CHOICE HOTELS INTERNATIONAL INC /DE
Form 10-Q
May 07, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED March 31, 2015
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
COMMISSION FILE NO. 001-13393

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

DELAWARE	52-1209792
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1 CHOICE HOTELS CIRCLE, SUITE 400
ROCKVILLE, MD 20850
(Address of principal executive offices)
(Zip Code)
(301) 592-5000
(Registrant's telephone number, including area code)

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

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

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 x No o

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	x	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	o

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

CLASS	SHARES OUTSTANDING AT March 31, 2015
Common Stock, Par Value $0.01 per share	57,587,566

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	Three Months Ended March 31,	
	2015	2014
REVENUES:		
Royalty fees	$62,431	$58,540
Initial franchise and relicensing fees	5,717	3,740
Procurement services	4,807	4,778
Marketing and reservation	98,713	89,606
Other	3,577	3,072
Total revenues	175,245	159,736
OPERATING EXPENSES:		
Selling, general and administrative	32,438	26,680
Depreciation and amortization	2,690	2,278
Marketing and reservation	98,713	89,606
Total operating expenses	133,841	118,564
Operating income	41,404	41,172
OTHER INCOME AND EXPENSES, NET:		
Interest expense	10,179	10,171
Interest income	(346)	(503)
Other (gains) and losses	(468)	(59)
Equity in net loss of affiliates	1,005	35
Total other income and expenses, net	10,370	9,644
Income from continuing operations before income taxes	31,034	31,528
Income taxes	9,440	10,059
Income from continuing operations, net of income taxes	21,594	21,469
Income from discontinued operations, net of income taxes	—	1,641
Net income	$21,594	$23,110
Basic earnings per share		
Continuing operations	$0.38	$0.37
Discontinued operations	—	0.03
	$0.38	$0.40
Diluted earnings per share		
Continuing operations	$0.37	$0.36
Discontinued operations	—	0.03
	$0.37	$0.39
Cash dividends declared per share	$0.195	$0.185

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 COMPREHENSIVE INCOME
(UNAUDITED, IN THOUSANDS)

	Three Months Ended March 31,	
	2015	2014
Net income	$21,594	$23,110
Other comprehensive income (loss), net of tax:		
Amortization of loss on cash flow hedge	215	215
Foreign currency translation adjustment	(1,447)	521
Other comprehensive income (loss), net of tax	(1,232)	736
Comprehensive income	$20,362	$23,846

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)

	March 31, 2015	December 31, 2014
ASSETS		
Current assets		
Cash and cash equivalents	$200,544	$214,879
Receivables (net of allowance for doubtful accounts of $9,842 and $10,084, respectively)	102,013	91,681
Deferred income taxes	25,674	23,860
Income taxes receivable	—	1,458
Investments, employee benefit plans, at fair value	177	214
Other current assets	28,864	19,322
Total current assets	357,272	351,414
Property and equipment, at cost, net	80,057	77,309
Goodwill	65,813	65,813
Franchise rights and other identifiable intangibles, net	8,001	8,912
Notes receivable, net of allowances	48,781	40,441
Investments, employee benefit plans, at fair value	17,916	17,539
Deferred income taxes	18,921	20,546
Other assets	64,361	65,296
Total assets	$661,122	$647,270
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	$54,631	$57,124
Accrued expenses	39,414	63,530
Deferred revenue	73,908	66,382
Current portion of long-term debt	12,362	12,349
Deferred compensation and retirement plan obligations	177	628
Income taxes payable	1,396	85
Total current liabilities	181,888	200,098
Long-term debt	799,628	782,082
Deferred compensation and retirement plan obligations	24,259	23,987
Other liabilities	68,840	69,904
Total liabilities	1,074,615	1,076,071
Commitments and Contingencies		
Common stock, $0.01 par value, 160,000,000 shares authorized; 95,065,638 shares issued at March 31, 2015 and December 31, 2014 and 57,587,566 and 57,337,720 shares outstanding at March 31, 2015 and December 31, 2014, respectively	576	573
Additional paid-in-capital	131,711	127,661
Accumulated other comprehensive loss	(8,203)	(6,971)
Treasury stock (37,478,072 and 37,727,918 shares at March 31, 2015 and December 31, 2014, respectively), at cost	(979,828)	(982,463)
Retained earnings	442,251	432,399
Total shareholders' deficit	(413,493)	(428,801)
Total liabilities and shareholders' deficit	$661,122	$647,270

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 FLOW
(UNAUDITED, IN THOUSANDS)

