

FIVE STAR QUALITY CARE INC  
Form 10-Q  
August 09, 2007

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2007**

**OR**

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

**Commission File Number 001-16817**

**FIVE STAR QUALITY CARE, INC.**

(Exact Name of Registrant as Specified in its Charter)

**Maryland**

(State or Other Jurisdiction of Incorporation or  
Organization)

**04-3516029**

(IRS Employer Identification No.)

**400 Centre Street, Newton, Massachusetts 02458**

(Address of Principal Executive Offices)

**617-796-8387**

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

Indicate by check mark whether the registrant 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

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

FIVE STAR QUALITY CARE, INC.

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Number of Common Shares outstanding at August 8, 2007: 31,704,134 shares of common stock, \$0.01 par value.

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FIVE STAR QUALITY CARE, INC.

FORM 10-Q

JUNE 30, 2007

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*As used herein the terms we, us, our and Five Star include Five Star Quality Care, Inc. and its consolidated subsidiaries unless otherwise expressly stated or the context otherwise requires.*

**Part I. Financial Information****Item 1. Consolidated Financial Statements**

## FIVE STAR QUALITY CARE, INC.

## CONSOLIDATED BALANCE SHEET

(dollars in thousands, except share amounts)

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
(unaudited)		
Current assets:		
Cash and cash equivalents	\$ 42,486	\$ 46,241
Accounts receivable, net of allowance of \$6,190 and \$5,005 at June 30, 2007 and December 31, 2006, respectively	60,877	67,791
Prepaid expenses	8,739	16,112
Investments in trading securities	38,771	50,434
Restricted cash - insurance arrangements	1,849	3,043
Restricted investments - insurance arrangements	4,514	2,448
Restricted cash - other	3,270	4,925
Other current assets	11,320	14,766
Total current assets	171,826	205,760
Property and equipment, net	132,772	114,898
Restricted cash - insurance arrangements	4,713	7,786
Restricted investments - insurance arrangements	11,505	6,262
Restricted cash - other	769	774
Goodwill and other intangible assets	22,477	22,611
Other long term assets	8,404	8,320
	\$ 352,466	\$ 366,411
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 18,316	\$ 22,805
Accrued expenses	26,577	18,825
Accrued compensation and benefits	20,757	19,218
Due to Senior Housing Properties Trust ( SNH )	10,960	9,988
Mortgage notes payable	155	33,317
Accrued real estate taxes	6,207	6,035
Security deposit liability	14,667	15,097
Other current liabilities	7,983	7,644
Total current liabilities	105,622	132,929
Long term liabilities:		
Mortgage notes payable	15,927	11,454
Convertible senior notes	126,500	126,500
Continuing care contracts	3,400	3,649
Other long term liabilities	25,455	24,449
Total long term liabilities	171,282	166,052
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, par value \$0.01: 1,000,000 shares authorized, none issued		
Common stock, par value \$0.01: 50,000,000 shares authorized, 31,704,134 and 31,682,134 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively	317	316
Additional paid-in capital	286,524	286,344
Accumulated deficit	(210,591)	(219,435)
Unrealized (loss) gain on investments	(688)	205

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Total shareholders equity	75,562	67,430
	\$ 352,466	\$ 366,411

See accompanying notes.

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## FIVE STAR QUALITY CARE, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(dollars in thousands, except per share amounts)

(unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
<b>Revenues:</b>				
Senior living revenue	\$ 200,024	\$ 182,649	\$ 396,525	\$ 363,437
Hospital revenue	25,873		52,643	
Pharmacy revenue	16,914	12,963	33,162	24,217
Total revenues	242,811	195,612	482,330	387,654
<b>Operating expenses:</b>				
Senior living wages and benefits	103,406	94,484	204,872	185,319
Other senior living operating expenses	48,406	45,794	97,875	94,282
Hospital expenses	24,151		48,407	
Pharmacy expenses	16,328	12,305	32,270	22,996
Management fee to Sunrise Senior Living Services, Inc. ( SLS )		2,854		6,392
Termination expense for SLS management agreements		89,833		89,833
Rent expense	31,858	25,846	64,029	51,453
General and administrative	10,887	8,016	20,946	15,238
Depreciation and amortization	3,265	2,289	6,444	4,557
Total operating expenses	238,301	281,421	474,843	470,070
Operating income (loss)	4,510	(85,809)	7,487	(82,416)
Interest and other income	1,521	816	2,586	1,140
Interest expense	(1,677)	(875)	(3,455)	(1,633)
Gain on extinguishment of debt	934		4,491	
Income (loss) from continuing operations before income taxes	5,288	(85,868)	11,109	(82,909)
Provision for income taxes	275		483	
Income (loss) from continuing operations	5,013	(85,868)	10,626	(82,909)
Loss from discontinued operations	(933)	(1,323)	(1,782)	(2,623)
Net income (loss)	\$ 4,080	\$ (87,191)	\$ 8,844	\$ (85,532)
Weighted average shares outstanding - basic	31,694	30,982	31,689	25,551
Weighted average shares outstanding - diluted	41,425	30,982	41,420	25,551
<b>Basic income (loss) per share from:</b>				
Continuing operations	\$ 0.16	\$ (2.78)	\$ 0.34	\$ (3.25)
Discontinued operations	(0.03)	(0.04)	(0.06)	(0.10)
Net income (loss) per share	\$ 0.13	\$ (2.82)	\$ 0.28	\$ (3.35)
<b>Diluted income (loss) per share from:</b>				
Continuing operations	\$ 0.15	\$ (2.78)	\$ 0.32	\$ (3.25)
Discontinued operations	(0.02)	(0.04)	(0.04)	(0.10)
Net income (loss) per share	\$ 0.13	\$ (2.82)	\$ 0.28	\$ (3.35)

See accompanying notes.

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FIVE STAR QUALITY CARE, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(dollars in thousands)

(unaudited)

	Six months ended June 30,	
	2007	2006
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 8,844	\$ (85,532 )
Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities:		
Depreciation and amortization	6,444	4,557
Gain on extinguishment of debt	(4,491 )	
Loss from discontinued operations	1,782	2,623
Provision for bad debt expense, net	1,185	1,334
Changes in assets and liabilities:		
Accounts receivable	5,729	(1,550 )
Prepaid expenses and other assets	10,665	(758 )
Investments in trading securities	11,663	(3,859 )
Accounts payable and accrued expenses	3,444	4,021
Accrued compensation and benefits	1,539	(1,766 )
Due to/from SLS		(8,076 )
Due to/from SNH	972	11
Other current and long term liabilities	838	424
Cash provided by (used in) operating activities	48,614	(88,571 )
Net cash used in discontinued operations	(1,782 )	(2,623 )
<b>Cash flows from investing activities:</b>		
Deposits into restricted cash and investment accounts, net	(2,275 )	(7,642 )
Acquisition of property and equipment	(36,199 )	(20,086 )
Acquisition of senior living community, net of cash acquired	(5,025 )	
Acquisition of pharmacy, net of cash acquired		(3,500 )
Proceeds from disposition of property and equipment held for sale	17,110	11,077
Withdrawals from restricted cash for purchases of property and equipment		4,638
Cash used in investing activities	(26,389 )	(15,513 )
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common shares, net		114,059
Proceeds from borrowings on revolving credit facility		28,000
Repayments of borrowings on revolving credit facility		(28,000 )
Proceeds from mortgage note payable	4,559	
Repayments of mortgage note payable	(28,757 )	(280 )
Cash (used in) provided by financing activities	(24,198 )	113,779
Change in cash and cash equivalents	(3,755 )	7,072
Cash and cash equivalents at beginning of period	46,241	16,376
Cash and cash equivalents at end of period	\$ 42,486	\$ 23,448
<b>Supplemental cash flow information:</b>		
Cash paid for interest	\$ 3,063	\$ 1,354
<b>Non-cash investing and financing activities:</b>		
Issuance of common stock	180	43



See accompanying notes.

FIVE STAR QUALITY CARE, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share amounts)

(unaudited)

**Note 1. Basis of Presentation and Organization**

Certain information and disclosures required by generally accepted accounting principles for complete financial statements have been condensed or omitted. We believe the disclosures made are adequate to make the information presented not misleading. However, the accompanying financial statements should be read in conjunction with the financial statements and notes contained in our Annual Report on Form 10-K for the year ended December 31, 2006. In the opinion of our management, all adjustments, which include only normal recurring adjustments considered necessary for a fair presentation, have been included. All intercompany transactions and balances have been eliminated. Our operating results for interim periods are not necessarily indicative of the results that may be expected for the full year.

