FIVE STAR QUALITY CARE INC
Form 10-Q
November 10, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008

OR

o	**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	**04-3516029**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

400 Centre Street, Newton, Massachusetts 02458

(Address of Principal Executive Offices) (Zip Code)

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 x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filed , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Yes o No x

Number of registrants shares of common stock, $0.01 par value outstanding as of November 6, 2008: 31,847,004.

Table of Contents

FIVE STAR QUALITY CARE, INC.

FORM 10-Q

SEPTEMBER 30, 2008

INDEX

Page

PART I	**Financial Information**	
Item 1.	Condensed Consolidated Financial Statements (unaudited)	
	Condensed Consolidated Balance Sheet September 30, 2008 and December 31, 2007	1
	Condensed Consolidated Statement of Operations Three and Nine Months Ended September 30, 2008 and 2007	2
	Condensed Consolidated Statement of Cash Flows Nine Months Ended September 30, 2008 and 2007	3
	Notes to Condensed Consolidated Financial Statements	4
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	29
Item 4.	Controls and Procedures	29
	Warning Concerning Forward Looking Statements	30
PART II	Other Information	
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	31
Item 5.	Other Information	31
Item 6.	Exhibits	40
	Signatures	41

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.

Table of Contents

Part I. Financial Information

Item 1. Condensed Consolidated Financial Statements

FIVE STAR QUALITY CARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(in thousands, except share data)

(unaudited)

		September 30, 2008		December 31, 2007
ASSETS				
Current assets:				
Cash and cash equivalents	$	39,972	$	30,999
Accounts receivable, net of allowance of $5,998 and $4,836 at September 30, 2008 and December 31, 2007, respectively		58,035		58,803
Prepaid expenses		6,644		9,041
Investment securities:				
Investments in trading securities				61,800
Investments in available for sale securities		7,141		7,455
Restricted cash		4,104		3,655
Restricted investments		2,472		3,946
Other current assets		11,036		7,140
Assets of discontinued operations		2,020		3,178
Total current assets		131,424		186,017
Property and equipment, net		152,047		131,705
Investments in trading securities		68,751		
Restricted cash		3,184		2,568
Restricted investments		6,869		10,375
Goodwill and other intangible assets		22,505		21,877
Other long term assets		4,740		7,912
	$	389,520	$	360,454
LIABILITIES AND SHAREHOLDERS EQUITY				
Current liabilities:				
Accounts payable	$	19,285	$	19,135
Accrued expenses		18,135		15,222
Accrued compensation and benefits		42,587		30,103
Due to Senior Housing Properties Trust		14,690		11,242
Mortgage notes payable		146		200
Accrued real estate taxes		11,225		7,352
Security deposit liability		12,695		13,361
Other current liabilities		8,314		7,229
Liabilities of discontinued operations		415		219

Total current liabilities		127,492		104,063
Long term liabilities:				
Mortgage notes payable		12,479		15,810
Convertible senior notes		126,500		126,500
Continuing care contracts		2,816		3,159
Other long term liabilities		34,029		24,100
Total long term liabilities		175,824		169,569
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, 31,847,004 and 31,818,144 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively		318		318
Additional paid-in capital		287,071		286,734
Accumulated deficit		(193,253)		(196,109)
Unrealized loss on investments		(7,932)		(4,121)
Total shareholders equity		86,204		86,822
	$	389,520	$	360,454

See accompanying notes.

Table of Contents

FIVE STAR QUALITY CARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three months ended September 30, 2008	Three months ended September 30, 2007	Nine months ended September 30, 2008	Nine months ended September 30, 2007
Revenues:				
Senior living revenue	$ 241,190	$ 203,656	$ 686,559	$ 601,319
Hospital revenue	23,938	25,361	73,103	76,711
Pharmacy revenue	16,814	15,581	52,301	43,734
Total revenues	281,942	244,598	811,963	721,764
Operating expenses:				
Senior living wages and benefits	120,704	100,659	341,593	306,497
Other senior living operating expenses	61,228	50,988	173,317	149,399
Hospital expenses	22,332	22,588	67,539	69,585
Pharmacy expenses	17,368	14,722	50,918	41,835
Rent expense	41,745	32,507	116,464	96,737
General and administrative	11,948	10,757	34,803	31,703
Depreciation and amortization	3,691	3,551	10,973	9,940
Total operating expenses	279,016	235,772	795,607	705,696
Operating income	2,926	8,826	16,356	16,068
Interest and other income	1,071	1,511	4,867	4,343
Interest expense	(1,696)	(1,464)	(4,890)	(4,919)
Unrealized loss on investments in trading securities	(1,733)		(6,099)	
Impairment on investments in available for sale securities	(3,019)		(3,019)	
Gain on extinguishment of debt	743		743	4,491
Income (loss) from continuing operations before income taxes	(1,708)	8,873	7,958	19,983
(Provision) benefit for income taxes	90	(277)	(920)	(760)
Income (loss) from continuing operations	(1,618)	8,596	7,038	19,223
Loss from discontinued operations	(632)	(835)	(4,182)	(2,619)
Net income (loss)	$ (2,250)	$ 7,761	$ 2,856	$ 16,604
Weighted average shares outstanding - basic	31,845	31,705	31,832	31,694
Weighted average shares outstanding - diluted	31,845	41,436	31,832	41,425
Basic (loss) income per share from:				
Continuing operations	$ (0.05)	$ 0.27	$ 0.22	$ 0.61
Discontinued operations	(0.02)	(0.03)	(0.13)	(0.09)
Net (loss) income per share	$ (0.07)	$ 0.24	$ 0.09	$ 0.52
Diluted (loss) income per share from:				

