HILTON HOTELS CORP
Form 10-Q
August 09, 2006

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended June 30, 2006

OR

o 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 1-3427

HILTON HOTELS CORPORATION

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**36-2058176** (I.R.S. Employer Identification No.)
9336 Civic Center Drive, Beverly Hills, California (Address of principal executive offices)	**90210** (Zip code)

(310) 278-4321

(Registrant s telephone number, including area code)

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 twelve 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 o

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 o Non-accelerated filer 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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of July 31, 2006 Common Stock, $2.50 par value 385,786,794 shares.

PART I FINANCIAL INFORMATION

Company or group of companies for which report is filed:

HILTON HOTELS CORPORATION AND SUBSIDIARIES

ITEM 1. FINANCIAL STATEMENTS

Consolidated Statements of Income
(in millions, except per share amounts)

	Three Months Ended June 30, 2005 (unaudited)	2006	Six Months Ended June 30, 2005 (unaudited)	2006
Revenue				
Owned hotels	$ 575	681	1,070	1,189
Leased hotels	31	671	59	937
Management and franchise fees	117	175	219	327
Timeshare and other income	148	217	302	428
	871	1,744	1,650	2,881
Other revenue from managed and franchised properties	305	460	602	842
	1,176	2,204	2,252	3,723
Expenses				
Owned hotels	391	477	767	857
Leased hotels	27	572	53	802
Depreciation and amortization	78	117	158	203
Impairment loss and related costs	5		7	
Other operating expenses	116	190	238	368
Corporate expense	26	43	50	87
	643	1,399	1,273	2,317
Other expenses from managed and franchised properties	303	457	596	833
	946	1,856	1,869	3,150
Operating income from unconsolidated affiliates	16	18	26	28
Operating Income	246	366	409	601
Interest and dividend income	4	4	8	15
Interest expense	(66)	(139)	(130)	(235)
Net interest from unconsolidated affiliates and non-controlled interests	(7)	(13)	(13)	(22)
Net gain on foreign currency transactions		3		20
Net gain on asset dispositions and other	61	19	72	23
Loss from non-operating affiliates	(4)	(4)	(9)	(8)
Income Before Taxes and Minority and Non-Controlled Interests	234	236	337	394
Provision for income taxes	(25)	(92)	(61)	(144)
Minority and non-controlled interests, net	(7)		(10)	(2)
Net Income	$ 202	144	266	248
Basic Earnings Per Share	$ .53	.37	.69	.65
Diluted Earnings Per Share	$ .49	.35	.65	.61

See notes to consolidated financial statements.

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Hilton Hotels Corporation and Subsidiaries
Consolidated Balance Sheets
(in millions)

	December 31, 2005	June 30, 2006 (unaudited)
ASSETS		
Current Assets		
Cash and equivalents	$ 1,154	103
Restricted cash	182	245
Accounts receivable, net	312	736
Inventories	219	402
Deferred income taxes	85	97
Current portion of notes receivable, net	40	58
Other current assets	97	199
Total current assets	2,089	1,840
Investments, Property and Other Assets		
Investments and notes receivable, net	707	790
Property and equipment, net	2,985	5,746
Management and franchise contracts, net	302	1,241
Leases, net	107	450
Brands	970	2,691
Goodwill	1,216	3,932
Other assets	367	625
Total investments, property and other assets	6,654	15,475
Total Assets	$ 8,743	17,315
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable and accrued expenses	$ 772	1,700
Current maturities of long-term debt	47	433
Current maturities of non-recourse debt and capital lease obligations of non-controlled entities		11
Income taxes payable	45	60
Total current liabilities	864	2,204
Long-term debt	3,572	7,929
Non-recourse debt and capital lease obligations of non-controlled entities	100	509
Deferred income taxes and other liabilities	1,396	3,377
Stockholders equity	2,811	3,296
Total Liabilities and Stockholders Equity	$ 8,743	17,315

See notes to consolidated financial statements.