As of June 30, 2007, we operated 161 senior living communities containing 18,007 living units, including 112 primarily independent and assisted living communities containing 13,597 living units and 49 nursing homes containing 4,410 living units. Of our 112 primarily independent and assisted living communities, we leased 95 communities containing 12,330 living units from Senior Housing Properties Trust, or Senior Housing, our former parent, and we owned or leased from parties other than Senior Housing 17 communities containing 1,267 living units. We leased 47 of our 49 nursing homes from Senior Housing. Our 161 communities include 5,667 independent living apartments, 6,371 assisted living suites and 5,969 skilled nursing beds. We also operated six institutional pharmacies, one of which provided mail order pharmaceuticals to the general public, and we operated two rehabilitation hospitals that we leased from Senior Housing. Our two rehabilitation hospitals contain 342 beds available for inpatient services and 21 affiliated outpatient clinics.

**Note 2. Property and Equipment**

Property and equipment, at cost, consists of:

	June 30, 2007	December 31, 2006
Land	\$ 7,195	\$ 6,685
Buildings and improvements	98,552	82,293
Furniture, fixtures and equipment	54,131	46,685
	159,878	135,663
Accumulated depreciation	(27,106 )	(20,765 )
	\$ 132,772	\$ 114,898

As of June 30, 2007 and December 31, 2006, we had assets classified as held for sale of \$25,127 and \$15,478, respectively, included in our property and equipment that we intend to sell to Senior Housing as permitted by our leases.

**Note 3. Comprehensive Income (Loss)**

Comprehensive income (loss) for the three and six months ended June 30, 2007 and 2006 is summarized below:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Net income (loss)	\$ 4,080	\$ (87,191 )	\$ 8,844	\$ (85,532 )
Unrealized loss on investments in available for sale securities	(850 )	(336 )	(893 )	(358 )
Comprehensive income (loss)	\$ 3,230	\$ (87,527 )	\$ 7,951	\$ (85,890 )

**Note 4. Financial Data By Segment**

Our reportable segments consist of our senior living community business and our rehabilitation hospital business that we began to operate in October 2006. In the senior living community segment, we operate independent living

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and congregate care communities, assisted living communities and nursing homes. Our rehabilitation hospital segment provides inpatient health rehabilitation services at our two hospital locations and three satellite locations and outpatient health rehabilitation services at 21 locations. We do not consider our pharmacy operations to be a material, separately reportable segment of our business, but we report our pharmacy revenues and expense as separate items combined with our corporate and other activities. All of our operations and assets are located in the United States.

We use segment operating profit as an important measure to evaluate our performance and for decision making purposes. Segment operating profit excludes interest and other income, interest expense and certain corporate expenses.

Our revenues by segment, along with a reconciliation of segment operating profit to income from continuing operations before income taxes for the three and six months ended June 30, 2007 and 2006 are as follows:

	Senior Living Communities	Rehabilitation Hospitals	Corporate and other (1)	Total
<b>Three months ended June 30, 2007</b>				
Revenues	\$ 200,024	\$ 25,873	\$ 16,914	\$ 242,811
Segment expenses:				
Operating expenses	151,812	24,151	16,328	192,291
Rent expense	29,296	2,562		31,858
Depreciation and amortization	2,289	279	697	3,265
Total segment expenses	183,397	26,992	17,025	227,414
Segment operating profit (loss)	16,627	(1,119)	(111)	15,397
General and administrative expenses (2)			(10,887)	(10,887)
Operating income (loss)	16,627	(1,119)	(10,998)	4,510
Interest and other income			1,521	1,521
Interest expense	(432)		(1,245)	(1,677)
Gain on extinguishment of debt	934			934
Provision for income taxes			(275)	(275)
Income (loss) from continuing operations	\$ 17,129	\$ (1,119)	\$ (10,997)	\$ 5,013
Total Assets as of June 30, 2007	\$ 235,382	\$ 23,821	\$ 93,263	\$ 352,466
<b>Three months ended June 30, 2006</b>				
Revenues	\$ 182,649	\$	\$ 12,963	\$ 195,612
Segment expenses:				
Operating expenses	140,278		12,305	152,583
Management fee to SLS	2,854			2,854
Termination expense for SLS management agreements	89,833			89,833
Rent expense	25,846			25,846
Depreciation and amortization	1,759		530	2,289
Total segment expenses	260,570		12,835	273,405
Segment operating (loss) profit	(77,921)		128	(77,793)
General and administrative expenses (2)			(8,016)	(8,016)
Operating loss	(77,921)		(7,888)	(85,809)
Interest and other income			816	816
Interest expense	(867)		(8)	(875)
Loss from continuing operations	\$ (78,788)	\$	\$ (7,080)	\$ (85,868)
Total Assets as of June 30, 2006	\$ 224,058	\$	\$ 28,276	\$ 252,334

**Six months ended June 30, 2007**

Revenues	\$ 396,525	\$ 52,643	\$ 33,162	\$ 482,330
Segment expenses:				
Operating expenses	302,747	48,407	32,270	383,424
Rent expense	58,898	5,131		64,029
Depreciation and amortization	4,500	496	1,448	6,444
Total segment expenses	366,145	54,034	33,718	453,897
Segment operating profit (loss)	30,380	(1,391 )	(556 )	28,433
General and administrative expenses (2)			(20,946 )	(20,946 )
Operating income (loss)	30,380	(1,391 )	(21,502 )	7,487
Interest and other income			2,586	2,586
Interest expense	(969 )		(2,486 )	(3,455 )
Gain on extinguishment of debt	4,491			4,491
Provision for income taxes			(483 )	(483 )
Income (loss) from continuing operations	\$ 33,902	\$ (1,391 )	\$ (21,885 )	\$ 10,626

**Six months ended June 30, 2006**

Revenues	\$ 363,437	\$	\$ 24,217	\$ 387,654
Segment expenses:				
Operating expenses	279,601		22,996	302,597
Management fee to SLS	6,392			6,392
Termination expense for SLS management agreements	89,833			89,833
Rent expense	51,453			51,453
Depreciation and amortization	3,614		943	4,557
Total segment expenses	430,893		23,939	454,832
Segment operating (loss) profit	(67,456 )		278	(67,178 )
General and administrative expenses (2)			(15,238 )	(15,238 )
Operating loss	(67,456 )		(14,960 )	(82,416 )
Interest and other income			1,140	1,140
Interest expense	(1,510 )		(123 )	(1,633 )
Loss from continuing operations	\$ (68,966 )	\$	\$ (13,943 )	\$ (82,909 )

(1) Corporate and Other includes operations that we do not consider a significant, separately reportable segment of our business and income and expenses that are not attributable to a specific segment.

(2) General and administrative expenses are not attributable to a specific segment and include items such as corporate payroll and benefits and outside service expenses.

**Note 5. Income Taxes**

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48 Accounting for Uncertainty in Income Taxes, or FIN 48. FIN 48 prescribes how we should recognize, measure and present in our financial statements uncertain tax positions that have been taken or are expected to be taken in a tax return. Pursuant to FIN 48, we can recognize a tax benefit only if it is more likely than not that a particular tax position will be sustained upon examination or audit. To the extent the more likely than not standard has been satisfied, the benefit associated with a tax position is measured as the largest amount that has a greater than 50% likelihood of being realized upon settlement.

As required, we adopted FIN 48 effective January 1, 2007 and have concluded the effect is not material to our consolidated financial statements. Accordingly, we did not record a cumulative effect adjustment related to the adoption of FIN 48. At the date of adoption, we had \$785 in unrecognized tax benefits related to FIN 48 plus significant tax loss carry forwards totaling approximately \$202,500 which, if recognized, would favorably affect our



effective tax rate. We do not believe that our unrecognized tax benefits related to FIN 48 will change significantly in the next 12 months.

Because we have historically reported losses we do not currently recognize the benefit of all of our deferred tax assets, including tax loss carry forwards that may be used to offset future taxable income. We will, however, continue to assess our ability to generate sufficient taxable income during future periods in which our deferred tax assets may be realized. When we believe that we will more likely than not recover our deferred tax assets, we will record deferred tax assets as an income tax benefit in the consolidated statement of operations, which will affect our results of operations. Our net operating loss carry forwards begin to expire in 2023, if unused. The tax loss carry forwards and tax returns filed for the 2002 through 2006 tax years are subject to examination by taxing authorities.

For the six months ended June 30, 2007, we recognized tax expenses of \$483, which includes \$369 of alternative minimum taxes and certain state taxes that are payable without regard to our tax loss carry forwards and \$114 of a non cash deferred tax liability arising from the amortization of goodwill for tax purposes but not for book purposes. We may recognize this deferred tax liability as a reduction in the income tax provision if, in some future period, we expense the related items of goodwill for book purposes as the result of its sale, other disposition or impairment.

