

CHOICE HOTELS INTERNATIONAL INC /DE
Form 10-K
February 27, 2017
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the year ended December 31, 2016

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 52-1209792
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

1 Choice Hotels Circle, Suite 400, Rockville, Maryland 20850
(Address of Principal Executive Offices) (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 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

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months. Yes 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.

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

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 definitions of “large accelerated filer, accelerated filer and smaller reporting company” in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer Accelerated filer Smaller reporting company Non-accelerated filer
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act)

Yes No

The aggregate market value of common stock of Choice Hotels International, Inc. held by non-affiliates was \$1,582,842,609 as of June 30, 2016 based upon a closing price of \$47.62 per share.

The number of shares outstanding of Choice Hotels International, Inc.’s common stock at February 16, 2017 was 56,280,477.

Table of Contents

DOCUMENTS INCORPORATED BY REFERENCE.

Certain portions of our definitive proxy statement, to be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the Annual Meeting of Shareholders to be held on April 21, 2017, are incorporated by reference under Part III of this Form 10-K.

Table of Contents

CHOICE HOTELS INTERNATIONAL, INC.

Form 10-K

Table of Contents

	Page No.
Part I	
Item 1. <u>Business</u>	<u>4</u>
Item 1A. <u>Risk Factors</u>	<u>25</u>
Item 1B. <u>Unresolved Staff Comments</u>	<u>34</u>
Item 2. <u>Properties</u>	<u>34</u>
Item 3. <u>Legal Proceedings</u>	<u>34</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>34</u>
Part II	
Item 5. <u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>34</u>
Item 6. <u>Selected Financial Data</u>	<u>38</u>
Item 7. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>39</u>
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>63</u>
Item 8. <u>Financial Statements and Supplementary Data</u>	<u>64</u>
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>121</u>
Item 9A. <u>Controls and Procedures</u>	<u>121</u>
Item 9B. <u>Other Information</u>	<u>124</u>
Part III	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	<u>124</u>
Item 11. <u>Executive Compensation</u>	<u>124</u>
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>124</u>
Item 13. <u>Certain Relationships and Related Transactions and Director Independence</u>	<u>124</u>
Item 14. <u>Principal Accounting Fees and Services</u>	<u>125</u>
Part IV	
Item 15. <u>Exhibits, Financial Statement Schedules</u>	<u>125</u>
Item 16. <u>Form 10-K Summary</u>	<u>130</u>
<u>SIGNATURE</u>	<u>131</u>

Table of Contents

PART I

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

Forward-Looking Statements

Certain matters discussed in this 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, assumption 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, expenses, 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; changes in law and regulation applicable to the lodging and franchising industries; foreign currency fluctuations; 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 and our relationships with our franchisees; our ability to keep pace with improvements in technology utilized for marketing and reservations systems and other operating systems; the commercial acceptance of our SkyTouch division's products and services; our ability to grow our franchise system; exposure to risks relating to development activities; fluctuations in the supply and demand for hotels rooms; our ability to realize anticipated benefits of acquired businesses; the level of acceptance of alternative growth strategies we may implement; cyber security and data breach risks; operating risks associated with our international operations; the outcome of litigation; and our ability to effectively manage our indebtedness. These and other risk factors are discussed in detail in Item 1A. "Risk Factors" of this report. 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.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current 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 1-800-SEC-0330 for further information on its public reference room. Information on or connected to our website is neither part of nor incorporated by reference into this annual report on Form 10-K or any other SEC filings.

Item 1. Business.

Overview

We are one of the largest hotel franchisors in the world with 6,514 hotels open and 775 hotels under construction, awaiting conversion or approved for development as of December 31, 2016 representing 516,122 rooms open and 62,547 rooms under construction, awaiting conversion or approved for development in 50 states, the District of Columbia and over 40 countries and territories outside the United States. Choice franchises lodging properties under the following proprietary brand names: Comfort Inn[®], Comfort Suites[®], Quality[®], Clarion[®], Sleep Inn[®], Econo

Lodge[®], Rodeway Inn[®], MainStay Suites[®], Suburban Extended Stay Hotel[®], Cambria[®] hotels & suites, and Ascend Hotel Collection[®] (collectively, the "Choice brands").

The Company's primary segment is the hotel franchising business, which represents over 99% of the Company's total revenues. 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. 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 and relicensing fee revenue, ongoing royalty fees and procurement services revenues. In addition to these revenues, we

Table of Contents

also collect marketing and reservation system fees to provide support activities for the franchise system. Our operating results can also be improved through our company-wide efforts related to improving property level performance.

The principal factors that affect the Company's franchising results are: the number and 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 royalty and marketing and reservation system fees are primarily based upon room revenues or the number of rooms 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 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 contractually required by our franchise agreements to use the marketing and reservation system fees we collect for system-wide support activities. These expenditures help to enhance awareness, increase consumer preference for our brands and deliver guests to our franchisees. 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 them with hotel franchises that strive to generate the highest return on investment of any hotel franchise. We have developed an operating system dedicated to our franchisees' success that focuses on delivering guests to our franchised hotels and reducing costs for our hotel owners.