Hilton Hotels Corporation and Subsidiaries
Consolidated Statements of Cash Flow
(in millions)

	Six Months Ended June 30, 2005 (unaudited)	**2006**
Operating Activities		
Net income	$ 266	248
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	158	203
Amortization of loan costs	4	8
Net gain on asset dispositions	(72)	(23)
Loss from non-operating affiliates	9	8
Impairment loss and related costs	7	
Change in working capital components:		
Inventories	(22)	(154)
Accounts receivable	(88)	(80)
Other current assets	3	(28)
Accounts payable and accrued expenses	74	(166)
Income taxes payable	12	(9)
Restricted cash	6	(33)
Change in deferred income taxes	61	49
Change in other liabilities	(27)	64
Unconsolidated affiliates distributions (less than) in excess of earnings	(4)	1
Change in timeshare notes receivable	(49)	(51)
Excess tax benefits from share-based payment arrangements		(8)
Other		13
Net cash provided by operating activities	338	42
Investing Activities		
Capital expenditures	(255)	(230)
Additional investments	(21)	(128)
Proceeds from asset dispositions	364	138
Asset disposition proceeds held in escrow as restricted cash	(267)	
Payments received on notes and other	35	113
Acquisitions, net of cash acquired		(5,460)
Net cash used in investing activities	(144)	(5,567)
Financing Activities		
Change in revolving loans, net of issuance costs		1,935
Long-term borrowings, net of issuance costs	14	2,582
Reduction of long-term debt	(7)	(75)
Issuance of common stock	49	42
Repurchase of common stock	(271)	
Cash dividends	(15)	(31)
Excess tax benefits from share-based payment arrangements		8
Net cash (used in) provided by financing activities	(230)	4,461
Exchange rate effect on Cash and Equivalents		13
Decrease in Cash and Equivalents	(36)	(1,051)
Cash and Equivalents at Beginning of Year	303	1,154
Cash and Equivalents at End of Period	$ 267	103

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 1: General

The consolidated financial statements presented herein have been prepared by Hilton Hotels Corporation in accordance with the accounting policies described in our Annual Report on Form 10-K for the year ended December 31, 2005 and should be read in conjunction with the Notes to Consolidated Financial Statements which appear in that report.

The consolidated financial statements for the three and six months ended June 30, 2005 and 2006 are unaudited; however, in the opinion of management, all adjustments (which include normal recurring accruals) have been made which are considered necessary to present fairly the operating results and financial position for the unaudited periods.

Note 2: Purchase of Hilton International

On December 29, 2005, we announced an agreement to acquire the lodging assets of Hilton Group plc (known collectively as Hilton International or HI) for approximately £3.3 billion. On February 23, 2006, we completed the acquisition of the lodging assets of Hilton International in an all-cash transaction (the HI Acquisition). The HI properties that we acquired consisted of 392 hotels with 102,455 rooms, including 39 owned, 201 leased, four partially owned through joint ventures, 118 managed and 30 franchised properties. The hotels we acquired in the HI acquisition consisted of 249 properties operated under the Hilton brand and 131 properties operated under the mid-market Scandic brand, one property under the Conrad brand and 11 non-branded properties. We also acquired 80 LivingWell Health Clubs, primarily in Europe, and six timeshare properties. As a result of the HI Acquisition, we now wholly own the Hilton HHonors Worldwide frequent guest program and the Hilton Reservations Worldwide reservation system, both of which were previously owned equally by us and HI. We also obtained worldwide ownership of the luxury Conrad hotel brand, which had been operated as a joint venture between us and HI since 2002. As a result of the HI Acquisition, we now own all the rights to the Hilton and Conrad brands, including the right to develop these, along with all of our other proprietary brands, on a worldwide basis. Results of operations in the first six months of 2006 include the income of the acquired properties from February 23, 2006.

In order to fund the HI Acquisition, we used approximately $867 million of cash and equivalents and borrowed approximately $4.81 billion under new senior credit facilities with a syndicate of financial institutions (see Note 8: Debt for further information). The aggregate cash consideration for the HI Acquisition is as follows:

	(in millions)
Payment to Hilton Group plc from cash on hand	$ 867
Payment to Hilton Group plc from new senior credit facilities	4,809
Total consideration paid to Hilton Group plc	5,676
Direct acquisition costs	78
Total	$ 5,754

Allocation of Purchase Price

Statement of Financial Accounting Standard (FAS) No. 141 requires that the total purchase price be allocated to the assets acquired and liabilities assumed based on their fair values at the acquisition date. In valuing acquired assets and assumed liabilities, fair values are based on, but are not limited to, quoted

market prices, expected future cash flows, current replacement costs, market rate assumptions and appropriate discount and growth rates.

Under the purchase method of accounting, the assets and liabilities of Hilton International were recorded at their respective fair values as of the date of the acquisition. We are in the process of finalizing internal studies and third-party valuations of assets, including investments, property and equipment, intangible assets and certain liabilities, including deferred tax liabilities. The fair values set forth below are based on preliminary valuations and are subject to adjustment as additional information is obtained. When finalized, adjustments to goodwill may result. In the 2006 second quarter, we reduced the goodwill balance by approximately $125 million reflecting an adjustment to the preliminary other liabilities allocation. The following table summarizes the preliminary estimated fair values of the assets acquired and liabilities assumed as of the acquisition date.