**Note 6. Earnings Per Share**

Basic earnings per share for the periods ended June 30, 2007 and 2006 is computed using the weighted average number of shares outstanding during the periods. Diluted earnings per share for the period ended June 30, 2007 reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income applicable to common shareholders that would result from the assumed issuance. The effect of our convertible senior notes on loss from discontinued operations per share is anti-dilutive for the three and six months ended June 30, 2007, respectively.

The following table provides a reconciliation of both net income and the number of common shares used in the computations of diluted earnings per share, or EPS:

	Three Months Ended June 30, 2007			2006		
	Income (loss)	Shares	Per Share	Income (loss)	Shares	Per Share
Income from continuing operations	\$ 5,013	31,694	\$ 0.16	\$ (85,868 )	30,982	\$ (2.78 )
Effect of convertible senior notes	1,245	9,731				
Amounts used to calculate diluted EPS from continuing operations	6,258	41,425	\$ 0.15	(85,868 )	30,982	\$ (2.78 )
Amounts used to calculate diluted EPS from discontinued operations	\$ (933 )	41,425	\$ (0.02 )	\$ (1,323 )	30,982	\$ (0.04 )

	Six Months Ended June 30, 2007			2006		
	Income (loss)	Shares	Per Share	Income (loss)	Shares	Per Share
Income from continuing operations	\$ 10,626	31,689	\$ 0.34	\$ (82,909 )	25,551	\$ (3.25 )
Effect of convertible senior notes	2,486	9,731				
Amounts used to calculate diluted EPS from continuing operations	13,112	41,420	\$ 0.32	(82,909 )	25,551	\$ (3.25 )
Amounts used to calculate diluted EPS from discontinued operations	\$ (1,782 )	41,420	\$ (0.04 )	\$ (2,623 )	25,551	\$ (0.10 )

**Note 7. Acquisitions**

In April 2007, we acquired a 48 unit assisted living community located in Tennessee for \$5,025. We financed the acquisition by assuming a \$4,559 non recourse United States Department of Housing, or HUD, insured mortgage and paying the balance of the purchase price with cash on hand. The interest rate on the assumed HUD insured mortgage is 7.65%. We included the results of this community's operations in our consolidated financial statements from the date of acquisition. All of the community's revenues come from residents' private resources. We acquired this community to expand our business in high quality senior living operations where residents pay for our services with private resources.

**Note 8. Line of Credit**

In June 2007, we amended our revolving line of credit. The amendment increased the line from \$25,000 to \$40,000, extended the termination date to May 8, 2009 and reduced the interest rate by 25 basis points. Our revolving line of credit is available for acquisitions, working capital and general business purposes. The amount we are able to borrow at any time is subject to limitations based upon qualifying collateral. We are the borrower under this revolving credit facility and certain of our subsidiaries guarantee our obligations under the facility, which is secured by our and our guarantor subsidiaries' accounts receivable, deposit accounts and related assets. The facility contains covenants requiring us to maintain collateral, minimum net worth and certain other financial ratios, limits our ability to incur or assume debt or create liens with respect to certain of our properties and has other customary provisions. In certain circumstances and subject to available collateral and lender approvals, the maximum amounts which we may draw under this credit facility may be increased to \$80,000. The termination date may be extended twice, in each case by twelve months, subject to lender approval, our payment of extension fees and other conditions. As of June 30, 2007 and August 8, 2007, no amounts were outstanding under this credit facility. As of June 30, 2007 and August 8, 2007 we believe we are in compliance with all applicable covenants under this credit facility. Interest expense and other associated costs related to this facility were \$113 and \$8 for the three months ended June 30, 2007 and 2006, respectively, and \$196 and \$123 for the six months ended June 30, 2007 and 2006, respectively.

**Note 9. Mortgages Payable**

At June 30, 2007, four of our communities were encumbered by five HUD insured mortgages totaling \$16,082. In February 2007, we prepaid six mortgages that were secured by five of our senior living communities. We paid \$22,923 to retire these six mortgages, which consisted of approximately \$22,198 in principal and interest and \$725 in prepayment penalties. Because we had carried these mortgages at a premium to their face value, we recognized a net gain of \$3,557 in connection with the early extinguishment of debt. In April 2007, we prepaid one mortgage that was secured by one of our communities. We paid \$5,944 to retire this mortgage, which consisted of approximately \$5,828 in principal and interest and \$116 in prepayment penalties. Because we had carried this mortgage at a premium to its face value, we recognized a net gain of approximately \$934 in connection with the early extinguishment of debt. Mortgage interest expense, including premium amortization, was \$319 and \$694 for the three months ended June 30, 2007 and 2006, respectively, and \$773 and \$1,338 for the six months ended June 30, 2007 and 2006, respectively.

As discussed in Note 7, in April 2007, we acquired a 48 unit assisted living community located in Tennessee for \$5,025. We financed the acquisition by assuming a \$4,559 non recourse HUD insured mortgage and paying the balance of the purchase price with cash on hand. The interest rate on the assumed HUD insured mortgage is 7.65%.

**Note 10. Convertible Senior Notes due 2026**

In October 2006, we issued \$126,500 principal amount of 3.75% convertible senior notes. Our net proceeds from this offering were approximately \$122,600. These notes are convertible into our common shares at any time. The initial conversion rate, which is subject to adjustment, is 76.9231 common shares per \$1 principal amount of notes, which represents an initial conversion price of \$13.00 per share. Interest expense and other associated costs on the notes were \$1,245 and \$2,486 for the three and six months ended June 30, 2007, respectively. The notes are guaranteed by certain of our domestic wholly owned subsidiaries (see Note 13). These notes mature on October 15, 2026; we may prepay them at anytime after October 20, 2011 and the note holders may require that we purchase all or a portion of these notes on each of October 15, 2013, October 15, 2016 and October 15, 2021. We issued these



notes pursuant to an indenture which contains various customary covenants; we believe we are in compliance with all applicable covenants of the indenture.

**Note 11. Related Party Transactions**

We lease 142 of the 161 senior living communities and the two rehabilitation hospitals that we operated on June 30, 2007 from Senior Housing for total annual minimum rent of \$126,078. In addition to the minimum rent, we paid \$616 and \$377 in percentage rent to Senior Housing for the three months ended June 30, 2007 and 2006, respectively and \$1,168 and \$670 for the six months ended June 30, 2007 and 2006, respectively.

During the six months ended June 30, 2007, as permitted by our leases with Senior Housing, we sold to Senior Housing, at cost, \$17,110 of improvements made to properties leased from Senior Housing, and the annual rent payable to Senior Housing increased by \$1,677.

**Note 12. Discontinued Operations**

In March 2007, we agreed with Senior Housing that it should sell two assisted living communities in Pennsylvania, which we lease from Senior Housing. We and Senior Housing are in the process of selling these assisted living communities and, upon their sale, our annual minimum rent payable to Senior Housing will decrease by 9.5% of the net proceeds of the sale to Senior Housing. As of June 30, 2007, we have disposed of substantially all of our assets and settled all liabilities related to these two communities. We have reclassified the statement of operations for all periods presented to show the results of operations of the communities which have been sold or are expected to be sold as discontinued. A summary of the operating results of these discontinued operations included in the financial statements for the three and six months ended June 30, 2007 and 2006 is:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Revenues	\$ 779	\$ 6,351	\$ 1,531	\$ 14,213
Expenses	(1,712 )	(7,674 )	(3,313 )	(16,836 )
Net loss	\$ (933 )	\$ (1,323 )	\$ (1,782 )	\$ (2,623 )

**Note 13. Guarantor Financial Information**

Our convertible notes are guaranteed by certain of our domestic wholly owned subsidiaries. Such guarantees are full, unconditional and joint and several. Condensed consolidating financial information related to the Company, its guarantor subsidiaries and non-guarantor subsidiaries for all periods presented are as follows:

**Consolidating Statement of Operations  
For the three months ended June 30, 2007**

	Parent	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Consolidated
<b>Revenues:</b>					
Senior living revenue	\$	\$ 84,988	\$ 115,036	\$	\$ 200,024
Hospital revenue			25,873		25,873
Pharmacy revenue			16,914		16,914
Total revenues		84,988	157,823		242,811
<b>Operating expenses:</b>					
Senior living wages and benefits		38,242	65,164		103,406
Other senior living operating expenses		24,536	23,870		48,406
Hospital expenses			24,151		24,151
Pharmacy expenses			16,328		16,328
Rent expense		16,613	15,245		31,858
General and administrative expenses			10,887		10,887