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. We maintain a capital structure that generates high financial returns and use our excess cash flow to provide returns to our shareholders primarily through share repurchases, dividends or investing in growth opportunities.

Historically, we have returned value to our shareholders in two primary ways: share repurchases and dividends. In 1998, we instituted a share repurchase program which has generated substantial value for our shareholders. Since the program's inception through December 31, 2016, we have repurchased 48.7 million shares (including 33.0 million prior to the two-for-one stock split effected in October 2005) of common stock at a total cost of \$1.3 billion. Considering the effect of the two-for-one stock split, the Company has repurchased 81.7 million shares at an average price of \$15.38 per share. In December 2016, the Company's board of directors approved increasing the number of shares authorized for repurchase. As a result, at December 31, 2016, the Company had 4.0 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 board of directors repurchase authorization and 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; however the declaration of future dividends is subject to the discretion of the board of directors. In the fourth quarter of 2016, the board of directors announced a 5% increase to the quarterly cash dividend rate to \$0.215 per share, beginning with the dividend payable in the first quarter of 2017. The projected annual dividend in 2017 is \$0.86 per share. We expect to continue to pay dividends in the future, subject to quarterly declaration by our board of directors as well as future business performance, economic conditions, changes in income tax regulations and other factors.

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.

Our direct lodging property real estate exposure is limited to activity in the United States and consists of four parcels of real estate that the Company has acquired and intends to resell to incent franchise development in strategic markets or to pursue hotel development through joint ventures. In addition, our development activities that involve financing, equity investments and guaranty support to hotel developers create limited additional exposure to the real estate markets.

The Company was incorporated in 1980 under the laws of the State of Delaware.

Table of Contents

The Lodging Industry

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 RevPAR, managing operating expenses and financial leverage. The ownership model has a high fixed-cost structure that results in a high degree of operating leverage relative to RevPAR performance. As a result, profits escalate rapidly in a lodging up-cycle but erode quickly in a downturn as costs rarely decline as fast as revenue. Profits from an ownership model increase at a greater rate from RevPAR growth attributable to average daily rate ("ADR") growth, than from 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 owner 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 franchisor's brand standards. Under a typical franchise agreement, the hotel owner pays the franchisor an initial fee, a percentage-of-revenue royalty fee and a marketing/reservation fee. A franchisor's revenues are dependent on the number of rooms in its system and the 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 typically costs little to add a new hotel franchise to an existing system. Franchisors normally benefit from higher industry supply growth, because unit growth usually outpaces 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.

Similarly to other industries, lodging experiences both positive and negative operating cycles. Positive cycles are characterized as periods of sustained occupancy growth, increasing room rates and hotel development. These cycles usually continue until either the economy sustains a prolonged downturn, excess supply conditions exist or some external factor occurs such as war, terrorism or natural resource shortages. Negative cycles are characterized by hoteliers reducing room rates to stimulate occupancy and a reduction of hotel development. Industry recovery usually begins with an increase in occupancy followed by hoteliers increasing room rates. As demand begins to exceed room supply, occupancies and rates continue to improve. These factors result in increased hotel development.

Hotel room supply growth is cyclical as hotel construction responds to interest rates, construction and material supply conditions, capital availability and industry fundamentals. Historically, the industry has added hotel rooms to its inventory through new construction due largely to favorable lending environments that encouraged hotel development. Typically, hotel development continues during favorable lending environments until the increase in room supply outpaces demand. The excess supply eventually results in lower occupancies, which results in hoteliers reducing room rates to stimulate demand, and reduced hotel development. Over time, the slow growth in hotel supply results in increased occupancy rates and allows hotels to again raise room rates. The increase in occupancy and room rates serves as a catalyst for increased hotel development.

Table of Contents

The following chart demonstrates these trends over the last fifteen years:

US Lodging Industry Trends: 2002 - 2016

Year	Occupancy Rates	Average Daily Room Rates (ADR)	Change in ADR Versus Prior Year	Change in CPI Versus Prior Year	Revenue Per Available Room (RevPAR)	New Rooms Added (Gross)
2002	59.2 %	\$83.15	(2.0)%	1.6 %	\$49.22	86,366
2003	59.1 %	\$83.19	0.1 %	2.3 %	\$49.20	65,876
2004	61.3 %	\$86.41	3.9 %	2.7 %	\$52.93	55,245
2005	63.1 %	\$90.84	5.1 %	3.4 %	\$57.34	65,900
2006	63.4 %	\$97.31	7.1 %	3.2 %	\$61.69	73,308
2007	63.1 %	\$104.04	6.9 %	2.8 %	\$65.61	94,541
2008	60.3 %	\$106.96	2.8 %	3.8 %	\$64.49	146,312
2009	54.5 %	\$98.17	(8.2)%	(0.4)%	\$53.50	142,287
2010	57.5 %					