

HILTON HOTELS CORP
Form 10-Q/A
May 12, 2006

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

(Mark one)

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

For the quarterly period ended March 31, 2006

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 1-3427

HILTON HOTELS CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)
9336 Civic Center Drive, Beverly Hills, California
(Address of principal executive offices)

36-2058176
(I.R.S. Employer
Identification No.)
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 No

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

Accelerated filer

Non-accelerated filer

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

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of April 30, 2006: Common Stock, \$2.50 par value 384,616,511 shares.

EXPLANATORY NOTE

This Form 10-Q/A amends Item 1 of our previously filed Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 (the Original Form 10-Q) for the sole purpose of correcting the number disclosed in the line item Acquisitions, net of cash acquired under the sub-heading Investing Activities in our Consolidated Statements of Cash Flow for the three months ended March 31, 2006. During the EDGAR formatting process, the number (\$5,640) was inadvertently transposed in the Original Form 10-Q, and the correct number is (\$5,460). The total amount of Net cash used in investing activities for the three months ended March 31, 2006 of (\$5,467) contained in the Original Form 10-Q filing is correct. This amendment includes Item 1. All other information previously filed in the Original Form 10-Q remains unchanged.

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	
	March 31,	
	2005	2006
	(unaudited)	
Revenue		
Owned hotels	\$ 495	508
Leased hotels	28	266
Management and franchise fees	102	152
Timeshare and other income	154	211
	779	1,137
Other revenue from managed and franchised properties	297	382
	1,076	1,519
Expenses		
Owned hotels	376	380
Leased hotels	26	230
Depreciation and amortization	80	86
Impairment loss and related costs	2	
Other operating expenses	122	178
Corporate expense	24	44
	630	918
Other expenses from managed and franchised properties	293	376
	923	1,294
Operating income from unconsolidated affiliates	10	10
Operating Income	163	235
Interest and dividend income	4	11
Interest expense	(64)	(96)
Net interest from unconsolidated affiliates and non-controlled interests	(6)	(9)
Net gain on foreign currency transactions		17
Net gain on asset dispositions and other	11	4
Loss from non-operating affiliates	(5)	(4)
Income Before Taxes and Minority and Non-Controlled Interests	103	158
Provision for income taxes	(36)	(52)
Minority and non-controlled interests, net	(3)	(2)
Net Income	\$ 64	104
Basic Earnings Per Share	\$.17	.27
Diluted Earnings Per Share	\$.16	.26

See notes to consolidated financial statements.

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

	December 31, 2005	March 31, 2006 (unaudited)
ASSETS		
Current Assets		
Cash and equivalents	\$ 1,154	163
Restricted cash	182	223
Accounts receivable, net	312	674
Inventories	219	285
Deferred income taxes	85	95
Current portion of notes receivable, net	40	59
Other current assets	97	191
Total current assets	2,089	1,690
Investments, Property and Other Assets		
Investments and notes receivable, net	707	759
Property and equipment, net	2,985	5,571
Management and franchise contracts, net	302	1,229
Leases, net	107	441
Brands	970	2,623
Goodwill	1,216	3,940
Other assets	367	607
Total investments, property and other assets	6,654	15,170
Total Assets	\$ 8,743	16,860
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable and accrued expenses	\$ 772	1,652
Current maturities of long-term debt	47	75
Current maturities of non-recourse debt and capital leases of non-controlled entities		10
Income taxes payable	45	36
Total current liabilities	864	1,773
Long-term debt	3,572	8,183
Non-recourse debt and capital leases of non-controlled entities	100	499
Deferred income taxes and other liabilities	1,396	3,434
Stockholders equity	2,811	2,971
Total Liabilities and Stockholders Equity	\$ 8,743	16,860

See notes to consolidated financial statements.