Depreciation and amortization		1,198	2,067		3,265
Total operating expenses		80,589	157,712		238,301
Operating income		4,399	111		4,510
Interest and other income			1,521		1,521
Interest expense			(1,677)		(1,677)
Gain on extinguishment of debt			934		934
Equity in earnings of subsidiaries	4,080			(4,080)	
Income from continuing operations before income taxes	4,080	4,399	889	(4,080)	5,288
Provision for income taxes			275		275
Income from continuing operations	4,080	4,399	614	(4,080)	5,013
Loss from discontinued operations			(933)		(933)
Net income	\$ 4,080	\$ 4,399	\$ (319)	\$ (4,080)	\$ 4,080

**Consolidating Statement of Operations  
For the three months ended June 30, 2006**

	Parent	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Consolidated
<b>Revenues:</b>					
Senior living revenue	\$	\$ 82,136	\$ 100,513	\$	\$ 182,649
Pharmacy revenue			12,963		12,963
Total revenues		82,136	113,476		195,612
<b>Operating expenses:</b>					
Senior living wages and benefits		35,539	58,945		94,484
Other senior living operating expenses		24,838	20,956		45,794
Pharmacy expenses			12,305		12,305
Management fee to SLS		2,854			2,854
Termination expense for SLS management agreements		89,833			89,833
Rent expense		16,202	9,644		25,846
General and administrative expenses			8,016		8,016
Depreciation and amortization		1,015	1,274		2,289
Total operating expenses		170,281	111,140		281,421
Operating (loss) income		(88,145)	2,336		(85,809)
Interest and other income		67	749		816
Interest expense		(4)	(871)		(875)
Equity in earnings of subsidiaries	(87,191)			87,191	
(Loss) income from continuing operations before income taxes	(87,191)	(88,082)	2,214	87,191	(85,868)
Provision for income taxes					
(Loss) income from continuing operations	(87,191)	(88,082)	2,214	87,191	(85,868)
(Loss) income from discontinued operations		(25)	(1,298)		(1,323)
Net (loss) income	\$ (87,191)	\$ (88,107)	\$ 916	\$ 87,191	\$ (87,191)



**Consolidating Statement of Operations****For the six months ended June 30, 2007**

	<b>Parent</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Revenues:</b>					
Senior living revenue	\$	\$ 169,027	\$ 227,498	\$	\$ 396,525
Hospital revenue			52,643		52,643
Pharmacy revenue			33,162		33,162
Total revenues		169,027	313,303		482,330
<b>Operating expenses:</b>					
Senior living wages and benefits		76,971	127,901		204,872
Other senior living operating expenses		50,592	47,283		97,875
Hospital expenses			48,407		48,407
Pharmacy expenses			32,270		32,270
Rent expense		33,237	30,792		64,029
General and administrative expenses			20,946		20,946
Depreciation and amortization		2,372	4,072		6,444
Total operating expenses		163,172	311,671		474,843
Operating income		5,855	1,632		7,487
Interest and other income		(8	) 2,594		2,586
Interest expense			(3,455	)	(3,455
Gain on extinguishment of debt			4,491		4,491
Equity in earnings of subsidiaries	8,844			(8,844	)
Income from continuing operations before income taxes	8,844	5,847	5,262	(8,844	) 11,109
Provision for income taxes			483		483
Income from continuing operations	8,844	5,847	4,779	(8,844	) 10,626
Loss from discontinued operations			(1,782	)	(1,782
Net income	\$ 8,844	\$ 5,847	\$ 2,997	\$ (8,844	) \$ 8,844

**Consolidating Statement of Operations****For the six months ended June 30, 2006**

	<b>Parent</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Revenues:</b>					
Senior living revenue	\$	\$ 163,144	\$ 200,293	\$	\$ 363,437
Pharmacy revenue			24,217		24,217
Total revenues		163,144	224,510		387,654
<b>Operating expenses:</b>					
Senior living wages and benefits		70,106	115,213		185,319
Other senior living operating expenses		50,776	43,506		94,282
Hospital expenses					

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Pharmacy expenses			22,996		22,996
Management fee to SLS		6,392			6,392
Termination expense for SLS management agreements		89,833			89,833
Rent expense		32,237	19,216		51,453
General and administrative expenses			15,238		15,238
Depreciation and amortization		1,964	2,593		4,557
Total operating expenses		251,308	218,762		470,070
Operating (loss) income		(88,164 )	5,748		(82,416 )
Interest and other income		150	990		1,140
Interest expense		(4 )	(1,629 )		(1,633 )
Equity in earnings of subsidiaries	(85,532 )			85,532	
Income from continuing operations before income taxes	(85,532 )	(88,018 )	5,109	85,532	(82,909 )
Provision for income taxes					
(Loss) income from continuing operations	(85,532 )	(88,018 )	5,109	85,532	(82,909 )
Loss from discontinued operations		(94 )	(2,529 )		(2,623 )
Net income	\$ (85,532 )	\$ (88,112 )	\$ 2,580	\$ 85,532	\$ (85,532 )

**Condensed Consolidating Balance Sheet  
As of June 30, 2007**

	Parent	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Consolidated
<b>ASSETS</b>					
<b>Current assets:</b>					
Cash and cash equivalents	\$	\$ 2,990	\$ 39,496	\$	\$ 42,486
Accounts receivable, net		12,499	48,378		60,877
Restricted cash and investments		2,940	6,693		9,633
Investments in trading securities			38,771		38,771
Prepaid expenses and other current assets		4,465	15,594		20,059
Total current assets		22,894	148,932		171,826
Property and equipment, net		25,767	107,005		132,772
Investment in subsidiary and long term receivable from (to) subsidiaries	200		200	(400 )	
Restricted cash and investments		3,082	13,905		16,987
Intercompany	228,837			(228,837 )	
Goodwill and other intangible assets			22,477		22,477
Other long term assets			8,404		8,404
	\$ 229,037	\$ 51,743	\$ 300,923	\$ (229,237 )	\$ 352,466

## LIABILITIES AND SHAREHOLDERS EQUITY

## Current liabilities:

Accounts payable and other current liabilities	\$	\$ 28,122	\$ 77,345	\$	\$ 105,467
Mortgage notes payable			155		155
Total current liabilities		28,122	77,500		105,622

## Long term liabilities:

Mortgage notes payable			15,927		15,927
Convertible senior notes			126,500		126,500
Notes payable to related parties	200			(200)	
Other long term liabilities		6,066	22,789		28,855
Total long term liabilities	200	6,066	165,216	(200)	171,282

Total shareholders equity	228,837	17,555	58,207	(229,037)	75,562
	\$ 229,037	\$ 51,743	\$ 300,923	\$ (229,237)	\$ 352,466

**Condensed Consolidating Balance Sheet**  
**As of December 31, 2006**

	Parent	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Consolidated
<b>ASSETS</b>					
Current assets:					
Cash and cash equivalents	\$	\$ 8,065	\$ 38,176	\$	\$ 46,241
Accounts receivable, net		13,209	54,582		67,791
Investments in trading securities			50,434		50,434
Prepaid expenses and other current assets		8,353	32,941		41,294
Total current assets		29,627	176,133		205,760
Property and equipment, net		23,061	91,837		114,898
Investment in subsidiary and long term receivable from (to) subsidiaries	200		200	(400)	
Restricted cash		3,072	11,750		14,822
Intercompany	228,656			(228,656)	
Goodwill and other intangible assets			22,611		22,611
Other long term assets			8,320		8,320
	\$ 228,856	\$ 55,760	\$ 310,851	\$ (229,056)	\$ 366,411

## LIABILITIES AND SHAREHOLDERS EQUITY

## Current liabilities:

Accounts payable and other current liabilities	\$	\$ 41,852	\$ 57,760	\$	\$ 99,612
Mortgage notes payable			33,317		33,317
Total current liabilities		41,852	91,077		132,929

Long term liabilities:					
Mortgage notes payable			11,454		11,454
Convertible senior notes			126,500		126,500
Notes payable to related parties	200			(200)	)
Other long term liabilities		6,431	21,667		28,098
Total long term liabilities	200	6,431	159,621	(200)	) 166,052
Total shareholders' equity	228,656	7,477	60,153	(228,856)	) 67,430
	\$ 228,856	\$ 55,760	\$ 310,851	\$ (229,056)	) \$ 366,411