	Preliminary Fair Value (in millions)
Current assets, including $467 in cash and equivalents	$ 971
Property and equipment	2,754
Amortizable intangible assets	1,053
Brands	1,650
Goodwill	2,592
Other assets	271
Current liabilities	(1,310)
Long-term debt, including capital lease obligations	(607)
Deferred income taxes	(1,328)
Other liabilities	(292)
	$ 5,754

Pro Forma Financial Information

The following pro forma consolidated results of operations assume that the HI Acquisition was completed as of January 1, 2005 and 2006 for the three and six months ended June 30, 2005 and 2006, respectively.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2005	**2006**	**2005**	**2006**
	(unaudited)		**(unaudited)**	
	(in millions, except per share amounts)			
Total revenue	$ 2,196	2,204	4,184	4,236
Net income	$ 212	144	242	228
Diluted earnings per share	$ 0.51	0.35	0.59	0.56

The pro forma amounts represent the historical operating results of Hilton Hotels Corporation and Hilton International with adjustments for purchase price allocation and for translation from International Financial Reporting Standards (IFRS) to United States Generally Accepted Accounting Principles (US GAAP).

Goodwill and Intangible Assets Acquired

Goodwill resulting from the HI Acquisition totaled approximately $2.59 billion. We do not expect any of the goodwill to be tax deductible. Goodwill has been assigned to our segments as follows: Hotel ownership $1.47 billion; and Managing and Franchising $1.12 billion. We also have an intangible asset

relating to the brand names acquired in the HI Acquisition totaling $1.65 billion as of the acquisition date. Goodwill and brands are considered to have an indefinite life and are not amortized, but rather are reviewed annually for impairment or more frequently if indicators of impairment exist.

Intangible assets with definite lives subject to amortization acquired in the HI Acquisition are as follows:

	Preliminary Fair Value (in millions)	**Weighted-Average Amortization Period (in years)**
Leases	$ 337	29
Management contracts	633	20
Franchise contracts	83	12
	$ 1,053	22

Note 3: Earnings Per Share (EPS)

Basic EPS is computed by dividing net income available to common stockholders by the weighted-average number of common shares outstanding for the period. The weighted-average number of common shares outstanding totaled 381 million and 384 million for the three and six months ended June 30, 2005 and 385 million and 384 million for the three and six months ended June 30, 2006, respectively. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted. The dilutive effect of stock-based compensation and convertible securities increased the weighted-average number of common shares by 35 million and 34 million for the three and six months ended June 30, 2005, respectively, and 34 million for both the three and six months ended June 30, 2006. In addition, the increase to net income resulting from interest on convertible securities assumed to have not been paid was $3 million for the three month periods ended June 30, 2005 and 2006, and $6 million for the six month periods ended June 30, 2005 and 2006. The sum of basic EPS for the first two quarters of 2005 and 2006 differs from the year to date EPS due to the required method of computing EPS in the respective periods.

Note 4: Stock-Based Compensation

As of January 1, 2006, we maintained three stock plans with substantially identical terms that provide for the grant of options, in addition to the 2004 Omnibus Equity Compensation Plan (2004 Plan) which provides for the grant of options, stock units, performance units and other stock-based awards. At June 30, 2006, there were approximately 20 million shares available for issuance under the 2004 Plan and no authorized shares remaining available for grant under the other three stock plans.

Effective January 1, 2006, we adopted FAS 123R, Share-Based Payment. In accordance with the modified prospective transition method of FAS 123R, financial results for prior periods have not been restated. We recognize compensation expense on a straight-line basis over the requisite service period of the award, taking into consideration the applicable estimated forfeiture rates. Compensation expense associated with performance awards is subject to adjustments for changes in estimates relating to whether the performance objective will be achieved (see Restricted Stock Units, below). Total pre-tax compensation expense included in net income was $6 million and $11 million for the three and six months ended June 30, 2005, and $9 million and $19 million for the three and six months ended June 30, 2006, respectively. The adoption of FAS 123R resulted in incremental pre-tax expense of $5 million ($3 million, net of tax) and $8 million ($5 million, net of tax) in the three and six month periods ending June 30, 2006, respectively. The impact to both basic and diluted EPS was $.01 for both the three and six month periods ended June 30, 2006.