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

	Three Months Ended March 31, 2005 2006 (unaudited)	
Operating Activities		
Net income	\$ 64	104
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	80	86
Amortization of loan costs	2	3
Net gain on asset dispositions	(11)	(4)
Loss from non-operating affiliates	5	4
Impairment loss and related costs	2	
Change in working capital components:		
Inventories	(11)	(38)
Accounts receivable	(58)	(27)
Other current assets	16	(27)
Accounts payable and accrued expenses	15	(107)
Income taxes payable		(32)
Restricted cash	16	(11)
Change in deferred income taxes	15	21
Change in other liabilities	9	(24)
Unconsolidated affiliates' distributions in excess of earnings		5
Change in timeshare notes receivable	(22)	(22)
Excess tax benefits from share-based payment arrangements		(5)
Other	(3)	24
Net cash provided by (used in) operating activities	119	(50)
Investing Activities		
Capital expenditures	(27)	(108)
Additional investments	(15)	(115)
Proceeds from asset dispositions	9	108
Payments received on notes and other	30	108
Acquisitions, net of cash acquired		(5,460)
Net cash used in investing activities	(3)	(5,467)
Financing Activities		
Change in revolving loans		1,954
Long-term borrowings	14	2,582
Reduction of long-term debt	(4)	(54)
Issuance of common stock	19	22
Repurchase of common stock	(158)	
Cash dividends	(8)	(15)
Excess tax benefits from share-based payment arrangements		5
Net cash (used in) provided by financing activities	(137)	4,494
Exchange rate effect on cash and equivalents		32
Decrease in Cash and Equivalents	(21)	(991)
Cash and Equivalents at Beginning of Year	303	1,154
Cash and Equivalents at End of Period	\$ 282	163

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 months ended March 31, 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 consist of 392 hotels with 102,455 rooms, of which 39 hotels are owned, 201 are leased, four are partially owned through joint ventures, 118 are managed and 30 are franchised. The hotels we acquired in the HI Acquisition consist 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. The first quarter 2006 results of operations include the income from 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 paid 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. 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	2,717
Other assets	271
Current liabilities	(1,310)
Long-term debt, including capital lease obligations	(607)
Deferred income taxes	(1,328)
Other liabilities	(417)
	\$ 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 months ended March 31, 2005 and 2006, respectively.

	Three Months Ended March 31,	
	2005	2006
	(unaudited)	
	(in millions, except per share amounts)	
Total revenue	\$ 1,988	2,032
Net income	\$ 30	84
Diluted earnings per share	\$ 0.08	0.21

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 \$2.72 billion. We do not expect any of the goodwill to be tax deductible. Goodwill has been assigned to our segments as follows: Hotel Ownership \$1.55 billion; and Managing and Franchising \$1.17 billion. We also have an intangible asset relating to the brand names acquired in the HI Acquisition totaling \$1.65 billion. 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 387 million and 383 million for the three months ended March 31, 2005 and 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 34 million and 35 million for the three months ended March 31, 2005 and 2006, respectively. In addition, the increase to net income resulting from interest on convertible securities assumed to have not been paid was \$3 million for each of the three months ended March 31, 2005 and 2006.

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 March 31, 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 \$5 million and \$10 million in the three months ended March 31, 2005 and 2006, respectively.

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 \$5 million in the three months ended March 31, 2006. As of March 31, 2006, there was \$116 million of unrecognized compensation cost, which is expected to be recognized over a weighted-average period of 22 months.

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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 period 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	
	March 31,	
	2005	2006
	(in millions, except per share amounts)	
Net income:		
As reported	\$ 64	104
Add back: Compensation expense included in reported net income, net of tax	3	6
Deduct: Fair-value compensation expense for all awards, net of tax	(6)	(6)
As adjusted	\$ 61	104
Basic earnings per share:		
As reported	\$.17	.27
As adjusted	\$.16	.27
Diluted earnings per share:		
As reported	\$.16	.26
As adjusted	\$.15	.26

During the three months ended March 31, 2005 and 2006, the total intrinsic value of stock options exercised was \$15 million and \$19 million, respectively, and the total fair value of stock awards vested was \$20 million and \$16 million, 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. Cash received from options exercised under all share-based payment arrangements in the three months ended March 31, 2006 was \$22 million. The actual tax benefit realized for the tax deductions from options exercised totaled \$8 million in the three months ended March 31, 2006.

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The fair values of options granted in the three months ended March 31, 2006 were estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions: 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 three months ended March 31, 2006 is as follows:

Options 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	(1,691,390)	13.12		
Forfeited	(47,378)	11.87		
Balance at March 31, 2006	17,688,317	\$ 16.18	5.5	\$ 168
Exercisable at March 31, 2006	11,327,568	\$ 12.50	5.0	\$ 147

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). 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 the three months ended March 31, 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).

