CHOICE HOTELS INTERNATIONAL INC /DE
Form 10-K
March 16, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2005

OR

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

For the transition period from to

Commission file number 001-13393

CHOICE HOTELS INTERNATIONAL, INC.

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE **(State or Other Jurisdiction of** **Incorporation or Organization)**	**52-1209792** **(I.R.S. Employer** **Identification No.)**
10750 Columbia Pike, Silver Spring, Maryland **(Address of Principal Executive Offices)**	**20901** **(Zip Code)**

Registrant s telephone number, including area code (301) 592-5000

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, Par Value $0.01 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

The aggregate market value of common stock of Choice Hotels International, Inc. held by non-affiliates was $1,115,547,831 as of June 30, 2005 based upon a closing price of $32.85 per share.

The number of shares outstanding of Choice Hotels International, Inc. s common stock at February 28, 2006 was 65,537,878.

DOCUMENTS INCORPORATED BY REFERENCE.

Certain portions of our definitive proxy statement, to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than March 31, 2006, are incorporated by reference under Part III.

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PART I

Throughout this report, we refer to Choice Hotels International, Inc., together with its subsidiaries as we , us or the Company .

Forward-Looking Statements

Certain statements in this report that are not historical facts constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act. Words such as believes, anticipates, expects, intends, estimates, projects, and other similar expressions, which are predictions of or indicate future events and trends, typically identify forward-looking statements. Such statements are subject to a number of risks and uncertainties which could cause actual results to differ materially from those projected, including: competition; business strategies and their intended results; the balance between supply of and demand for hotel rooms; our ability to obtain new franchise agreements; our ability to develop and maintain positive relationships with current and potential hotel owners; the effect of international, national and regional economic conditions and geopolitical events such as acts of god, acts of war, terrorism or epidemics; the availability of capital to allow potential hotel owners to fund investments in and construction of hotels; the cost and other effects of legal proceedings; and other risks described from time to time in our filings with the Securities and Exchange Commission, including those set forth in Item 1A Risk Factors . Given these uncertainties, you are cautioned not to place undue reliance on such statements. We also undertake no obligation to publicly update or revise any forward-looking statement to reflect current or future events or circumstances.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and special reports, proxy statements and other information with the Securities and Exchange Commission (SEC). Our SEC filings are available to the public over the internet at the SEC s web site at http://www.sec.gov. Our SEC filings are also available free of charge on our website at http://www.choicehotels.com as soon as reasonably practicable following the time that they are filed with or furnished to the SEC. You may also read and copy any document we file with the SEC at its public reference room located at 100 F Street, NE Washington DC 20549. Please call the SEC at (202) 551-8090 for further information on their public reference room.

Item 1. Business.

Reference is made to the consolidated financial statements included in Item 8 of this annual report on Form 10-K for the financial information required to be included herein.

Overview

Choice Hotels International, Inc. and subsidiaries is one of the largest hotel franchisors in the world with 5,210 hotels open and 687 hotels under development as of December 31, 2005, representing 427,056 rooms open and 54,075 rooms under development in 49 states, the District of Columbia and more than 45 countries and territories outside the United States. Choice franchises lodging properties under the proprietary brand names (the Choice brands): Comfort Inn®, Comfort Suites®, Quality®, Clarion®, Sleep Inn®, Econo Lodge®, Rodeway Inn®, MainStay Suites®, Suburban Extended Stay Hotel®, Cambria Suites and Flag Hotels®. We operate in a single reportable segment encompassing our franchising business. Approximately 95% of the Company s 2005 and 2004 revenues were generated from hotels franchised in the United States.

Our direct lodging property real estate exposure is limited to three company-owned MainStay Suites® hotels.

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

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

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

Company History

Prior to becoming a separate, publicly held company on October 15, 1997 pursuant to the Company Spin-off (which we describe below), the Company was known as Choice Hotels Franchising, Inc. and was a wholly owned subsidiary of Choice Hotels International, Inc. (Former Choice). On October 15, 1997, Former Choice distributed to its stockholders its hotel franchising business (which had previously been primarily conducted by the Company) and its European hotel ownership and franchising business through a pro rata distribution to its stockholders of all of the stock of the Company (the Company Spin-off). At the time of the Company Spin-off, the Company changed its name to Choice Hotels International, Inc., and Former Choice changed its name to Sunburst Hospitality Corporation (or Sunburst).