Continuing operations	$	(0.05)	$	0.24	$	0.22	$	0.55
Discontinued operations		(0.02)		(0.02)		(0.13)		(0.06)
Net (loss) income per share	$	(0.07)	$	0.22	$	0.09	$	0.49

See accompanying notes.

Table of Contents

FIVE STAR QUALITY CARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

(unaudited)

	Nine months ended September 30, 2008	2007
Cash flows from operating activities:		
Net income	$ 2,856	$ 16,604
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	10,973	9,940
Gain on extinguishment of debt	(743)	(4,491)
Loss from discontinued operations	4,182	2,619
Unrealized loss on investments in trading securities	6,099	
Impairment on investments in available for sale securities	3,019	
Provision for losses on receivables, net	1,162	1,158
Changes in assets and liabilities:		
Accounts receivable	(103)	8,001
Prepaid expenses and other assets	1,802	9,942
Investment securities	(12,736)	(27,038)
Accounts payable and accrued expenses	(234)	(4,893)
Accrued compensation and benefits	12,484	10,477
Due to Senior Housing Properties Trust	3,448	985
Other current and long term liabilities	12,578	2,931
Cash provided by operating activities	44,787	26,235
Net cash used in discontinued operations	(1,016)	(2,535)
Cash flows from investing activities:		
Payments (deposits) into restricted cash and investment accounts, net	(2,578)	1,757
Acquisition of property and equipment	(53,493)	(56,128)
Acquisition of senior living communities	(21,350)	
Assumption of net working capital deficit (exclusive of cash) of acquired senior living communities	3,204	
Proceeds from disposition of property and equipment held for sale	42,061	33,077
Cash used in investing activities	(32,156)	(21,294)
Cash flows from financing activities:		
Repayments of mortgage notes payable	(2,642)	(28,772)
Cash used in financing activities	(2,642)	(28,772)
Change in cash and cash equivalents	8,973	(26,366)
Cash and cash equivalents at beginning of period	30,999	46,241
Cash and cash equivalents at end of period	$ 39,972	$ 19,875
Supplemental cash flow information:		
Cash paid for interest	$ 2,879	$ 4,491
Cash paid for income taxes	$ 2,117	$ 516

Non-cash investing and financing activities:				
Issuance of common stock	$	337	$	187
Real estate acquisition	$		$	5,025
Assumption of mortgage note payable	$		$	4,559

See accompanying notes.

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

(unaudited)

Note 1. Basis of Presentation and Organization

The accompanying condensed consolidated financial statements of Five Star Quality Care, Inc. and its subsidiaries have been prepared without audit. 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, 2007. In the opinion of our management, all adjustments, which include only normal recurring adjustments, considered necessary for a fair presentation have been included. All material 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 September 30, 2008, we leased, owned or operated 202 senior living communities containing 21,340 living units, including 153 primarily independent and assisted living communities with 16,930 living units and 49 skilled nursing facilities with 4,410 beds. Of our 153 primarily independent and assisted living communities, we leased 133 communities containing 15,427 living units from Senior Housing Properties Trust, or Senior Housing, our former parent, and we owned or leased from parties other than Senior Housing 20 communities with 1,503 living units. We leased 47 of our 49 skilled nursing facilities from Senior Housing. Our 202 communities include 6,017 independent living apartments, 9,112 assisted living suites and 6,211 skilled nursing beds. We also operated six institutional pharmacies, one of which provides mail order pharmaceuticals to the general public, and two rehabilitation hospitals that we leased from Senior Housing. Our two rehabilitation hospitals had 321 beds available for inpatient services, three satellite locations and 18 affiliated outpatient clinics. Included in the above counts are two assisted living communities containing 173 living units and two pharmacies which have previously been reclassified to discontinued operations.