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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, which is to be expensed over the next 33 months. Incremental cost was insignificant to the 2006 first quarter results as the grants were made on the last day of the quarter.

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A summary of the activity of TBUs and PBUs granted under our 2004 Plan for the three months ended March 31, 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	(108,439)	18.86
Balance at March 31, 2006	4,680,533	\$ 22.48
PBUs		
Balance at December 31, 2005	1,519,907	\$ 19.84
Granted	1,620,328	24.84
Forfeited	(56,285)	19.53
Cancelled	(1,199,439)	23.30
Balance at March 31, 2006	1,884,511	\$ 21.94

Supplemental Retention and Retirement Plan

We also provide supplemental retirement benefits to eligible senior officers in the form of stock units that settle for 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 March 31, 2006, an insignificant amount of stock units remain unvested. The pre-tax compensation expense under these plans was not significant in the three months ended March 31, 2005 and 2006.

Note 5: Comprehensive Income

Comprehensive income for the three months ended March 31, 2005 and 2006 is as follows:

	Three Months Ended	
	March 31, 2005	2006
	(in millions)	
Net income	\$ 64	104
Change in unrealized gains and losses, net of tax	(2)	2
Cash flow hedge adjustment, net of tax	1	1
Cumulative translation adjustment, net of tax		36
Comprehensive income	\$ 63	143

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 approximately \$4 million and \$5 million for the three months ended March 31, 2006 and 2005, 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 \$4 million and \$6 million for the three months ended March 31, 2006 and 2005, respectively. As a result there was no net benefit to our net income from the investment for the three months ended March 31, 2006 and a \$1 million net benefit for the three months ended March 31, 2005.

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 three months ended March 31, 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 in 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 for the three months ended March 31, 2006 include an immaterial pre-tax loss resulting from a decrease in the market value of this derivative contract, which 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 March 31, 2006 is as follows:

	December 31, 2005 (in millions)	March 31, 2006
Industrial development revenue bonds at adjustable rates, due 2015	\$ 82	82
Senior notes, with an average rate of 8.0%, due 2007 to 2031(1)	2,040	2,038
Mortgage notes, 5.8% to 8.6%, due 2006 to 2013	310	242
7.95% Collateralized borrowings, due 2010	463	461
Chilean inflation-indexed note, effective rate of 7.65%, due 2009(1)	148	144
3.375% Contingently convertible senior notes due 2023	575	575
Capital leases, 6.34% to 8.75%, due 2006 to 2097	1	132
Term loan A, at adjustable rates, due 2011		2,090
Term loan B, at adjustable rates, due 2013		450
Revolving loans, at adjustable rates, due 2011		1,983
Other		61
	3,619	8,258
Less current maturities of long-term debt	(47)	(75)
Net long-term debt	\$ 3,572	8,183

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

Our total debt 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 leases of non-controlled entities at December 31, 2005 and March 31, 2006 are as follows:

	December 31, 2005 (in millions)	March 31, 2006
Mortgage note, 5.48%, due 2007	\$ 100	100
Capital leases, 6.34%, due 2006 to 2025		378
Other		31
	100	509
Less current maturities of non-recourse debt and capital leases of non-controlled entities		(10)
Net non-recourse debt and capital leases of non-controlled entities	\$ 100	499

Debt maturities are as follows:

March 31,	(in millions)
2007	\$ 85
2008	501
2009	501
2010	416
2011	3,569
Thereafter	3,695
Total	\$ 8,767

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 amount 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 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 \$1.070 billion was available to us at March 31, 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 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 require the payment of rent equal to the greater of a minimum rent or percentage rent based on a percentage of revenue or income, and expire through 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:

March 31,	Operating Leases (in millions)	Capital Leases	Non-Recourse Capital Leases
2007	\$ 313	13	30
2008	307	13	30
2009	301	14	31
2010	284	48	31
2011	277	6	31
Thereafter	3,424	167	473
	\$ 4,906	261	626
Less imputed interest at 6.34%		(129)	(248)
Present value of net minimum lease payments		132	378

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 No. 123R, using the modified prospective method, will result in incremental pre-tax expense in the year ending December 31, 2006 of approximately \$21 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.