The Lodging Industry(1)

Companies participating in the lodging industry primarily do so through a combination of one or more of the three primary lodging industry activities: ownership, franchising and management. A company s relative reliance on each of these activities determines which drivers most influence its profitability.

Ownership requires a substantial capital commitment and involves the most risk but offers high returns due to the owner s ability to influence margins by driving revenue per available room (RevPAR) and managing operating expenses. The ownership model has a high fixed-cost structure that results in a high degree of financial leverage. As a result, profits escalate rapidly in a lodging up-cycle but erode quickly in a downturn as costs rarely fall as fast as revenue. Profits from an ownership model increase at a greater rate from RevPAR growth attributable to average daily rate (ADR) growth, versus occupancy gains since there are more incremental costs associated with higher guest volumes compared to higher pricing.

Franchisors license their brands to a hotel owner, giving the hotel the right to use the brand name, logo, operating practices, and reservations systems in exchange for a fee and an agreement to operate the hotel in accordance with the brand standards. Under a typical franchise agreement, the hotel pays the franchisor an initial fee, a percentage-of-revenue royalty fee and a marketing/reservation reimbursement. A franchisor s revenues are dependent on the number of rooms in its system and the

(1) Certain industry statistics included in this section, such as the number of hotel rooms, number of affiliated and non-affiliated rooms, US Lodging Industry Trends From 1997 2005, etc. were obtained from Smith Travel Research.

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top-line performance of those hotels. Earnings drivers include RevPAR increases, unit growth and effective royalty rate improvement. Franchisors enjoy significant operating leverage in their business model since it costs little to add a new hotel franchise to an existing system. Franchisors normally benefit from higher industry supply growth, because the benefits of unit growth usually outweigh lower RevPAR resulting from excess supply. As a result, franchisors benefit from both RevPAR growth and supply increases which aids in reducing the impact of lodging industry economic cycles.

Management companies operate hotels for owners that do not have the expertise and/or the desire to self-manage. These companies collect management fees predominately based on revenues earned and/or profits generated. Similar to franchising activities, the key drivers of revenue based management fees are RevPAR and unit growth and similar to ownership activities, profit based fees are driven by improved hotel margins and RevPAR growth.

The lodging industry has historically experienced economic cycles reflected in positive and negative operating performance for various periods of time. Positive cycles are characterized as periods of sustained occupancy growth. These cycles usually continue until the economy sustains a prolonged downturn, excess supply conditions exist or some external factor occurs such as war, terrorism or natural resource shortages. Recovery in the industry usually begins with an increase in occupancy followed by hoteliers increasing their room rates. As occupancies and rates continue to improve, growth stabilizes and demand begins to exceed room supply. These pressures result in increased hotel development.

The hotel industry posted positive and consistent RevPAR growth from the mid-1990 s until 2000 as the industry was able to increase its ADR at a pace faster than the increase in the Consumer Price Index (CPI), a common measure of inflation published by the US Department of Labor. The following chart demonstrates these trends:

US Lodging Industry Trends 1997 - 2005

Year	Occupancy Rates	Average Daily Room Rates (ADR)	Increase in ADR Versus Prior Year	Increase in CPI Versus Prior Year	Revenue Per Available Room (RevPAR)	Profits (in billions)	New Rooms Added
1997	64.5%	$ 75.16	6.1%	1.9%	$ 48.50	$ 17.0	128,000
1998	64.0%	$ 78.62	4.6%	2.3%	$ 50.29	$ 22.0	143,000
1999	63.3%	$ 81.27	3.4%	2.7%	$ 51.44	$ 23.0	143,148
2000	63.5%	$ 85.24	4.9%	3.4%	$ 54.13	$ 24.0	121,476
2001	60.1%	$ 84.85	-0.5%	2.9%	$ 50.99	$ 16.7	101,279
2002	59.2%	$ 83.15	-2.0%	1.6%	$ 49.22	$ 16.1	86,366
2003	59.1%	$ 83.19	0.1%	2.3%	$ 49.20	$ 15.0	65,876
2004	61.3%	$ 86.41	3.9%	2.7%	$ 52.93	$ 17.0	55,245
2005	63.1%	$ 90.84	5.1%	3.4%	$ 57.34	$ 21.0	65,900

However, due to the economic recession, which began to affect the lodging industry during 2001, coupled with the terrorist attacks of September 11, 2001, industry profits and RevPAR declined between 2001 and 2003. Nonetheless, the industry remained profitable through this period.