	Three Months Ended March 31, 2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$21,594	$23,110
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,690	2,278
Gain on sale of assets	(292)	(2,572)
Provision for bad debts, net	823	1,399
Non-cash stock compensation and other charges	2,509	2,875
Non-cash interest and other (income) loss	506	416
Deferred income taxes	(233)	2,344
Equity (earnings) losses from unconsolidated joint ventures, net of distributions received	1,205	216
Changes in assets and liabilities:		
Receivables	(11,624)	(19,931)
Advances to/from marketing and reservation activities, net	4,626	10,903
Forgivable notes receivable, net	(13,371)	(3,623)
Accounts payable	(1,152)	2,080
Accrued expenses	(24,052)	(19,861)
Income taxes payable/receivable	2,773	3,160
Deferred revenue	7,552	7,932
Other assets	(9,826)	(3,103)
Other liabilities	437	(2,359)
Net cash provided (used) by operating activities	(15,835)	5,264
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment in property and equipment	(6,804)	(3,015)
Proceeds from sales of assets	1,592	8,703
Equity method investments	(1,921)	(3,379)
Purchases of investments, employee benefit plans	(1,089)	(890)
Proceeds from sales of investments, employee benefit plans	925	281
Issuance of mezzanine and other notes receivable	—	(587)
Collections of mezzanine and other notes receivable	105	68
Other items, net	(77)	(154)
Net cash provided (used) by investing activities	(7,269)	1,027
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net borrowings pursuant to revolving credit facility	20,700	15,000
Principal payments on long-term debt	(3,082)	(2,052)
Purchases of treasury stock	(6,227)	(4,530)
Dividends paid	(11,710)	(10,784)
Excess tax benefits from stock-based compensation	4,473	1,024
Proceeds from exercise of stock options	5,619	1,547
Net cash provided by financing activities	9,773	205
Net change in cash and cash equivalents	(13,331)	6,496
Effect of foreign exchange rate changes on cash and cash equivalents	(1,004)	587

Cash and cash equivalents at beginning of period	214,879	167,795
Cash and cash equivalents at end of period	$200,544	$174,878
Supplemental disclosure of cash flow information:		
Cash payments during the period for:		
Income taxes, net of refunds	$2,357	$5,842
Interest, net of capitalized interest	$18,729	$19,613
Non-cash investing and financing activities:		
Dividends declared but not paid	$11,230	$11,173
Issuance of common stock pursuant to share based compensation plans	$6,952	$7,253
Investment in property and equipment acquired in accounts payable	$1,380	$603

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, 2014 and notes thereto included in the Company’s Form 10-K, filed with the SEC on March 2, 2015 (the "10-K"). Interim results are not necessarily indicative of the entire year results. All inter-company transactions and balances between Choice Hotels International, Inc. and its subsidiaries have been eliminated in consolidation.

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

Discontinued Operations

In the first quarter of 2014, the Company's management approved a plan to dispose of the three Company owned Mainstay Suites hotels. As a result, the Company has reported the operations related to these three hotels as discontinued operations in this Quarterly Report on Form 10-Q. 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 March 31, 2015 and December 31, 2014, $6.7 million and $5.4 million, respectively, of book overdrafts representing outstanding checks in excess of funds on deposit are included in accounts payable in the accompanying consolidated balance sheets.

The Company maintains cash balances in domestic banks, which at times, may exceed the limits of amounts insured by the Federal Deposit Insurance Corporation. In addition, as of March 31, 2015, the Company maintains cash balances of $195.1 million in international banks which do not provide deposit insurance.

Recently Adopted Accounting Guidance

In April 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“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 No. 2014-08"). ASU No. 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 No. 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 adopted this ASU on January 1, 2015 and it did not have a material impact on its financial statements.

Future Adoption of Recently Announced Accounting Guidance

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

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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. The FASB has tentatively deferred ASU No. 2014-09 for one year, and with that deferral, the standard will be effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period, which will be our 2018 first quarter. We are permitted to use either the retrospective or modified retrospective method when adopting ASU No. 2014-09. We are still assessing the potential impact that ASU No. 2014-09 will have on its financial statements and disclosures.
In January 2015, the FASB issued ASU No. 2015-01, Income Statement - Extraordinary and Unusual Items (Subtopic 225-20) ("ASU No. 2015-01"). ASU No. 2015-01 was issued changing the requirements for reporting extraordinary and unusual items in the income statement. The update eliminates the concept of extraordinary items. The presentation and disclosure guidance for items that are unusual in nature or occur infrequently will be retained and will be expanded to include items that are both unusual in nature and infrequently occurring. ASU No. 2015-01 is effective for annual reporting periods beginning after December 15, 2015, including interim periods within that reporting period. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The adoption of this newly issued guidance is not expected to have an impact to our consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02, Consolidation (Topic 810) ("ASU No. 2015-02"). ASU No. 2015-02 changes the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. This guidance must be applied using one of two retrospective application methods and will be effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted. The Company is currently evaluating the impact, if any, the adoption of this newly issued guidance will have on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30) ("ASU No. 2015-03"). ASU No. 2015-03 changes the presentation of debt issuance costs in the financial statements to present such costs as a direct deduction from the related debt liability rather than as an asset. Amortization of debt issuance costs will continue to be reported as interest expense. This standard is effective for annual reporting periods beginning after December 15, 2015, including interim periods within that reporting period. Early adoption is permitted and the standard is to be applied on retrospective basis. The Company currently does not believe that ASU No. 2015-03 will have a material impact on its consolidated financial position, results of operations, or cash flows.
In April 2015, the FASB issued ASU No. 2015-05, Intangibles-Goodwill - Internal Use Software (Subtopic 350-40) ("ASU No. 2015-05"). ASU No. 2015-05 provides guidance to customers about whether a cloud computing arrangement includes a software license or should be accounted for as a service contract. The standard is effective for annual reporting periods, including interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and an entity can elect to adopt the amendment either (1) prospectively to all arrangements entered into or materially modified after the effective date or (2) retrospectively. The adoption of this newly issued guidance is not expected to have a material impact to our consolidated financial statements.

