period. The Company expects the number of new franchise units that will open during 2014 to increase from 340 in 2013 to approximately 348 hotels. Although there has been an increase in the number of projected openings, 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 126 in the six months ended June 30, 2013 to 102 for the six months ended June 30, 2014. The decline in net terminations primarily reflects a decrease in the number of hotels removed from our franchise system for non-payment of franchise fees and 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 six months ended June 30, 2014, the Company repositioned 52 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.

International rooms open and operating increased 0.9% to 105,669 as of June 30, 2014 from 104,701 as of June 30, 2013. The total number of international hotels declined 0.8% from 1,169 as of June 30, 2013 to 1,160 as of June 30, 2014. Despite the increase in open rooms, international royalties decreased by \$0.2 million or 2% from the six months ended June 30, 2013 to \$11.8 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

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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 \$0.3 million to \$4.3 million for the six months ended June 30, 2014 from \$4.6 million for the six months ended June 30, 2013. Domestic initial fee revenue decreased approximately 8% primarily due to a 2% 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 as well as an increase in the percentage of franchise agreements executed in the current year 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. New domestic franchise agreements executed in the six months ended June 30, 2014 totaled 184 representing 14,654 rooms compared to 187 agreements representing 14,834 rooms executed in the same period of 2013. During the six months ended June 30, 2014, 48 of the executed agreements were for new construction hotel franchises representing 3,493 rooms compared to 24 contracts representing 1,671 rooms for the six months ended June 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 136 representing 11,161 rooms for the six months ended June 30, 2014 compared to 163 agreements representing 13,163 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 21 new franchise agreements for our Ascend Hotel Collection brand during the six months ended June 30, 2013.

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

|                         | Six Months Ended June, 2014 |            |       | Six Months Ended June 30, 2013 |            |       | % Change         |            |       |     |     |    |
|-------------------------|-----------------------------|------------|-------|--------------------------------|------------|-------|------------------|------------|-------|-----|-----|----|
|                         | New Construction            | Conversion | Total | New Construction               | Conversion | Total | New Construction | Conversion | Total |     |     |    |
| Comfort Inn             | 10                          | 8          | 18    | 5                              | 18         | 23    | 100              | % (56      | )%    | (22 | )%  |    |
| Comfort Suites          | 7                           | —          | 7     | 5                              | 2          | 7     | 40               | % (100     | )%    | —   | %   |    |
| Sleep                   | 14                          | 1          | 15    | 5                              | —          | 5     | 180              | % NM       |       | 200 | %   |    |
| Quality                 | 3                           | 48         | 51    | 1                              | 44         | 45    | 200              | % 9        | %     | 13  | %   |    |
| Clarion                 | —                           | 11         | 11    | —                              | 7          | 7     | NM               |            | 57    | %   | 57  | %  |
| Econo Lodge             | —                           | 27         | 27    | —                              | 31         | 31    | NM               |            | (13   | )%  | (13 | )% |
| Rodeway                 | 1                           | 31         | 32    | —                              | 24         | 24    | NM               |            | 29    | %   | 33  | %  |
| MainStay                | 5                           | 1          | 6     | 4                              | —          | 4     | 25               | % NM       |       | 50  | %   |    |
| Suburban                | 1                           | 3          | 4     | —                              | 1          | 1     | NM               |            | 200   | %   | 300 | %  |
| Ascend Hotel Collection | 6                           | 6          | 12    | 3                              | 36         | 39    | 100              | % (83      | )%    | (69 | )%  |    |
| Cambria Suites          | 1                           | —          | 1     | 1                              | —          | 1     | —                | % NM       |       | —   | %   |    |
| Total Domestic System   | 48                          | 136        | 184   | 24                             | 163        | 187   | 100              | % (17      | )%    | (2  | )%  |    |

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 \$0.8 million or 25% from \$3.0 million for the six months ended June 30, 2013 to \$3.8 million for the six months ended June 30, 2014. The increase in revenues is due to a 20% 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 132 in the six months ended June 30, 2013 to 158 for the six months ended June 30, 2014.

Procurement Services: Revenues increased \$1.3 million or 11% from \$11.5 million for the six months ended June 30, 2013 to \$12.8 million for the six months ended June 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.

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Other Income: Revenue increased \$2.3 million from the six months ended June 30, 2013 to \$6.6 million for the six months ended June 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 \$58.1 million for the six months ended June 30, 2014, an increase of \$1.7 million or 3% from the six months ended June 30, 2013.

SG&A expenses for the six months ended June 30, 2014 and 2013 include approximately \$7.5 million and \$4.4 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 six months ended June 30, 2014 decreased \$1.5 million from the prior year primarily due to higher occupancy costs incurred in 2013 due to the relocation of the Company's corporate headquarters, prior year litigation related settlement expenses and lower variable procurement services expenses incurred in 2014 compared to the prior year. In addition, compensation expense recognized on deferred compensation arrangements declined by approximately \$0.4 million. 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 six months ended June 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 increased 4% from \$186.4 million for the six months ended June 30, 2013 to \$193.4 million for the six months ended June 30, 2014. Marketing and reservation system revenues recognized during the six months ended June 30, 2014 were impacted by the deferral of approximately \$15.9 million of revenue as the Company collected marketing and reservation system fees in excess of cumulative advances. 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 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 collected 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 six months ended June 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 revenue deferred during the six month period ended June 30, 2014, 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 June 30, 2014, cumulative marketing and reservation system fees collected exceeded expenses by \$15.9 million with the excess reflected as an other long-term liabilities in the accompanying consolidated balance sheets.