In 2004, the resumption of economic growth increased lodging demand and occupancy rates. This coupled with the relatively slow growth in hotel supply, allowed hotels to aggressively raise room rates during 2004. These factors resulted in annual RevPAR growth in 2004 for the first time since the year 2000. The lodging industry recovery continued in 2005 with RevPAR increasing 8.3%.

Hotel room supply growth is cyclical as hotel construction responds to interest rates, construction and material costs, capital availability and industry fundamentals. Historically, the industry added hotel rooms to its

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inventory through new construction due largely to a favorable lending environment that encouraged hotel development. This resulted in an over supply of rooms which, coupled with the decrease in industry performance between 2001 and 2003, has led to reduced hotel development. We believe that development of newly constructed hotels will not fully recover until economic gains and lodging trend improvements are sustained.

New hotel construction entered the recovery phase during 2005 with 65,900 rooms added to the industry. This growth marked the first annual increase in newly constructed hotel rooms since 1999. However, the volume of new room additions still lags the pre-2001 economic recession levels. Despite rising interest rates and construction costs, some economic forecasters have predicted a continuing rise in the supply of hotel rooms to meet demand.

As a franchisor, we are well positioned in any stage of the lodging cycle. We benefit from both the RevPAR gains typically experienced in the early stage of recovery, as our revenues are based on our franchisees gross room revenues, and the supply growth normally noted in the later stages as we increase our portfolio size. During lodging cycle downturns, we benefit from the conversion of independent and other hotel chain affiliates into our system in an effort to improve their performance.

Hotels are broadly segmented into two categories: full-service and limited service. Full-service hotels generally offer food and beverage (F&B) facilities and/or meeting facilities. Limited-service hotels, usually offer only rooms, although some offer modest F&B (e.g. breakfast buffets) and/or small meeting rooms. Full-service hotels are generally larger, command higher room rates, and generate higher profits, although overall margins are lower because F&B is a lower-margin business. The lodging industry can be further divided into chain scale segments or groupings of generally competitive brands as follows:

Chain Scale	Brand Examples	Room Count	% of Total	Avg. Hotel Size
Luxury	Four Seasons, Ritz Carlton	74,981	1.7%	312
Upper Upscale	Marriott, Hilton, Sheraton	540,262	12.1%	384
Upscale	Hilton Garden Inn, Courtyard, Residence Inn	393,647	8.8%	157
Midscale w/ F&B	Quality, Clarion, Holiday Inn, Best Western, Ramada	557,980	12.4%	121
Sub-Total Full Service		**1,566,870**	**35.0%**	**178**
Midscale w/o F&B	Comfort, La Quinta, Baymont Inn, Hampton Inn	666,428	14.9%	87
Economy	Econo Lodge, Days Inn, Super 8, Red Roof Inn	736,277	16.4%	78
Sub-Total Limited Service		**1,402,705**	**31.3%**	**82**
Independents		1,506,896	33.7%	66
Total all Hotels		**4,476,471**	**100.0%**	**92**

Source: Smith Travel Research (December 2005)

According to Smith Travel Research, Choice branded system-wide market share in the United States has increased 89 basis points to 7.35% of total industry rooms since 2002. The total number of domestic hotel rooms has increased at an annual rate of less than 1% per annum during these same 3 years.

Recently, independent operators of hotels not owned or managed by major lodging companies have increasingly joined national hotel franchise chains as a means of remaining competitive with hotels owned by or affiliated with national lodging companies. Over the past 15 years, the industry has seen a significant movement of hotels from independent to chain affiliation, with affiliated hotels increasing from 46% of the market in 1990 to 66% of the market in 2005. Because a significant portion of the costs of owning and operating a hotel are generally fixed, increases in revenues generated by affiliation with a franchise lodging chain can improve a hotel s financial performance.