2. Other Current Assets
Other current assets consist of the following:

	March 31, 2015	December 31, 2014
	(in thousands)	
Notes receivable, net of allowances (See Note 3)	$3,966	$3,961
Prepaid expenses	19,653	12,280
Other current assets	5,245	3,081

Total	$28,864	$19,322

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

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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:

	March 31, 2015 (in thousands)			December 31, 2014 (in thousands)		
Credit Quality Indicator	Forgivable Notes Receivable	Mezzanine & Other Notes Receivable	Total	Forgivable Notes Receivable	Mezzanine & Other Notes Receivable	Total
Senior	$—	$10,152	$10,152	$—	$10,152	$10,152
Subordinated	—	3,844	3,844	—	3,863	3,863
Unsecured	41,558	3,888	45,446	32,379	3,995	36,374
Total notes receivable	41,558	17,884	59,442	32,379	18,010	50,389
Allowance for losses on non-impaired loans	4,399	1,510	5,909	3,661	1,540	5,201
Allowance for losses on receivables specifically evaluated for impairment	—	786	786	—	786	786
Total loan reserves	4,399	2,296	6,695	3,661	2,326	5,987
Net carrying value	$37,159	$15,588	$52,747	$28,718	$15,684	$44,402
Current portion, net	$162	$3,804	$3,966	$124	$3,837	$3,961
Long-term portion, net	36,997	11,784	48,781	28,594	11,847	40,441
Total	$37,159	$15,588	$52,747	$28,718	$15,684	$44,402

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

The following table summarizes the activity related to the Company's Forgivable Notes Receivable and Mezzanine and Other Notes Receivable allowance for losses for the three months ended March 31, 2015:

	Forgivable Notes Receivable (in thousands)	Mezzanine & Other Notes Receivable
Beginning balance	$3,661	$2,326
Provisions	952	—
Recoveries	(194)	(30)
Write-offs	(149)	—

Other[1]	129	—
Ending balance	$4,399	$2,296

(1) Consists of default rate assumption changes

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Forgivable Notes Receivable

As of March 31, 2015 and December 31, 2014, the unamortized balance of the Company's forgivable notes receivable totaled $41.6 million and $32.4 million, respectively. The Company recorded an allowance for credit losses on these forgivable notes receivable of $4.4 million and $3.7 million at March 31, 2015 and December 31, 2014, respectively. Amortization expense included in the accompanying consolidated statements of income related to the notes for the three months ended March 31, 2015 and 2014 was $1.8 million and $1.2 million, respectively.

Past due balances of forgivable notes receivable are as follows:

	30-89 days Past Due	> 90 days Past Due	Total Past Due	Current	Total Notes Receivable
	(in thousands)				
As of March 31, 2015					
Forgivable Notes	$—	$1,168	$1,168	$40,390	$41,558
	$—	$1,168	$1,168	$40,390	$41,558
As of December 31, 2014					
Forgivable Notes	$—	$1,227	$1,227	$31,152	$32,379
	$—	$1,227	$1,227	$31,152	$32,379

Mezzanine and Other Notes Receivable

The Company determined that approximately $0.8 million of its mezzanine and other notes receivable were impaired at both March 31, 2015 and December 31, 2014, respectively. The Company recorded allowance for credit losses on these impaired loans at both March 31, 2015 and December 31, 2014 totaling $0.8 million. For the three months ended March 31, 2015 and 2014, the average mezzanine and other notes receivable on non-accrual status was approximately $0.8 million and $12.5 million, respectively. The Company recognized approximately $33 thousand and $54 thousand of interest income on impaired loans during the three months ended March 31, 2015 and 2014, respectively, on the cash basis. The Company provided loan reserves on non-impaired loans totaling $1.5 million at both March 31, 2015 and December 31, 2014.

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

	30-89 days Past Due	> 90 days Past Due	Total Past Due	Current	Total Notes Receivable
	(in thousands)				
As of March 31, 2015					
Senior	$—	$—	$—	$10,152	$10,152
Subordinated	3,359	—	3,359	485	3,844
Unsecured	—	47			