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 qualify as capital leases under FAS 13. As of March 31, 2006, our consolidated balance sheet include the assets and liabilities of these non-controlled joint ventures, including \$15 million of cash and equivalents and \$409 million of debt and capital lease obligations, which is non-recourse to us. The net equity of the hotels is a retained deficit of approximately \$82 million at March 31, 2006, and is reflected on our consolidated balance sheet in other assets. The revenues 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 other earnings of these properties, which belongs to the hotel owners, is eliminated from our consolidated results through minority and non-controlled interest expense in the consolidated statements 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	
	March 31,	2006
	2005	
	(in millions)	
Revenue		
Hotel Ownership	\$ 531	802
Managing and Franchising	399	534
Timeshare	146	183
	\$ 1,076	1,519
Operating income:		
Hotel Ownership	\$ 76	127
Managing and Franchising	95	141
Timeshare	40	47
Corporate and other unallocated expenses	(48)	(80)
Total operating income	163	235
Interest and dividend income	4	11
Interest expense	(64)	(96)
Net interest from unconsolidated affiliates and non-controlled interests	(6)	(9)
Net gain on foreign currency transactions		17
Net gain on asset dispositions and other	11	4
Loss from non-operating affiliates	(5)	(4)
Income before taxes and minority and non-controlled interests	103	158
Provision for income taxes	(36)	(52)
Minority and non-controlled interests, net	(3)	(2)
Net Income	\$ 64	104

Segment assets are as follows:

	December 31,	March 31,
	2005	2006
	(in millions)	
Assets		
Hotel Ownership	\$ 4,283	9,955
Managing and Franchising	2,083	5,337
Timeshare	659	794
Corporate and other	1,718	774
Total assets	\$ 8,743	16,860

Note 13: Acquisitions and Dispositions

We consider properties to be held for sale when management approves and commits to a formal plan to actively market a property for sale, executes a formal sales contract, allows the buyer to complete its due diligence review and receives a non-refundable deposit. Until necessary approvals have been received and substantive conditions to the buyer's obligation to perform have been satisfied, we do not consider a sale to be probable.

Upon designation as an asset held for sale, we review the carrying value of the property and, as appropriate, adjust the value to the lower of its carrying value or its estimated fair value less estimated cost to sell, and we cease recording depreciation expense.

To the extent we realize a gain from the sale of real estate and maintain significant continuing involvement in the form of a long-term management contract, the gain is deferred and recognized in earnings over the term of the contract. Results in the three months ended March 31, 2005 and 2006 include the recognition of pre-tax deferred gains totaling \$4 million and \$9 million, respectively.

First Quarter 2006 Transactions

In the first quarter of 2006, we acquired the long-term management contracts for the Hilton Dallas Anatole, in Texas; the Grand Wailea Resort Hotel & Spa on the island of Maui in Hawaii; the Arizona Biltmore Resort & Spa in Phoenix, Arizona; and the La Quinta Resort & Club in La Quinta, California.

On February 23, 2006, we completed the acquisition of the lodging assets of Hilton Group plc operated by its subsidiary, Hilton International Co., for approximately £3.3 billion in an all-cash transaction. See Note 2: Purchase of Hilton International for further information.

In March 2006, we completed the sale of two wholly-owned hotels. The Pointe Hilton Tapatio Cliffs in Arizona was sold for cash of approximately \$85 million, resulting in a pre-tax loss of approximately \$33 million. The sale of the Pointe Hilton Tapatio Cliffs resulted in a reduction in our consolidated goodwill balance of approximately \$10 million. The Hilton Minneapolis in Minnesota was sold for approximately \$92 million in cash, resulting in a pre-tax loss of approximately \$5 million. We have retained long-term management agreements on both of the aforementioned properties. In addition to the sales of these wholly-owned hotels, we sold our minority interest in the Hilton Times Square in New York, a joint venture property, for proceeds of approximately \$27 million, resulting in a pre-tax gain of approximately \$11 million.

The \$4 million net gain on asset dispositions and other in our consolidated statement of income for the three months ended March 31, 2006 also includes a \$25 million gain on settlement recoveries related to mold found in certain areas of the Hilton Hawaiian Village in 2002 and \$6 million of other gains.

We have engaged Eastdil Secured, LLC to act as our broker for the sale of certain of our owned hotels. Fees earned by Eastdil related to owned hotels sold in the first quarter of 2006 were approximately \$1 million. No fees were earned by Eastdil in the first quarter 2005. Benjamin V. Lambert, a director of the Company, is Chairman of Eastdil.