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The large franchise lodging chains, including us, generally provide a number of services to hotel operators to improve the financial performance of their properties including central reservation systems, marketing and advertising programs, training and education programs, property systems, revenue enhancement services, creating partnerships with vendors to streamline purchasing processes and make lower cost products available and direct sales programs. We believe that national franchise chains with a large number of hotels enjoy greater brand awareness among potential guests than those with fewer hotels, and that greater brand awareness can increase the desirability of a hotel to its potential guests.

We believe that hotel operators choose lodging franchisors based primarily on the perceived value and quality of each franchisor s brand and its services, and the extent to which affiliation with that franchisor may increase the hotel operator profitability.

Choice s Franchising Business

Choice operates primarily as a hotel franchisor offering 10 brands. Our Clarion® and Quality® brands compete primarily in the full service midscale with food and beverage segment; our Comfort Inn®, Comfort Suites®, and Sleep Inn® brands compete primarily in the limited service midscale without food & beverage segment; MainStay Suites® and Suburban Extended Stay Hotel® compete primarily in the extended stay segment and our Econo Lodge® and Rodeway Inn® brands compete primarily in the economy segment. In January 2005, we introduced a new brand, Cambria Suites®, that will compete in the upscale segment. As a result of our acquisition of Suburban Franchise Holding Company, Inc., the Suburban Extended Stay Hotel® brand was added to our portfolio on September 28, 2005.

Economics of Franchising Business. The fee and cost structure of our business provides opportunities for us to improve operating results by increasing the number of franchised properties, improving property level RevPAR performance and increasing the effective royalty rates quoted in our franchise contracts. As a hotel franchisor, we derive our revenue from various franchise fees. Our franchise fees consist primarily of an initial fee and ongoing royalty, marketing and reservation fees that are typically based on a percentage of the franchisee s gross room revenues. The initial fee and on-going royalty portion of the franchise fees are intended to cover our operating expenses, such as expenses incurred in business development, quality assurance, administrative support and other franchise services and to provide us with operating profits. The marketing and reservation fees are used exclusively for the expenses associated with national marketing and media advertising and providing such franchise services as the central reservation system.

Our fee stream depends on the number of rooms in our system, the gross room revenues generated by our franchisees and effective royalty rates. We enjoy significant operating leverage since the variable operating costs associated with our franchise system growth have historically been less than incremental royalty fees generated from new franchisees. Our business is well positioned in the lodging industry since we benefit from both RevPAR growth and new hotel construction.

Our various brand offerings position us well within the lodging industry. Our Cambria Suites®, Comfort Inn®, Comfort Suites®, Sleep Inn®, Suburban Extended Stay Hotel® and MainStay Suites® are primarily new build brands which offer hotel developers an array of choices in the upscale, midscale and extended stay segments during periods of supply growth, while our Clarion®, Quality®, Econo Lodge® and Rodeway Inn® brands offer conversion opportunities to independent operators who desire to affiliate with a brand and take advantage of the services a franchisor has to offer.

Strategy. Our Company s mission is a commitment to our customer s profitability by providing our customers with hotel franchises that strive to generate the highest return on investment of any hotel franchise. Our business strategy is to create franchise system growth by leveraging Choice s large and well-known hotel brands, franchise sales capabilities, effective marketing and reservation delivery efforts, RevPAR enhancing services and technology, and financial strength created by our significant free cash flow. We believe our brands

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growth will be driven by our ability to create a compelling return on investment for franchisees. Our strategic objective is to improve our franchisee s profitability by providing services, which increase business delivery, reduce operating and development costs for our franchisees, and/or improve guest satisfaction. Specific elements of our strategy include: build strong brands, deliver exceptional services, reach more consumers and leverage size, scale and distribution that reduce costs for hotel owners.

Build Strong Brands. Each of our brands has particular attributes and strengths, including awareness with both consumers and developers. Our strategy is to utilize the strengths of each brand for unit growth, RevPAR gains and royalty rate improvement that create revenue growth. We believe brand consistency, quality and guest satisfaction are critical in improving brand performance and building strong brands.

We have multiple brands that are positioned to meet the needs of many types of guests, and can be developed at various price points and applied to both new and existing hotels. This ensures that we have brands suitable for creating unit growth in various types of markets, with various types of customers, and during both industry contraction and growth cycles. During times of lower industry supply growth and tighter capital markets, we can target conversions of existing non-Choice affiliated hotels seeking the awareness and proven performance provided by our brands. During periods of strong industry supply growth, we expect a greater portion of our unit growth to come from our new construction brands. We believe that a large number of markets can still support our hotel brands, and the growth potential for our brands as well as new brands we may introduce remain strong.