**Condensed Consolidating Cash Flow Statement  
For the six months ended June 30, 2007**

	Parent	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Consolidated
<b>Cash Flows from operating activities:</b>					
Net income	\$ 8,844	\$ 5,847	\$ 2,997	\$ (8,844)	) \$ 8,844
Undistributed equity in earnings of subsidiaries	(8,844)	)		8,844	
Adjustments to reconcile net income to cash provided by (used in) operating activities, net		(6,350)	) 44,338		37,988
Net cash provided by (used in) operating activities		(503)	) 47,335		46,832
<b>Cash Flows from investing activities:</b>					
Capital expenditures		(11,970)	) (29,254)		(41,224)
Proceeds from the sale of property and equipment		6,907	) 10,203		17,110
Other, net			) (2,275)		(2,275)
Net cash used in investing activities		(5,063)	) (21,326)		(26,389)
<b>Cash Flows from financing activities:</b>					
Change in borrowings, net			) (24,198)		(24,198)
Net cash used in financing activities			) (24,198)		(24,198)
Change in cash and cash equivalents		(5,566)	) 1,811		(3,755)
Cash and cash equivalents at beginning of period		8,065	38,176		46,241
Cash and cash equivalents at end of period	\$	\$ 2,499	\$ 39,987	\$	\$ 42,486



**Condensed Consolidating Cash Flow Statement**  
**For the six months ended June 30, 2006**

	Parent	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Consolidated
<b>Cash Flows from operating activities:</b>					
Net (loss) income	\$ (85,532 )	\$ (88,111 )	\$ 2,579	\$ 85,532	\$ (85,532 )
Undistributed equity in earnings of subsidiaries	85,532			(85,532 )	
Adjustments to reconcile net income to cash provided by (used in) operating activities, net		85,094	(90,756 )		(5,662 )
Net cash used in operating activities		(3,017 )	(88,177 )		(91,194 )
<b>Cash Flows from investing activities:</b>					
Capital expenditures		(6,427 )	(17,159 )		(23,586 )
Proceeds from the sale of property and equipment		3,830	7,247		11,077
Other, net		1,037	(4,041 )		(3,004 )
Net cash used in investing activities		(1,560 )	(13,953 )		(15,513 )
<b>Cash Flows from financing activities:</b>					
Change in borrowings, net			(280 )		(280 )
Proceeds from issuance of common shares, net			114,059		114,059
Net cash provided by financing activities			113,779		113,779
Change in cash and cash equivalents		(4,577 )	11,649		7,072
Cash and cash equivalents at beginning of period		7,076	9,300		16,376
Cash and cash equivalents at end of period	\$	\$ 2,499	\$ 20,949	\$	\$ 23,448

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**Item 2. Management's discussion and Analysis of Financial Conditions and Results of Operations**

**RESULTS OF OPERATIONS**

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Our reportable segments consist of our senior living community business and our rehabilitation hospital business that we began to operate in October 2006. In the senior living community segment, we operate independent living and congregate care communities, assisted living communities and nursing homes. Our rehabilitation hospital segment provides inpatient health rehabilitation services at our two hospital locations and three satellite locations and outpatient health rehabilitation services at 21 locations. We did not report our rehabilitation hospital business as a separate segment in 2006 since we only began to operate these hospitals in October 2006. We do not consider our pharmacy operations to be a significant, separately reportable segment of our business, but we report our pharmacy revenues and expense as separate items combined with our corporate and other activities. All of our operations and assets are located in the United States.

We use segment operating profit as an important measure to evaluate our performance and for decision making purposes. Segment operating profit excludes interest and other income, interest expense and certain corporate expenses.

### **Key Statistical Data (for the three months ended June 30, 2007 and 2006):**

The following tables present a summary of our operations for the three months ended June 30, 2007 and 2006:

#### **Senior living communities:**

(dollars in thousands, except per day amounts)	Three months ended June 30,		\$ Variance	Change	
	2007	2006			
Senior living revenue	\$ 200,024	\$ 182,649	\$ 17,375	10	%
Senior living wages and benefits	103,406	94,484	8,922	9	%
Other senior living operating expenses	48,406	45,794	2,612	6	%
Management fee to SLS		2,854	(2,854 )	-100	%
Termination expense for certain SLS management agreements		89,833	(89,833 )	-100	%
Rent expense	29,296	25,846	3,450	13	%
Depreciation and amortization	2,289	1,759	530	30	%
Interest expense	432	867	(435 )	-50	%
Gain on extinguishment of debt	934		934		
Senior living income from continuing operations	17,129	(78,788 )	95,917	122	%
No. of communities (end of period)	161	149	12	8	%
No. of living units (end of period)	18,007	16,618	1,389	8	%
Occupancy	89.9	% 91.0	%	-1.2	%
Average daily rate	\$ 136	\$ 133	\$ 3	2	%
Percent of senior living revenue from Medicare	16	% 15	%	1	%
Percent of senior living revenue from Medicaid	18	% 19	%	-1	%
Percent of senior living revenue from private and other sources	66	% 66	%		
Comparable communities (communities that we operated continuously since April 1, 2006):					

(dollars in thousands, except per day amounts)	Three months ended June 30,		\$ Variance	Change	
	2007	2006			
Senior living revenue	\$ 191,011	\$ 182,649	\$ 8,362	5	%
Senior living community expenses	144,504	140,278	4,226	3	%
No. of communities (end of period)	149	149			
No. of living units (end of period)	16,618	16,618			
Occupancy	90.4	% 91.0	%	-0.6	%
Average daily rate	\$ 140	\$ 133	7	5	%
Percent of senior living revenue from Medicare	16	% 15	%	1	%
Percent of senior living revenue from Medicaid	19	% 19	%		
Percent of senior living revenue from private and other sources	65	% 66	%	-1	%

Rehabilitation hospitals:

(dollars in thousands)	Three months ended June 30,		\$ Variance	Change
	2007	2006		
Hospital revenues	\$ 25,873	\$	\$ 25,873	
Hospital expenses	24,151		24,151	
Rent expense	2,562		2,562	
Depreciation and amortization	279		279	
Hospital loss from continuing operations	(1,119 )	)	(1,119 )	)

Corporate and Other (1):

(dollars in thousands)	Three months ended June 30,		\$ Variance	Change	
	2007	2006			
Pharmacy revenue	\$ 16,914	\$ 12,963	\$ 3,951	30	%
Pharmacy expenses	16,328	12,305	4,023	33	%
Depreciation and amortization	697	530	167	32	%
General and administrative (2)	10,887	8,016	2,871	36	%
Interest and other income	1,521	816	705	86	%
Interest expense	1,245	8	1,237	15,463	%
Provision for income taxes	275		275		
Corporate and Other loss from continuing operations	(10,997 )	(7,080 )	(3,917 )	-55	%

(1) Corporate and Other includes operations that we do not consider a significant, separately reportable segment of our business and income and expenses that are not attributable to a specific segment.

(2) General and administrative expenses are not attributable to a specific segment and include items such as corporate payroll and benefits and outside service expenses.

Consolidated:

(dollars in thousands)	Three months ended June 30,		\$ Variance	Change	
	2007	2006			
Summary of revenue:					
Senior living revenue	\$ 200,024	\$ 182,649	\$ 17,375	10	%
Hospital revenue	25,873		25,873		
Corporate and Other	16,914	12,963	3,951	30	%
Total revenue	242,811	195,612	47,199	24	%
Summary of income (loss) from continuing operations:					
Senior living communities	17,129	(78,788 )	95,917	122	%
Rehabilitation hospitals	(1,119 )	)	(1,119 )	)	
Corporate and Other	(10,997 )	(7,080 )	(3,917 )	-55	%
Income from continuing operations	5,013	(85,868 )	90,881	106	%

Three Months Ended June 30, 2007, Compared to Three Months Ended June 30, 2006Senior living communities:

The 10% increase in senior living revenue is due primarily to revenues from the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007 and higher per diem charges to residents, partially offset by a decrease in occupancy. The 5% increase in senior living revenue at the communities that we have operated continuously since April 1, 2006 is due primarily to higher per diem charges to residents, partially offset by a decrease in occupancy.



Our 9% increase in senior living wages and benefits costs is primarily due to wages and benefits at the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007 and wage increases. The 6% increase in other senior living operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, primarily results from the other operating expenses at the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007, and increased charges from third parties. The senior living community expenses for the senior living communities that we have operated continuously since April 1, 2006 have increased by 3%, principally due to wage and benefit increases. Management fees to SLS were eliminated due to our termination of the last of our management agreements with SLS in 2006. The 13% rent expense increase is due to the communities that we began to lease in 2006 and our payment of additional rent for senior living community capital improvements purchased by Senior Housing since January 1, 2006.

The 30% increase in depreciation and amortization expense for the three months ended June 30, 2007 is primarily attributable to our purchase of furniture and fixtures for our communities as well as the one community we acquired in April 2007.