Prior to the adoption of FAS 123R, benefits of tax deductions in excess of recognized compensation costs were reported as operating cash flows. FAS 123R requires that excess tax benefits be reported as a financing cash inflow rather than as a reduction of taxes paid. Such amounts totaled $8 million for the six months ended June 30, 2006. As of June 30, 2006, there was $93 million of unrecognized compensation cost, which is expected to be recognized over a weighted average period of 21 months.

Prior to January 1, 2006, we applied Accounting Principles Board (APB) Opinion 25 and related interpretations in accounting for our stock-based compensation plans. Compensation cost for stock units and performance units awarded in 2004 and 2005 is being expensed over the respective vesting periods and is included in net income. No compensation cost related to stock option awards was reflected in net income for the periods prior to 2006, as all stock options had an exercise price greater than or equal to the market value of the underlying common stock on the date of grant.

Had the expense for all forms of our stock-based compensation been determined using the fair value based method defined in FAS 123R, our net income and net income per share would have been reduced to the pro forma amounts indicated below.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2005	**2006**	**2005**	**2006**
	(in millions, except per share amounts)			
Net income:				
As reported	$ 202	144	266	248
Add back: Compensation expense included in reported net income, net of tax	4	6	7	12
Deduct: Fair-value compensation expense for all awards, net of tax	(6)	(6)	(12)	(12)
As adjusted	$ 200	144	261	248
Basic earnings per share:				
As reported	$ .53	.37	.69	.65
As adjusted	$ .52	.37	.68	.65
Diluted earnings per share:				
As reported	$ .49	.35	.65	.61
As adjusted	$ .49	.35	.64	.61

The total intrinsic value of stock options exercised was $36 million and $42 million during the six months ended June 30, 2005 and 2006, respectively. The total fair value of restricted stock units vested was $8 million and $15 million during the six months ended June 30, 2005 and 2006, respectively.

Stock Options

Options may be granted to salaried officers, directors and other key employees to purchase our common stock at not less than the fair market value at the date of grant. Generally, options vest over a four year period, contingent upon continued employment, and remain outstanding for ten years from the date of grant. Options are generally exercisable in installments commencing one year after the date of grant.

We granted 400,000 stock options in the three months ended March 31, 2005 and 2,530,165 stock options in the three months ended March 31, 2006 with weighted average exercise prices of $22.19 and $25.35 per share, respectively, and estimated weighted average grant date fair values of approximately $13.12 and $13.44 per share, respectively. No options were granted in the three months ended June 30,

2005 or 2006. Cash received from options exercised under all share-based payment arrangements in the three and six months ended June 30, 2006 was $20 million and $42 million, respectively. The actual tax benefit realized for the tax deductions from options exercised totaled $9 million and $17 million for the three and six months ended June 30, 2006, respectively.

The fair values of the options granted in 2006 were estimated on the date of grant using the Black-Scholes option-pricing model. The assumptions used an expected volatility rate of 55%, dividend yield of 0.7%, expected term of 6 years, and a weighted average risk-free interest rate of 4.5%. Volatility is based on historic information with terms consistent with the expected life of our non-qualified stock options. The risk-free rate is based on the quoted treasury yield curve at the time of grant, with terms consistent with the expected life of our non-qualified stock options. The dividend yield is based on the current annual dividend payment of $0.16 per share.

A summary of stock option activity under our equity plans for the six months ended June 30, 2006 is as follows:

Option Activity	**Shares**	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Term (years)**	**Aggregate Intrinsic Value (in millions)**
Balance at December 31, 2005	16,896,920	$ 14.52		
Granted	2,530,165	25.35		
Exercised	(3,242,280)	13.04		
Forfeited	(95,552)	17.98		
Balance at June 30, 2006	16,089,253	16.51	5.4	$ 187
Exercisable at June 30, 2006	9,783,028	12.42	4.7	$ 153

Restricted Stock Units

During the three months ended March 31, 2005 and 2006, we awarded restricted stock under our 2004 Omnibus Equity Compensation Plan in the form of time-based units (TBU) and performance-based units (PBU). No awards were made in the three months ended June 30, 2005 or 2006. TBU awards generally vest annually in a straight-line method over four years. PBU awards have a performance and vesting period established by the Company s Compensation Committee, which was three years for the PBUs granted in 2005 and 2006. PBUs are payable from 0% to 150% of the target amount depending upon on the level of achievement of performance goals established by the Compensation Committee. Compensation expense for the TBU awards is measured at the fair value of the underlying stock at the date of grant. Compensation expense associated with the PBU awards is subject to adjustments for changes in estimates relating to the achievement of the established performance goals.