Interest Expense: Interest expense decreased \$0.7 million for the six months ended June 30, 2014 to \$20.9 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 declined from a gain of \$0.6 million for the six months ended June 30, 2014 to a \$0.5 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 30.6% and 28.7% for the six months ended June 30, 2014 and restated June 30, 2013, respectively. The effective income tax rate for the six months ended June 30,

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2014 and restated June 30, 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 restated six months ended June 30, 2013 also reflects the release of a valuation allowance on local country tax refunds received by our foreign subsidiary, further 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 \$1.8 million in the first six months of 2014 compared to net income of \$0.2 million in the first six 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 six months ended June 30, 2014.

**Net Income and Diluted EPS:** Diluted EPS increased 13% to \$0.99 for the six months ended June 30, 2014 from \$0.88 for the same period of the prior year. During the six months ended June 30, 2014 continuing and discontinued operations contributed \$0.96 and \$0.03, respectively, to diluted EPS. During the six months ended June 30, 2013 continuing operations and discontinued operations contributed \$0.88 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 six months ended June 30, 2014, net cash provided by operating activities totaled \$65.8 million compared to \$30.0 million during the six months ended June 30, 2013, an increase of \$35.8 million. The increase in cash flows from operating activities primarily reflects an increase in operating income, a \$25.9 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 \$31.5 million during the six months ended June 30, 2014 compared to \$5.6 million during the six months ended June 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, new advertising and distribution program fees and the timing of certain advertising and brand programs. Based on the current economic conditions, the Company expects marketing and reservation activities to provide cash flows from operations ranging between \$45 million and \$55 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 six months ended June 30, 2014 and 2013, the Company's net advances for these purposes totaled \$6.7 million and \$3.6 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 June 30, 2014, the Company had commitments to extend an additional \$13.3 million for these purposes provided certain conditions are met by its franchisees, of which \$5.9 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 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 June 30, 2014, the Company had commitments to extended \$25.3 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 provided by (utilized for) investing activities totaled \$4.6 million and \$(21.6) million for the six months ended June 30, 2014 and 2013, respectively. The increase in cash provided by investing activities for the six months ended June 30, 2014 compared to a use of cash in the prior year primarily reflects a decline in capital expenditures and \$12.2 million related to the proceeds from the sale of three Company owned MainStay Suites hotels.

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Additional information regarding these items is as follows:

During the six months ended June 30, 2014 and 2013, capital expenditures totaled \$7.3 million and \$22.0 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.

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 six months ended June 30, 2014, the Company advanced \$2.2 million and was repaid \$9.7 million from our franchisees for these purposes.

During the six months ended June 30, 2014 and 2013, the Company invested \$6.9 million and \$1.9 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.

During the six months ended June 30, 2014 and 2013, the Company sold investments totaling \$0.6 million and \$3.9 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, 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 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.





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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.

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:

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- 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.

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At June 30, 2014, the Company maintained a total leverage ratio of approximately 3.21x, a maximum secured leverage ratio of 0.55x and a minimum fixed charge coverage ratio of approximately 5.95x. At June 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 June 30, 2014, the Company had \$135.0 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 headquarter relocation and tenant improvement costs in consideration of the employment of permanent, full-time employees within the jurisdictions. At June 30, 2014, the Company has been advanced approximately \$3.4 million pursuant to these agreements and expects to receive the remaining \$1 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 June 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 six months ended June 30, 2014 remained unchanged from the previous quarterly declarations.

During the six months ended June 30, 2014, the Company paid cash dividends totaling \$22.0 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 \$43.6 million.

### Share Repurchases

No shares were repurchased under the share repurchase program during the six months ended June 30, 2014. Since the program's inception through June 30, 2014, we have repurchased 45.3 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 78.3 million shares at an average price of \$13.89 per share. As of June 30, 2014, the Company had approximately 1.4 million shares remaining under the current share repurchase authorization.

During the six months ended June 30, 2014, the Company redeemed 94,745 shares of common stock at a total cost of approximately \$4.5 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.



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### Other items

Approximately \$172.5 million of the Company's cash and cash equivalents at June 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. See Note 1 to our consolidated financial statements for additional information regarding recent changes to our accounting for these fees. 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 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.

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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 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.

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

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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. 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

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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.

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.

### Pension, Profit Sharing and Incentive Plans

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

In 2002, the Company adopted the Choice Hotels International, Inc. Executive Deferred Compensation Plan ("EDCP") which became effective January 1, 2003. Under the EDCP, certain executive officers may defer a portion of their salary into an irrevocable trust. Prior to January 1, 2010, participants could elect an investment return of either the annual yield of the 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

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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 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, 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 Form 10-K for the year ended December 31, 2013, filed with the Securities and Exchange Commission on March 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 \$17.4 million and \$16.4 million at June 30, 2014 and

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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 June 30, 2014, the Company had \$135.0 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 June 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 June 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, during the current period, 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. In addition, correcting the error in the three months ended June 30, 2014 would have been material to the interim (and full-year) 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.



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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. For additional information, see Note 1 of the notes to financial statements.

Changes in internal control over financial reporting

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 will be 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.

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## ITEM 1A. RISK FACTORS

There have been no material changes in our risk factors from those disclosed in Part I, Item 1A to our Annual Report on Form 10-K for the fiscal year ended December 31, 2013. In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

## Issuer Purchases of Equity Securities

The following table sets forth purchases and redemptions of Choice Hotels International, Inc. common stock made by the Company during the six months ended June 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   |
| Total             | 94,745                                       | \$47.96                      | —   | 1,418,991   |

(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 six months ended June 30, 2014, the Company redeemed 94,745 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.

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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.



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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.

August 11, 2014

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

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