Note 2. New Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board, or the FASB, issued Statement of Financial Accounting Standards No. 141 (revised 2007), Business Combinations , or SFAS No. 141(R). SFAS No. 141(R) establishes principles and requirements for how the acquirer shall recognize and measure in its financial statements the identifiable assets acquired, liabilities assumed, any noncontrolling interest in the acquiree and goodwill acquired in a business combination. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008.

In May 2008, the FASB issued FASB Staff Position APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) , or FSP 14-1. FSP 14-1 requires the issuer of certain convertible debt instruments that may be settled in cash (or other assets) on conversion to separately account for the liability and equity components of the instrument in a manner that is intended to reflect the issuer s nonconvertible debt borrowing rate. FSP 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years and does not permit earlier application. We are currently evaluating the effect that the adoption of FSP 14-1 will have on our consolidated financial statements.

Note 3. Property and Equipment

Property and equipment, at cost, consists of the following at:

	September 30, 2008	December 31, 2007
Land	$ 9,500	$ 7,196
Buildings and improvements	121,267	99,945
Furniture, fixtures and equipment	60,233	55,660
	191,000	162,801
Accumulated depreciation	(38,953)	(31,096)
	$ 152,047	$ 131,705

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

(unaudited)

As of September 30, 2008 and December 31, 2007, we had assets classified as held for sale of $26,798 and $25,222, respectively, included in our property and equipment that we intend to sell to Senior Housing as permitted by our leases.

Note 4. Comprehensive Income (Loss)

Comprehensive income (loss) for the three and nine months ended September 30, 2008 and 2007 is summarized below:

	Three months ended September 30,				Nine months ended September 30,			
	2008		2007		2008		2007	
Net income (loss)	$	(2,250)	$	7,761	$	2,856	$	16,604
Unrealized loss on investments		(3,188)		(1,011)		(3,811)		(1,904)
Comprehensive (loss) income	$	(5,438)	$	6,750	$	(955)	$	14,700

Note 5. Financial Data By Segment

Our reportable segments consist of our senior living community business and our rehabilitation hospital business. In the senior living community segment, we operate independent living and congregate care communities, assisted living communities and skilled nursing facilities. Our rehabilitation hospital segment provides inpatient medical rehabilitation services at two hospital locations and three satellite locations and outpatient medical rehabilitation services at 18 affiliated outpatient clinics. 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 within our corporate and other activities. All of our operations and assets are located in the United States except with regard to our two captive insurance companies which participate in our liability insurance programs and are located outside the United States in Bermuda and the Cayman Islands.

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

Our revenues by segment, and a reconciliation of segment operating profit to income (loss) from continuing operations before income taxes for the three and nine months ended September 30, 2008 and 2007 are as follows:

	Senior Living Communities	Rehabilitation Hospitals	Corporate and Other (1)	Total
Three months ended September 30, 2008				
Revenues	$ 241,190	$ 23,938	$ 16,814	$ 281,942
Segment expenses:				
Operating expenses	181,932	22,332	17,368	221,632
Rent expense	39,055	2,690		41,745
Depreciation and amortization	2,483	314	894	3,691
Total segment expenses	223,470	25,336	18,262	267,068
Segment operating profit (loss)	17,720	(1,398)	(1,448)	14,874
General and administrative expenses (2)			(11,948)	(11,948)
Operating income (loss)	17,720	(1,398)	(13,396)	2,926
Interest and other income	417		654	1,071
Interest expense	(359)		(1,337)	(1,696)
Unrealized loss on investments in trading securities			(1,733)	(1,733)
Impairment on investments in available for sale securities	(3,019)			(3,019)
Gain on extinguishment of debt	743			743
Provision for income taxes			90	90
Income (loss) from continuing operations	$ 15,502	$ (1,398)	$ (15,722)	$ (1,618)
Total Assets as of September 30, 2008	$ 262,762	$ 19,574	$ 107,184	$ 389,520

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

(unaudited)