In the three months ended March 31, 2005, we granted 1,272,313 TBUs and 810,749 PBUs (the Original 2005 PBUs), both with a grant date fair value of approximately $22.19 per share. On March 31, 2006, the Compensation Committee determined that, in light of the HI Acquisition on February 23, 2006, the performance goals established for the Original 2005 PBUs were no longer appropriate because they do not take into account the impact of the HI Acquisition on the performance of the new combined company. Accordingly, to encourage retention and to better align compensation incentives with the performance of the new combined company, the Compensation Committee issued new grants under the 2004 Plan consisting of PBUs, TBUs and stock options to all of the recipients of the Original 2005 PBU grants, as described in the table below (the Special Grants).

With respect to the Special Grants, the PBUs have a performance and vesting period ending on December 31, 2007, and the TBUs and stock options vest in full on January 5, 2008. On March 31, 2006, the Compensation Committee cancelled the Original 2005 PBUs, except for grants made to certain

executive officers. With respect to those executive officers, following the December 31, 2007 simultaneous close of the performance periods for both the Original 2005 PBUs and the PBU portion of the Special Grants, the Compensation Committee will assess the Company s overall performance in relation to the performance objectives established for the Original 2005 PBUs and the PBU portion of the Special Grants and the individual performance of each holder of those units and determine what payment is warranted based on such performance. The Compensation Committee believes that the amount payable with respect to the Original 2005 PBUs based on actual performance will be minimal or zero at the end of the full performance period. However, in the unlikely event that any amount becomes payable with respect to the Original 2005 PBUs, the Compensation Committee may nevertheless exercise its discretionary authority under the Original 2005 PBUs and the PBU portion of the Special Grants to reduce the amount payable thereunder so that the total compensation paid to each holder reflects the Compensation Committee s intent with regard to appropriate pay-for-performance under both grants and remains fair and reasonable in light of both Company and individual performance over the period.

In the first quarter of 2006, we granted 2,845,001 TBUs and 910,272 PBUs with weighted average grant date fair values of approximately $23.69 and $24.30 per share, respectively. The TBUs vest in full on January 5, 2009 and the PBUs have a performance and vesting period ending on December 31, 2008. On March 31, 2006, the Compensation Committee adjusted the 2006 PBU grants for all recipients as follows: (i) the target number of PBUs granted to each recipient was reduced by 50%; and (ii) each recipient received a nonqualified stock option grant under the 2004 Plan at a fair market value exercise price of $25.53, which vests in three equal annual installments on January 5 of each of 2007, 2008 and 2009.

The changes to the original 2005 and 2006 PBU awards are as follows:

Original 2005 PBU Grants			**Special Grants**		
Type	**Units**	**Weighted-Average Grant Date Fair Value**	**Type**	**Units**	**Weighted-Average Grant Date Fair Value**
PBU	810,749	$22.19	TBU	253,295	$ 25.53
			PBU	253,295	25.53
			Options	759,884	13.56

Original 2006 PBU Grants			**Adjusted 2006 Grants**		
Type	**Units**	**Weighted-Average Grant Date Fair Value**	**Type**	**Units**	**Weighted-Average Grant Date Fair Value**
PBU	910,272	$ 24.30	PBU	456,761	$ 25.53
			Options	1,370,281	13.56

Total incremental cost resulting from the grants made on March 31, 2006 is expected to be approximately $13 million, expensed over 33 months from the date of grant. As a result of the modification, we recognized additional compensation expense of approximately $2 million for the three and six months ended June 30, 2006.

A summary of the activity of TBUs and PBUs granted under our 2004 Plan for the six months ended June 30, 2006 is as follows:

	Units	Weighted-Average Grant Date Fair Value
TBUs		
Balance at December 31, 2005	2,330,078	$ 19.84
Granted	3,098,296	23.84
Vested	(639,402)	19.62
Forfeited	(245,776)	20.97
Balance at June 30, 2006	4,543,196	22.54
PBUs		
Balance at December 31, 2005	1,519,907	$ 19.84
Granted	1,620,328	24.84
Forfeited	(51,681)	20.37
Cancelled	(1,459,871)	23.50
Balance at June 30, 2006	1,628,683	21.59

Supplemental Retention and Retirement Plan

We also provide supplemental retirement benefits to eligible senior officers in the form of stock units that settle in shares of our common stock on a one-for-one basis. The compensation expense associated with the benefits is expensed over the four-year vesting period. At June 30, 2006, an insignificant amount of stock units remain unvested. The pre-tax compensation expense under these plans was not significant in the three and six months ended June 30, 2005 and 2006.