Our interest expense decreased by 50% because in February 2007, we prepaid six HUD insured mortgages that were secured by five of our communities. We recognized a net gain of \$3.6 million on extinguishments of these mortgages that consisted of the elimination of \$4.3 million of debt premium offset by \$725,000 in prepayment penalties. In April 2007, we prepaid an additional HUD insured mortgage that was secured by one of our communities. We recognized a net gain of \$934,000 on extinguishment of this mortgage that consisted of the elimination of \$1.1 million of debt premium offset by \$116,000 in prepayment penalties. This decrease was partially offset by interest we incurred on a \$4.6 million HUD insured mortgage that we assumed in connection with the community we acquired in April 2007.

#### Rehabilitation hospitals:

The increase in hospital revenues, hospital expenses, rent expense and depreciation and amortization expense from our hospitals is a result of our beginning operations at our hospitals in October 2006. We are currently experiencing losses from our operation of our two rehabilitation hospitals, and we may be unable to operate these hospitals profitably. Also, as of July 1, 2007, the required percentage of patients at these hospitals who meet certain Medicare requirements increased, and though we believe that we are in compliance with the current requirements, the percentage of patients at these hospitals who meet these Medicare requirements may not remain as high as we currently anticipate or may decline and, as a result, these hospitals may receive lower Medicare rates than we currently anticipate.

#### Corporate and other:

The increase in revenues and expenses from our pharmacies is primarily the result of our acquiring one pharmacy in each of May 2006 and November 2006.

The 36% increase in general and administrative expenses for the three months ended June 30, 2007 over the same period in 2006 results from our acquisition of 11 communities in the third and fourth quarters of 2006, from the 17 communities we began to operate in 2006 that were previously managed for us by SLS and from the rehabilitation hospitals we began to operate in October 2006.

The 32% increase in depreciation and amortization expense for the three months ended June 30, 2007 is primarily attributable to increases in assets associated with our pharmacy acquisitions.

Our interest and other income increased by \$705,000, or 86%, for the three months ended June 30, 2007, compared to the three months ended June 30, 2006, primarily as a result of higher levels of investable cash proceeds from our convertible senior notes offering.

Our interest expense increased by \$1.2 million, due to the issuance of our convertible senior notes in October 2006.

For the quarter ended June 30, 2007, we recognized taxes of \$275,000, which includes \$218,000 of alternative minimum taxes and certain state taxes that are payable without regard to our tax loss carry forwards and \$57,000 of a deferred tax liability arising from the amortization of goodwill for tax purposes but not for book purposes.

**Key Statistical Data (for the six months ended June 30, 2007 and 2006):**

The following tables present a summary of our operations for the six months ended June 30, 2007 and 2006:

**Senior living communities:**

(dollars in thousands, except per day amounts)	Six months ended June 30,		\$ Variance	Change	
	2007	2006			
Senior living revenue	\$ 396,525	\$ 363,437	\$ 33,088	9	%
Senior living wages and benefits	204,872	185,319	19,553	11	%
Other senior living operating expenses	97,875	94,282	3,593	4	%
Management fee to SLS		6,392	(6,392 )	-100	%
Termination expense for certain SLS management agreements		89,833	(89,833 )	-100	%
Rent expense	58,898	51,453	7,445	14	%
Depreciation and amortization	4,500	3,614	886	25	%
Interest expense	969	1,510	(541 )	-36	%
Gain on extinguishment of debt	4,491		4,491		
Senior living income from continuing operations	33,902	(68,966 )	102,868	149	%
No. of communities (end of period)	161	149	12	8	%
No. of living units (end of period)	18,007	16,618	1389	8	%
Occupancy	90.1	% 91.2	%	1.1	%
Average daily rate	\$ 135	\$ 133	\$ 2	2	%
Percent of net revenues from residents from Medicare	16	% 15	%	1	%
Percent of net revenues from residents from Medicaid	18	% 19	%	-1	%
Percent of net revenues from residents from private and other sources	66	% 66	%		

Comparable communities (communities that we operated continuously since January 1, 2006):

(dollars in thousands, except per day amounts)	Six months ended June 30,		\$ Variance	Change	
	2007	2006			
Net revenues from residents	\$ 378,983	\$ 363,437	\$ 15,546	4	%
Community expenses	288,051	279,601	8,450	3	%
No. of communities (end of period)	149	149			
No. of living units (end of period)	16,618	16,618			
Occupancy	90.5	% 91.2	%	-0.7	%
Average daily rate	\$ 139	\$ 133	6	5	%
Percent of net revenues from residents from Medicare	16	% 15	%	1	%
Percent of net revenues from residents from Medicaid	19	% 19	%		
Percent of net revenues from residents from private and other sources	65	% 66	%	-1	%

**Rehabilitation hospitals:**

(dollars in thousands)	Six months ended June 30,		\$ Variance	Change	
	2007	2006			
Hospital revenues	\$ 52,643	\$	\$ 52,643		
Hospital expenses	48,407		48,407		
Rent expense	5,131		5,131		
Depreciation and amortization	496		496		
Hospital loss from continuing operations	(1,391 )		(1,391 )		

Corporate and Other (1):

(dollars in thousands)	Six months ended June 30,		\$ Variance	Change	
	2007	2006			%
Pharmacy revenue	\$ 33,162	\$ 24,217	\$ 8,945	37	%
Pharmacy expenses	32,270	22,996	9,274	40	%
Depreciation and amortization	1,448	943	505	54	%
General and administrative (2)	20,946	15,238	5,708	37	%
Interest and other income	2,586	1,140	1,446	127	%
Interest expense	2,486	123	2,363	1,921	%
Provision for income taxes	483		483		
Corporate and Other loss from continuing operations	(21,885 )	(13,943 )	(7,942 )	57	%

(1) Corporate and Other includes operations that we do not consider a significant, separately reportable segment of our business and income and expenses that are not attributable to a specific segment.

(2) General and administrative expenses are not attributable to a specific segment and include items such as corporate payroll and benefits and outside service expenses.

Consolidated:

(dollars in thousands)	Six months ended June 30,		\$ Variance	Change	
	2007	2006			%
Summary of revenue:					
Senior living revenue	\$ 396,525	\$ 363,437	\$ 33,088	9	%
Hospital revenue	52,643		52,643		
Corporate and Other	33,162	24,217	8,945	37	%
Total revenue	482,330	387,654	94,676	24	%
Summary of income (loss) from continuing operations:					
Senior living communities	33,902	(68,966 )	102,868	149	%
Rehabilitation hospitals	(1,391 )		(1,391 )		
Corporate and Other	(21,885 )	(13,943 )	(7,942 )	57	%
Income from continuing operations	10,626	(82,909 )	93,535	113	%

Six Months Ended June 30, 2007, Compared to Six Months Ended June 30, 2006

Senior living communities:

The 9% increase in senior living revenue is due primarily to revenues from the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007, and higher per diem charges to residents, partially offset by a decrease in occupancy. The 4% increase in senior living revenue at the communities that we have operated continuously since January 1, 2006 is due primarily to higher per diem charges to residents, partially offset by a decrease in occupancy.

Our 11% increase in senior living wages and benefits costs is primarily due to wages and benefits at the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007, and wage increases. The 4% increase in other senior living operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, primarily results from the other operating expenses at the 11 communities we acquired in the third and fourth quarters of 2006, the one community we acquired in April 2007, and increased charges from third parties. The senior living community expenses for the senior living communities that we have operated continuously since January 1, 2006 have increased by 3%, principally due to wage and benefit increases. Management fees to SLS were eliminated due to our termination of the last of our management agreements with SLS in 2006. The 14% rent expense increase is due to the communities that we began to lease in 2006 and our payment of additional rent for senior living community capital improvements purchased by Senior Housing since January 1, 2006.



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The 25% increase in depreciation and amortization expense for the three months ended June 30, 2007 is primarily attributable to our purchase of furniture and fixtures for our communities as well as the one community we acquired in April 2007.

Our interest expense decreased by 36% because in February 2007, we prepaid six HUD insured mortgages that were secured by five of our communities. We recognized a net gain of \$3.6 million on extinguishments of these mortgages that consists of the elimination of \$4.3 million of debt premium offset by \$725,000 in prepayment penalties. In addition, In April 2007, we prepaid one HUD insured mortgage that was secured by one of our communities. We recognized a net gain of \$934,000 on extinguishment of this mortgage that consisted of the elimination of \$1.1 million of debt premium offset by \$116,000 in prepayment penalties. This decrease was partially offset by interest we incurred on a \$4.6 million HUD insured mortgage that we assumed in connection with one community we acquired in April 2007.