First Quarter 2005 Transactions

In the 2005 first quarter, we sold the Hilton Tarrytown in New York for cash of approximately \$9 million. The sale resulted in a pre-tax gain of approximately \$5 million. After the sale, the hotel was converted to a Doubletree under a long-term franchise agreement.

The \$11 million gain on asset dispositions and other in our consolidated statement of income for the 2005 first quarter also includes a \$5 million unrealized gain on an oil futures derivative based on the market value of the contract at March 31, 2005 and a net gain of \$1 million related to excess proceeds

received on the disposition of certain management and franchise agreements to which value had been assigned.

Note 14: Impairment Loss and Related Costs

Results in the three months ended March 31, 2005 include an impairment loss totaling \$2 million. This pre-tax charge represents the write down of a non-hotel cost basis investment to its estimated fair value.

Note 15: Stock Repurchases

There were no stock repurchases in the three months ended March 31, 2006. In the three months ended March 31, 2005, we repurchased approximately 7.2 million shares of our common stock at a total cost of approximately \$158 million. The timing of stock purchases is at the discretion of management. As of March 31, 2006, approximately 44.7 million shares remained authorized for repurchase.

Note 16: Guarantees

We have established franchise financing programs with third party lenders to support the growth of our brands. As of March 31, 2006, we have provided guarantees of \$35 million on loans outstanding under the programs. In addition, we have guaranteed \$36 million of debt and other obligations of unconsolidated affiliates and third parties. As part of the HI Acquisition, we acquired guarantees totaling \$24 million, bringing our total guarantees to approximately \$95 million. Our outstanding guarantees have remaining terms of one to 14 years and approximately \$15 million have indefinite terms. We also have commitments under letters of credit totaling \$109 million as of March 31, 2006. We believe it is unlikely that material payments will be required under our outstanding guarantees or letters of credit.

We have also provided performance guarantees to certain owners of hotels which we operate under management contracts. Most of these guarantees allow us to terminate the contract rather than fund shortfalls if specified performance levels are not achieved. In limited cases, we are obligated to fund performance shortfalls. Funding under these performance guarantees is expected to total approximately \$4 million in 2006. Funding under these guarantees in future periods is dependent on the operating performance levels of these hotels over the remaining term of the performance guarantee. Although we anticipate that the future operating performance levels of these hotels will be largely achieved, there can be no assurance that this will be the case. In addition, we do not anticipate losing a significant number of management contracts in 2006 pursuant to these guarantees.

Our consolidated financial statements at March 31, 2006 include liabilities of approximately \$4 million for potential obligations under our outstanding guarantees.

Note 17: Employee Benefit Plans

We have a noncontributory retirement plan (Basic Plan) which covers many of our non-union employees. Benefits are based upon years of service and compensation, as defined. Since December 31, 1996, employees have not accrued additional benefits under the Basic Plan. We do not expect to make any material contributions to the Basic Plan in 2006.

As a part of the HI Acquisition, we acquired a number of post-retirement plans. In the three months ended March 31, 2006, we paid approximately \$3 million in employer contributions to these plans. In addition, subsequent to the completion of the HI Acquisition, we contributed approximately \$97 million to one of these plans in order to reduce the unfunded deficit. We expect our recurring total annual contributions to the plans to be approximately \$25 million in 2006.

Our net periodic benefit cost for the three months ended March 31, 2005 and 2006 consisted of the following:

	Three Months Ended	
	March 31,	
	2005	2006
	(in millions)	
Expected return on plan assets	\$ 5	8
Service cost		(3)
Interest cost	(4)	(6)
Amortization of prior service cost	(1)	(1)
Net periodic benefit cost	\$	(2)

Note 18: Reclassifications

The consolidated financial statements reflect certain reclassifications to prior period balances to conform with classifications adopted in 2006. These reclassifications have no effect on net income.

PART II OTHER INFORMATION

ITEM 6. EXHIBITS

Exhibits

- 31.1 CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 CEO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 CFO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 12, 2006

HILTON HOTELS CORPORATION
(Registrant)
/s/ ROBERT M. LA FORGIA
Robert M. La Forgia
Executive Vice President and Chief Financial Officer
(Chief Accounting Officer)

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