We believe each of our brands appeals to targeted hotel owners and guests because of unique brand standards, service levels and pricing.

Deliver Exceptional Services. We provide a combination of services and technological products to help our franchisees improve performance. We have approximately 84 field services staff members located nationwide that help franchisees improve RevPAR performance and guest satisfaction. In addition, we provide our franchisees with technology products designed to improve property level performance. These services and products promote revenue gains for franchisees and translate into both higher royalties for Choice and improved returns for owners, leading to further unit growth by making Choice brands attractive to franchisees. We develop our services based on customer needs and focus on activities that generate high return on investment for our customers.

Reach More Consumers. We believe hotel owners value the large volume of guests we deliver through corporate and brand marketing, reservation systems, key account sales, and Choice s principal loyalty program, Choice Privileges®. Our strategy is to maximize the effectiveness of these activities in delivering both leisure and business travelers to Choice-branded hotels.

Choice will continue to increase awareness of its brands through its multi-branded national marketing campaign which features re-imaged signs, our We ll See You There tagline and our loyalty program promotions. This campaign is intended to generate the most compelling message in the midscale and economy segments and utilize Choice s significant size to create even greater awareness for our brands. Local and regional co-op marketing campaigns will continue to leverage the national marketing programs to drive business to Choice properties at a local level. We expect our efforts at marketing directly to guests will continue to be enhanced through the use of our customer relationship management technology. Our continued focus on overall brand quality coupled with our marketing initiatives is designed to stimulate room demand for our franchised hotels through improved guest awareness and satisfaction.

Our central reservations system is a critical technology used to deliver guests to our franchisees through multiple channels, including our call centers and proprietary websites, and global distribution systems (e.g., SABRE, Amadeus, and internet distribution sites). We believe our well-known brands, combined with our ability to partner with many internet distribution web sites benefits our franchisees, by facilitating increased rate and reservations delivery, and reducing costs and operational complexity.

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Leverage Size, Scale and Distribution. We continually focus on identifying methods for utilizing the significant number of hotels in our system to reduce costs and increase returns for our franchisees. For example, we create partnerships with vendors to: (i) make low-cost products available to our franchisees; (ii) streamline the purchasing process; and (iii) maintain brand standards and consistency. We plan to expand this business and identify new methods for decreasing hotel-operating costs by increasing penetration internally and enhancing our existing vendor relationships and/or creating new vendor relationships. We believe our efforts to leverage Choice s size, scale and distribution benefit the Company by enhancing brand quality and consistency, improving our franchisees returns and satisfaction, and creating partner services revenues.

Franchise System

Our franchises operate domestically under one of nine Choice brand names: Comfort Inn®, Comfort Suites®, Quality®, Clarion®, Sleep Inn®, Econo Lodge®, Rodeway Inn®, MainStay Suites® and Suburban Extended Stay Hotel®. The following table presents key statistics related to our domestic franchise system over the five fiscal years ended December 31, 2005.

COMBINED DOMESTIC FRANCHISE SYSTEM

	As of and For the Year Ended December 31,				
	2001	**2002**	**2003**	**2004**	**2005**
Number of properties, end of period	3,327	3,482	3,636	3,834	4,048
Number of rooms, end of period	270,514	282,423	294,268	309,586	329,353
Royalty fees ($000)	$ 133,244	$ 135,381	$ 141,150	$ 155,915	$ 175,588
Average royalty rate(1), (3)	3.95%	3.97%	4.01%	4.04%	4.08%
Average occupancy percentage(3)	57.5%	55.6%	54.7%	56.6%	57.6%
Average daily room rate (ADR)(3)	$ 62.31	$ 61.96	$ 62.53	$ 63.56	$ 66.24
Revenue per available room (RevPAR)(2), (3)	$ 35.83	$ 34.48	$ 34.21	$ 35.95	$ 38.15

(1) Represents domestic royalty fees as a percentage of aggregate gross room revenues of all domestic Choice brand franchised hotels except for Suburban Extended Stay Hotel acquired on September 28, 2005.

(2) The Company calculates RevPAR based on information reported to the Company on a timely basis by franchisees.

(3)