### Rehabilitation hospitals:

The increase in hospital revenues, hospital expenses, rent expense and depreciation and amortization expense from our hospitals is a result of our beginning operations at our hospitals in October 2006. We are currently experiencing losses from our operation of our two rehabilitation hospitals, and we may be unable to operate these hospitals profitably. Also, as of July 1, 2007, the required percentage of patients at these hospitals who meet certain Medicare requirements increased, and though we believe that we are in compliance with the current requirements, the percentage of patients at these hospitals who meet these Medicare requirements may not remain as high as we currently anticipate or may decline and, as a result, these hospitals may receive lower Medicare rates than we currently anticipate.

### Corporate and other:

The increase in revenues and expenses from our pharmacies is primarily the result of our acquiring one pharmacy in each of May 2006 and November 2006.

The 37% increase in general and administrative expenses for the six months ended June 30, 2007 over the same period in 2006 results from our acquisition of 11 communities in the third and fourth quarters of 2006, from the 30 communities we began to operate in 2006 that were previously managed for us by SLS and from the rehabilitation hospitals we began to operate in October 2006.

The 54% increase in depreciation and amortization expense for the six months ended June 30, 2007 is primarily attributable to increases in assets associated with our pharmacy acquisitions.

Our interest and other income increased by \$1.4 million, or 127%, for the six months ended June 30, 2007, compared to the six months ended June 30, 2006, primarily as a result of higher levels of investable cash proceeds from our convertible senior notes offering.

Our interest expense increased by 2.4 million, due to the issuance of our convertible senior notes in October 2006.

For the six months ended June 30, 2007, we recognized taxes of \$483,000, which includes \$369,000 of alternative minimum taxes and certain state taxes that are payable without regard to our tax loss carry forwards and \$114,000 of a deferred tax liability arising from the amortization of goodwill for tax purposes but not for book purposes.

### LIQUIDITY AND CAPITAL RESOURCES

**Assets and Liabilities**

Our total current assets at June 30, 2007 were \$171.8 million, compared to \$205.8 million at December 31, 2006. At June 30, 2007 and December 31, 2006, we had cash and cash equivalents of \$42.5 million and \$46.2 million, respectively. Our current liabilities were \$105.6 million at June 30, 2007, compared to \$132.9 million at December 31, 2006. The decrease in both current assets and current liabilities is primarily the result of our prepayment of seven mortgages in 2007.

**Our Leases with Senior Housing**

As of August 8, 2007, we lease 142 senior living communities and two rehabilitation hospitals from Senior Housing under six leases. Our leases with Senior Housing require us to pay minimum rent of \$126.1 million annually and percentage rent for most senior living communities. In addition to the minimum rent, we paid approximately \$616,000 and \$377,000 in percentage rent to Senior Housing for the three months ended June 30, 2007 and 2006, respectively, and \$1.2 million and \$670,000 for the six months ended June 30, 2007 and 2006, respectively.

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Upon our request, Senior Housing reimburses our capital expenditures made at the communities we lease from Senior Housing and increases our rent expense pursuant to contractual formulas. Senior Housing reimbursed us \$17.1 million during the six months ended June 30, 2007 for capital expenditures made at these leased communities and increased our annual rent by \$1.7 million.

### **Our Revenues**

Our revenues from services to residents at our senior living communities are our primary source of cash to fund our operating expenses, including rent, principal and interest payments on our debt and our capital expenditures. At some of our communities, operating revenues for nursing home services are received from the Medicare and Medicaid programs. Medicare and Medicaid revenues were earned primarily at our 49 nursing homes. We derived 34% of our senior living revenue from these programs in both the three and six month periods ended June 30, 2007 and 2006, respectively.

Our Medicare net revenues from senior living community residents totaled \$61.6 million and \$53.8 million for the six months ended June 30, 2007 and 2006, respectively. In October 2006 our Medicare rates increased by approximately 3% over the prior period. Our Medicaid net revenues from senior living community residents totaled \$71.2 million and \$69.1 million for the six months ended June 30, 2007 and 2006, respectively. The Bush administration and certain members of the Senate and the House of Representatives have proposed Medicare and Medicaid policy changes and rate reductions to be phased in during the next several years. In addition, some of the states in which we operate either have not raised Medicaid rates by amounts sufficient to offset increasing costs or are expected to reduce Medicaid funding. The magnitude of the potential Medicare and Medicaid rate reductions and the impact of the failure of these programs to increase rates to match increasing expenses, as well as the magnitude of the potential Medicare and Medicaid policy changes, cannot currently be estimated, but they may be material to our operations and may affect our future results of operations.

We began to operate two rehabilitation hospitals in October 2006. Approximately 70% and 69% of our revenues from these hospitals came from the Medicare and Medicaid programs for the three and six months ended June 30, 2007, respectively. In May 2004, the Federal Centers for Medicare and Medicaid Services, or CMS, issued a rule establishing revised Medicare standards that rehabilitation hospitals are required to meet in order to participate as inpatient rehabilitation facilities, or IRFs, in the Medicare program, known as the 75% Rule. The 75% Rule is being phased in over a four year period that began on July 1, 2004. For cost reporting periods starting on and after July 1, 2006, 60% of a facility's inpatient population must require intensive rehabilitation services for one of the CMS designated medical conditions. For cost reporting periods starting on and after July 1, 2007, the requirement is 65% and for cost reporting periods starting on and after July 1, 2008, the requirement is 75%. An IRF that fails to meet the requirements of the 75% Rule is subject to reclassification as a different type of healthcare provider; and the effect of such reclassification would be to lower Medicare payment rates. As of June 30, 2007 and August 8, 2007, we believe we are in compliance with the requirements of this rule.

### **Debt Instruments and Covenants**

In June 2007, we amended our revolving line of credit. The amendment increased the line from \$25.0 million to \$40.0 million, extended the termination date to May 8, 2009 and reduced the interest rate by 25 basis points. Our revolving line of credit is available for acquisitions, working capital and general business purposes. The amount we are able to borrow at any time is subject to limitations based upon qualifying collateral. We are the borrower under this revolving credit facility and certain of our subsidiaries guarantee our obligations under the facility, which is secured by our and our guarantor subsidiaries' accounts receivable, deposit accounts and related assets. The facility contains covenants requiring us to maintain collateral, minimum net worth and certain other financial ratios, limits our ability to incur or assume debt or create liens with respect to certain of our properties and has other customary provisions. In certain circumstances and subject to available collateral and lender approvals, the maximum amounts which we may draw under this credit facility may be increased to \$80.0 million. The termination date may be extended twice, in each case by twelve months, subject to lender approval, our payment of extension fees and other conditions. As of June 30, 2007 and August 8, 2007, no amounts were outstanding under this credit facility. As of June 30, 2007 and August 8, 2007 we believe we are in compliance with all applicable covenants under this credit facility.

In October 2006, we issued \$126.5 million principal amount of 3.75% convertible senior notes. Our net proceeds from this offering were approximately \$122.6 million. These notes are convertible into our common shares at any time. The initial conversion rate, which is subject to adjustment, is 76.9231 common shares per \$1,000 principal

amount of notes, which represents an initial conversion price of \$13.00 per share. The notes are guaranteed by certain of our wholly owned subsidiaries. These notes mature on October 15, 2026; we may prepay them at anytime after October 20, 2011 and the note holders may require that we purchase all or a portion of these notes on each of October 15, 2013, October 15, 2016 and October 15, 2021. We issued these notes pursuant to an indenture which contains various customary covenants. As of June 30, 2007 and August 8, 2007, we believe we are in compliance with all applicable covenants of the indenture.

At June 30, 2007, we had five HUD insured mortgage loans totaling \$16.1 million that were secured by four properties. The weighted average interest rate on these loans was 6.6%. Payments of principal and interest are due monthly until maturities at varying dates ranging from June 2035 to July 2043. These mortgages contain standard HUD mortgage covenants. We recorded mortgage premiums in connection with some of these HUD mortgages in order to record assumed mortgages at their estimated fair value. The mortgage premiums are being amortized as a reduction of interest expense until the maturity of the mortgages. The mortgage premium balance included in mortgage notes payable as of June 30, 2007 was \$771,000.

In February 2007, we prepaid six mortgages that were secured by five of our senior living communities. We paid \$22.9 million to retire these six mortgages, which consisted of approximately \$22.2 million in principal and interest and \$725,000 in prepayment penalties. Because we had carried these mortgages at a premium to their face value, we recognized a net gain of \$3.6 million in connection with the early extinguishment of debt. In April 2007, we prepaid one mortgage that was secured by one of our communities. We paid \$5.9 million to retire this mortgage, which consisted of approximately \$5.8 million in principal and interest and \$116,000 in prepayment penalties. Because we had carried this mortgage at a premium to its face value, we recognized a net gain of \$934,000 in connection with the early extinguishment of debt.