Note 5: Comprehensive Income

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2006	2005	2006
	(in millions)		(in millions)	
Net income	$ 202	144	266	248
Change in unrealized gains and losses, net of tax	2	1		3
Cash flow hedge adjustment, net of tax		(1)	1	
Cumulative translation adjustment, net of tax	(1)	161	(1)	197
Comprehensive income	$ 203	305	266	448

Note 6: Synthetic Fuel Investment

In August 2004, we acquired a 24 percent minority interest in a coal-based synthetic fuel facility for approximately $32 million. Our investment is accounted for using the equity method as we lack a controlling financial interest. The facility produced operating losses, our proportionate share of which totaled $4 million and $9 million for the three and six months ended June 30, 2005, respectively, and $4 million and $8 million for the three and six months ended June 30, 2006, respectively. These losses are reflected as loss from non-operating affiliates in the accompanying consolidated statements of income.

The synthetic fuel produced at this facility qualifies for tax credits (based on Section 45K of the Internal Revenue Code) which reduce our provision for income taxes. The tax credits, combined with the tax benefit associated with the operating losses, totaled approximately $6 million and $12 million for the three and six months ended June 30, 2005, respectively, and $4 million and $8 million for the three and

six months ended June 30, 2006, respectively. As a result, the net benefit to our net income from the investment was approximately $2 million and $3 million for the three and six months ended June 30, 2005, respectively, and no benefit for the three and six months ended June 30, 2006.

Note 7: Derivative Instruments and Hedging Activities

We have an outstanding swap agreement which qualifies for hedge accounting as a cash flow hedge of a foreign currency denominated liability. The gain or loss on the change in the fair value of the derivative is included in earnings to the extent it offsets the earnings impact of changes in the fair value of the hedged obligation. Any difference is deferred in accumulated other comprehensive income, a component of stockholders equity.

We have an interest rate swap on certain fixed rate senior notes which qualifies as a fair value hedge. This derivative impacts earnings to the extent of increasing or decreasing actual interest expense on the hedged notes to simulate a floating interest rate. Changes in the fair value of the derivative are offset by an adjustment to the value of the hedged notes.

We have three tranches of long-term debt denominated in foreign currencies which qualify as hedges of the foreign currency exposure of our net investment in foreign operations acquired as part of the HI Acquisition. The gains or losses on the long-term debt are included in other comprehensive income as part of the cumulative translation adjustment to the extent that the instruments are effective as a hedge.

We assess on a quarterly basis the effectiveness of our hedges in offsetting the variability in the cash flow or fair values of the hedged obligations. There were no amounts recognized or reclassified into earnings for the six months ended June 30, 2005 or 2006 due to hedge ineffectiveness or due to excluding from the assessment of effectiveness any component of the derivatives.

In January 2006, we entered into a derivative contract covering 1.85 million barrels of oil relating to our investment in a synthetic fuel facility. This contract is effective for the calendar year ending December 31, 2006. The contract involves two call options that provide for net cash settlement at expiration based on the full year 2006 average trading price of oil in relation to the strike price of the options. If the average price of oil in 2006 is less than $68.50 per barrel, the derivative will yield no payment. If the average price of oil exceeds $68.50 per barrel, the derivative will yield a payment equal to the excess of the average price over $68.50 per barrel, up to a maximum price per barrel of $72.50. The purpose of the transaction is to provide economic protection against an increase in oil prices that could limit or eliminate the amount of tax credits available under Section 45K of the Internal Revenue Code to the point of a negative return on our investment. The strike prices of the two options are intended to approximate the price ranges under which the expected tax credits could be reduced to an amount which no longer covers our after-tax production costs from the investment for the 2006 calendar year. This agreement does not qualify for hedge accounting and, as a result, changes in the fair value of the derivative agreement are reflected in earnings. Results include a pre-tax gain of $1 million for the three and six months ended June 30, 2006, resulting from changes in the market value of this derivative contract. This amount is included in net gain on asset dispositions and other in the accompanying consolidated statements of income.

Note 8: Debt

Long-term debt at December 31, 2005 and June 30, 2006 is as follows:

	December 31, 2005 (in millions)	**June 30, 2006**
Industrial development revenue bonds at adjustable rates, due 2015	$ 82	82
Senior notes, with an average rate of 8.1%, due 2007 to 2031(1)	2,040	2,040
Mortgage notes, 5.8% to 8.6%, due 2008 to 2013	310	241
7.95% Collateralized borrowings, due 2010	463	459
Chilean inflation-indexed note, effective rate of 7.65%, due 2009(1)	148	140
3.375% Contingently convertible senior notes due 2023	575	575
Capital leases, 6.34% to 8.75%, due 2006 to 2097	1	139
Term loan A, at adjustable rates, due 2011		2,214
Term loan B, at adjustable rates, due 2013		449
Revolving loans, at adjustable rates, due 2011		1,970
Other		53
	3,619	8,362
Less current maturities of long-term debt	(47)	(433)
Net long-term debt	$ 3,572	7,929

(1) Interest rates include the impact of interest rate swaps.

In addition to our long-term debt, our consolidated balance sheet includes debt and capital lease obligations related to variable interest entities consolidated under FIN 46R that are non-recourse to us. Non-recourse debt and capital lease obligations of non-controlled entities at December 31, 2005 and June 30, 2006 are as follows:

	December 31, 2005 (in millions)	**June 30, 2006**
Mortgage note, 5.98%, due 2007	$ 100	100
Capital leases, 6.34%, due 2006 to 2025		388
Other		32
	100	520
Less current maturities of non-recourse debt and capital lease obligations of non-controlled entities		(11)
Net non-recourse debt and capital lease obligations of non-controlled entities	$ 100	509

Debt maturities, including non-recourse debt and capital lease obligations of non-controlled entities, are as follows:

June 30,	**(in millions)**
2007	$ 444
2008	536
2009	102
2010	415
2011	5,041
Thereafter	2,344
Total	$ 8,882

In February 2006, in connection with the HI Acquisition (see Note 2: Purchase of Hilton International), we entered into new senior credit facilities in an aggregate principal U.S. dollar equivalent of approximately $5.75 billion with a syndicate of financial institutions. These facilities replaced our $1 billion revolving credit facility and are secured by a pledge of the capital stock of certain of our wholly-owned subsidiaries. The credit facilities consist of the following:

- U.S. Dollar Denominated Revolver 5 year, $3.25 billion available in U.S. dollars, British Pounds Sterling, Euros and Swedish Kronor or other currencies acceptable to the administrative agent. Interest is at a variable rate depending upon our leverage ratio and senior debt ratings, with initial borrowings at applicable LIBOR plus 150 basis points (which includes a 25 basis point annual facility fee). The capacity under our revolver was also used to support certain outstanding letters of credit. Total revolving debt capacity of approximately $1.083 billion was available to us at June 30, 2006.

- Foreign Currency Denominated Term Loan A 5 year, approximate equivalent of $2 billion to be denominated in £675 million, 675 million and Australian $140 million. Interest is at a variable rate depending upon our leverage ratio and senior debt ratings, with initial borrowings at applicable LIBOR plus 150 basis points.

- U.S. Dollar Denominated Term Loan B 7 year, $500 million term loan available only in U.S. dollars. Interest is at a rate of LIBOR plus 137.5 basis points.

We also have the option to increase the credit facilities by $500 million.

Subsequent to our announcement in December 2005 of our agreement to acquire the lodging assets of Hilton Group plc, Standard & Poor s Ratings Group lowered our senior debt rating from BBB- to BB. In addition, Moody s Investor Services lowered our senior debt rating from Baa3 to Ba2. These downgrades are reflected in the interest rates and facility fee of our new $5.75 billion senior credit facilities. Under the terms of the senior credit facilities, proceeds, if any, from the sale of certain owned properties acquired as part of the HI Acquisition are required to be used for the repayment of our senior credit facilities. In addition, we expect that excess cash flow, if any, will be used to repay outstanding debt balances to improve our credit position.

Note 9: Leases

We lease hotel properties and land under operating leases. Prior to the HI Acquisition we leased six hotels. We acquired 201 leased hotels in the HI Acquisition, of which seven are capital leases and 194 are operating leases. Our hotel leases may require the payment of fixed rent payments, variable payments based on a percentage of revenue or income, or the payment of rent equal to the greater of a minimum rent or percentage rent based on a percentage of revenue or income. Our hotel leases expire through December 2097, with varying renewal options. Our land leases represent ground leases for certain owned hotels and, in addition to minimum rental payments, may require the payment of additional rents based on varying percentages of revenue or income.