In April 2007, we acquired a 48 unit assisted living community located in Tennessee for \$5.0 million. We financed the acquisition by assuming a \$4.6 million non recourse HUD insured mortgage and paying the balance of the purchase price with cash on hand. The interest rate on the assumed HUD insured mortgage is 7.65%.

As of June 30, 2007 and August 8, 2007, we believe we are in compliance with all covenants of our mortgages.

### **Seasonality**

Our business is subject to modest effects of seasonality. During the calendar fourth quarter holiday periods, nursing home and assisted living residents are sometimes discharged to join family celebrations and admission decisions are often deferred. The first quarter of each calendar year usually coincides with increased illness among nursing home and assisted living residents that can result in increased costs or discharges to hospitals. As a result of these factors, nursing home and assisted living operations sometimes produce greater earnings in the second and third quarters of a calendar year and lesser earnings in the first and fourth quarters. We do not believe that this seasonality will cause fluctuations in our revenues or operating cash flow to such an extent that we will have difficulty paying our expenses, including rent, which do not fluctuate seasonally.

### **Related Party Transactions**

We lease 142 of the 161 senior living communities and the two rehabilitation hospitals that we operate from Senior Housing for total annual minimum rent of \$126.1 million. In addition, we paid approximately \$616,000 and \$377,000 in percentage rent to Senior Housing for the three months ended June 30, 2007 and 2006, respectively, and approximately \$1.2 million and \$670,000 for the six months ended June 30, 2007 and 2006, respectively.

During the six months ended June 30, 2007, as permitted by our leases with Senior Housing, we sold to Senior Housing, at cost, \$17.1 million of improvements made to properties leased from Senior Housing, and the annual rent payable to Senior Housing increased by approximately \$1.7 million.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to risks associated with market changes in interest rates. We manage our exposure to this market risk by monitoring available financing alternatives. Our strategy to manage exposure to changes in interest rates remains unchanged since December 31, 2006. Other than as described below, we do not now anticipate any significant changes in our exposure to fluctuations in interest rates or in how we manage this risk in the future.



Changes in market interest rates also affect the fair value of our debt obligations; increases in market interest rates decrease the fair value of our fixed rate debt, while decreases in market interest rates increase the fair value of our fixed rate debt. For example: based upon discounted cash flow analysis, if prevailing interest rates were to decline by 10% of existing interest rates and other credit market considerations remained unchanged, the market value of our \$142.6 million mortgage debt and convertible notes outstanding on June 30, 2007, would increase by about \$5.3 million; and, similarly, if prevailing interest rates were to increase by 10% of existing interest rates, the market value of our \$142.6 million mortgage debt and convertible notes would decline by about \$4.9 million.

Our revolving credit facility bears interest at floating rates and matures in May 2009. As of June 30, 2007 and August 8, 2007, no amounts were outstanding under this credit facility. We borrow in U.S. dollars and borrowings under our revolving credit facility bear interest at LIBOR plus a premium. Accordingly, we are vulnerable to changes in U.S. dollar based short term interest rates, specifically LIBOR. A change in interest rates would not affect the value of any outstanding floating rate debt but could affect our operating results. For example, if the maximum amount of \$40.0 million were drawn under our credit facility and interest rates decreased or increased by 1% per annum, our interest expense would decrease or increase by \$400,000 per year, or \$0.01 per share, based on our currently outstanding common shares. If interest rates were to change gradually over time, the impact would occur over time.

Our exposure to fluctuations in interest rates may increase in the future if we incur debt to fund acquisitions or otherwise.

#### **Item 4. Controls and Procedures**

As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of our President and Chief Executive Officer and our Treasurer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15(e). Based upon that evaluation, our President and Chief Executive Officer and our Treasurer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

There have been no changes in our internal control over financial reporting during the quarter ended June 30, 2007, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**WARNING CONCERNING FORWARD LOOKING STATEMENTS**

THIS QUARTERLY REPORT CONTAINS STATEMENTS WHICH CONSTITUTE FORWARD LOOKING STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND OTHER FEDERAL SECURITIES LAWS. ALSO, WHENEVER WE USE WORDS SUCH AS BELIEVE , EXPECT , ANTICIPATE , INTEND , PLAN , ESTIMATE OR SIMILAR EXPRESSIONS, WE ARE MAKING FORWARD LOOKING STATEMENTS. THESE FORWARD LOOKING STATEMENTS ARE BASED UPON OUR PRESENT INTENT, BELIEFS OR EXPECTATIONS, BUT FORWARD LOOKING STATEMENTS ARE NOT GUARANTEED TO OCCUR AND MAY NOT OCCUR. ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE CONTAINED IN OR IMPLIED BY OUR FORWARD LOOKING STATEMENTS AS A RESULT OF VARIOUS FACTORS.

IMPORTANT FACTORS THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE IN OUR FORWARD LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION:

- WE ARE CURRENTLY EXPERIENCING LOSSES FROM OUR OPERATION OF OUR TWO REHABILITATION HOSPITALS, AND WE MAY BE UNABLE TO OPERATE THESE HOSPITALS PROFITABLY. ALSO, AS OF JULY 1, 2007, THE REQUIRED PERCENTAGE OF PATIENTS AT THESE HOSPITALS WHO MEET CERTAIN MEDICARE REQUIREMENTS INCREASED, AND THOUGH WE BELIEVE THAT WE ARE IN COMPLIANCE WITH THE CURRENT REQUIREMENTS, THE PERCENTAGE OF PATIENTS AT THESE HOSPITALS WHO MEET THESE MEDICARE REQUIREMENTS MAY NOT REMAIN AS HIGH AS WE CURRENTLY ANTICIPATE OR MAY DECLINE AND, AS A RESULT, THESE HOSPITALS MAY RECEIVE LOWER MEDICARE RATES THAN WE CURRENTLY ANTICIPATE.
- OTHER RISKS MAY ADVERSELY IMPACT US, AS DESCRIBED MORE FULLY UNDER ITEM 1A. RISK FACTORS IN OUR ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2006.

YOU SHOULD NOT PLACE UNDUE RELIANCE UPON FORWARD LOOKING STATEMENTS.

EXCEPT AS REQUIRED BY LAW, WE UNDERTAKE NO OBLIGATION TO UPDATE OR REVISE ANY FORWARD LOOKING STATEMENTS AS A RESULT OF NEW INFORMATION, FUTURE EVENTS OR OTHERWISE.

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**Part II. Other Information**

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On May 15, 2007, we granted 4,000 shares of common stock, par value \$0.01 per share, valued at \$7.86 per share, the closing price of our common shares on the American Stock Exchange on that day, to each of our five directors as part of their annual compensation. We made these grants pursuant to the exemption from registration contained in Section 4(2) of the Securities Act of 1933, as amended.

**Item 4. Submission of Matters to a Vote of Security Holders**

At our regular annual meeting of shareholders held on May 15, 2007, our shareholders re-elected Bruce M. Gans, M.D. (28,326,150 shares voted in favor and 938,365 shares withheld) as director. The term of office of Dr. Gans will extend until our annual meeting of shareholders in 2010. Ms. Barbara D. Gilmore, Messrs. Barry M. Portnoy Arthur G. Koumantzelis and Gerard Martin continue to serve as directors with terms of office expiring in 2008, 2008, 2009 and 2009, respectively.

**Item 6. Exhibits**

- 10.1 Fifth Amendment to Credit and Security Agreement, dated as of June 18, 2007, by and among Five Star Quality Care, Inc., each of the Guarantors party thereto and Wachovia Bank, National Association. *(Incorporated by reference to the Company's Current Report on Form 8-K dated June 20, 2007.)*
- 31.1 Rule 13a-14(a) Certification of Chief Executive Officer. *(Filed herewith.)*
- 31.2 Rule 13a-14(a) Certification of Chief Financial Officer. *(Filed herewith.)*
- 32.1 Section 1350 Certification of Chief Executive Officer and Chief Financial Officer. *(Furnished herewith.)*

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**SIGNATURES**

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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.

FIVE STAR QUALITY CARE, INC.

/s/ Everett W. Benton  
Evrett W. Benton  
President and Chief Executive Officer  
Dated: August 9, 2007

/s/ Bruce J. Mackey Jr.  
Bruce J. Mackey Jr.  
Treasurer and Chief Financial Officer  
(Principal Financial Officer)  
Dated: August 9, 2007

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