Minimum lease commitments under non-cancelable operating and capital leases are as follows:

June 30,	Operating Leases (in millions)	Capital Leases	Non-Recourse Capital Leases
2007	$ 309	14	30
2008	304	15	31
2009	293	15	32
2010	281	50	31
2011	275	7	32
Thereafter	3,400	174	481
	$ 4,862	275	637
Less imputed interest at 6.34%		(136)	(249)
Present value of net minimum lease payments		139	388

Note 10: New Accounting Standards

In December 2004, the Financial Accounting Standards Board (FASB) issued FAS 123R, Share-Based Payment, which eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, Accounting for Stock Issued to Employees, and generally requires that such transactions be accounted for using a fair-value-based method. Pro forma disclosure is no longer an alternative. FAS 123R also requires that the tax benefit associated with these share-based payments be classified as financing activities in the statement of cash flow rather than operating activities as currently permitted. In April 2005, the Securities and Exchange Commission (SEC) adopted a rule that delayed adoption of FAS 123R, which we had previously been required to adopt no later than July 1, 2005. The SEC s rule allows companies to implement FAS 123R at the beginning of their next fiscal year, and as such, we adopted FAS 123R effective January 1, 2006.

As permitted by FAS 123R, we previously accounted for share-based payments to employees using APB 25 s intrinsic value method and, as such, generally recognized no compensation expense for employee stock options. Had we adopted FAS 123R in prior periods, the impact of the standard would have approximated the impact of FAS 123R as described in the disclosure of pro forma net income and earnings per share in Note 4.

The adoption of FAS 123R, using the modified prospective method, will result in incremental pre-tax expense in the year ending December 31, 2006 of approximately $17 million based on the quantity of unvested stock options at December 31 2005, new stock option grants estimated in the year ending December 31, 2006, applicable forfeiture rates, and the respective grant date fair values.

In December 2004, the FASB issued FAS 152, Accounting for Real Estate Time-Sharing Transactions. FAS 152 amends existing accounting guidance to reference the financial accounting and reporting guidance for real estate time-sharing transactions provided in AICPA Statement of Position 04-02, Accounting for Real Estate Time-Sharing Transactions. FAS 152 is effective for our financial statements issued after January 1, 2006. The new accounting guidance requires, among other things, that costs incurred to sell timeshare units generally be charged to expense as incurred, including indirect sales and marketing expenses. The new standard also requires a change in the classification of certain items currently reported as expenses, requiring these items to be reflected as reductions of revenue. The new classifications have not affected timeshare operating income, and operating margin has improved.

FAS 152 also impacts the timing of expense recognition when pre-sales of projects under construction occur and we use the percentage of completion method of accounting. We were previously allowed to defer sales and marketing expenses in the same proportion as the deferred revenue during construction. FAS 152 allows only the deferral of direct sales and marketing expenses. This results in earlier

recognition of sales and marketing expenses during the construction period, but does not impact the total sales and marketing expenses recognized. This change has not materially affected reported results in 2006.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), to clarify the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FAS 109, Accounting for Income Taxes. Effective January 1, 2007, FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We are currently evaluating the impact, if any, that FIN 48 will have on our financial statements.

Note 11: Variable Interest Entities

As part of the HI Acquisition on February 23, 2006, we acquired a minority ownership interest in three joint ventures that lease hotels which are managed by us. We have variable interests, as defined in FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46R), which expose us to the majority of expected cash flow variability of the joint ventures. As a result, we are considered to be the primary beneficiary under FIN 46R, and are required to consolidate the balance sheet and results of operations of the joint ventures. In addition, two of the hotel leases are accounted for as capital leases under FAS 13, Accounting for Leases. As of June 30, 2006, our consolidated balance sheet includes the assets and liabilities of these non-controlled joint ventures, including $15 million of cash and equivalents and $420 million of debt and capital lease obligations, which are non-recourse to us. The net equity of the hotels is a retained deficit of approximately $79 million at June 30, 2006, and is reflected on our consolidated balance sheet in other assets. The revenue and operating expenses of these properties are included in leased hotel revenue and expenses in the consolidated statement of income. The net effect of the earnings of these properties applicable to other ownership interests is eliminated from our consolidated results through minority and non-controlled interest expense in the consolidated statement of income.

Note 12: Segment Information

Our operations consist of three reportable segments which are based on similar products or services: Hotel Ownership, Managing and Franchising, and Timeshare. Segment results are presented net of consolidating eliminations for fee-based services, which is the basis used by management to evaluate segment performance. Managing and Franchising revenue includes reimbursements from managed properties and franchisees for certain costs incurred on their behalf, which are included in other revenue from managed and franchised properties in the consolidated statements of income. Segment results are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2006	2005	2006
	(in millions)		(in millions)	
Revenue				