	Senior Living Communities	Rehabilitation Hospitals	Corporate and Other (1)	Total
Three months ended September 30, 2007				
Revenues	$ 203,656	$ 25,361	$ 15,581	$ 244,598
Segment expenses:				
Operating expenses	151,647	22,588	14,722	188,957
Rent expense	29,943	2,564		32,507
Depreciation and amortization	2,405	294	852	3,551
Total segment expenses	183,995	25,446	15,574	225,015
Segment operating profit (loss)	19,661	(85)	7	19,583
General and administrative expenses (2)			(10,757)	(10,757)
Operating profit (loss)	19,661	(85)	(10,750)	8,826
Interest and other income	463		1,048	1,511
Interest expense	(279)		(1,185)	(1,464)
Provision for income taxes			(277)	(277)
Income (loss) from continuing operations	$ 19,845	$ (85)	$ (11,164)	$ 8,596
Total Assets as of September 30, 2007	$ 231,384	$ 21,845	$ 108,866	$ 362,095
Nine months ended September 30, 2008				
Revenues	$ 686,559	$ 73,103	$ 52,301	$ 811,963
Segment expenses:				
Operating expenses	514,910	67,539	50,918	633,367
Rent expense	108,443	8,021		116,464
Depreciation and amortization	7,370	931	2,672	10,973
Total segment expenses	630,723	76,491	53,590	760,804
Segment operating profit (loss)	55,836	(3,388)	(1,289)	51,159
General and administrative expenses (2)			(34,803)	(34,803)
Operating income (loss)	55,836	(3,388)	(36,092)	16,356
Interest and other income	2,194		2,673	4,867
Interest expense	(992)		(3,898)	(4,890)
Unrealized loss on investments in trading securities			(6,099)	(6,099)
Impairment on investments in available for sale securities	(3,019)			(3,019)
Gain on extinguishment of debt	743			743
Provision for income taxes			(920)	(920)
Income (loss) from continuing operations	$ 54,762	$ (3,388)	$ (44,336)	$ 7,038

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

(unaudited)

Nine months ended September 30, 2007				
Revenues	$ 601,319	$ 76,711	$ 43,734	$ 721,764
Segment expenses:				
Operating expenses	455,896	69,585	41,835	567,316
Rent expense	89,042	7,695		96,737
Depreciation and amortization	6,926	787	2,227	9,940
Total segment expenses	551,864	78,067	44,062	673,993
Segment operating profit (loss)	49,455	(1,356)	(328)	47,771
General and administrative expenses (2)			(31,703)	(31,703)
Operating income (loss)	49,455	(1,356)	(32,031)	16,068
Interest and other income	1,244		3,099	4,343
Interest expense	(935)		(3,984)	(4,919)
Gain on extinguishment of debt	4,491			4,491
Provision for income taxes			(760)	(760)
Income (loss) from continuing operations	$ 54,255	$ (1,356)	$ (33,676)	$ 19,223

(1) Corporate and Other includes operations that we do not consider significant, separately reportable segments of our business, as well as 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 supporting home office activities.

Note 6. Income Taxes

Because we have previously 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, which begin to expire in 2023 if unused, are subject to audit and adjustments by the Internal Revenue Service.

For the nine months ended September 30, 2008, we recognized tax expenses of $920, which include (i) a tax benefit of $351 related to prior year refunds resulting from the application of tax credits that offset federal alternative minimum taxes, (ii) $1,088 of state taxes that are payable without regard to our tax loss carry forwards, and (iii) $183 related to 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 7. Income (Loss) Per Share

Basic income (loss) per share for the periods ended September 30, 2008 and 2007 are computed using the weighted average number of shares outstanding during those periods. Diluted income per share for the nine months ended September 30, 2008 reflect 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 upon conversion of our 3.75% convertible senior notes, or the Notes (See Note 11). The following table provides a reconciliation of both income (loss) and the number of common shares, in thousands, used in the computations of diluted income (loss) per share. The effect of conversion of our Notes on income (loss) from continuing and discontinued operations per share is anti-dilutive for the three and nine months ended September 30, 2008. The effect of conversion of our Notes on income (loss) from continuing operations per share also is anti-dilutive for the three and nine months ended September 30, 2007.

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

(unaudited)

	Three Months Ended September 30,					
	2008			2007		
	Income (loss)	Shares (in 000 s)	Per Share	Income (loss)	Shares (in 000 s)	Per Share
Income (loss) from continuing operations	$ (1,618)	31,845	$ (0.05)	$ 8,596	31,705	$ 0.27
Conversion of the Notes				1,238	9,731	
Diluted income (loss) from continuing operations	$ (1,618)	31,845	$ (0.05)	$ 9,834	41,436	$ 0.24
Diluted loss from discontinued operations	$ (632)	31,845	$ (0.02)	$ (835)	41,436	$ (0.02)

	Nine months Ended September 30,					
	2008			2007		
	Income (loss)	Shares (in 000 s)	Per Share	Income (loss)	Shares (in 000 s)	Per Share
Income from continuing operations	$ 7,038	31,832	$ 0.22	$ 19,223	31,694	$ 0.61
Conversion of the Notes				3,719	9,731	
Diluted income from continuing operations	$ 7,038	31,832	$ 0.22	$ 22,942	41,425	$ 0.55
Diluted loss from discontinued operations	$ (4,182)	31,832	$ (0.13)	$ (2,619)	41,425	$ (0.06)

Note 8. Fair Values of Assets and Liabilities

As required, we adopted SFAS 157 effective January 1, 2008 for assets and liabilities we measure on a recurring basis. Although the adoption of SFAS 157 did not materially impact our financial condition, results of operations, or cash flow, we are now required to provide additional disclosures as part of our financial statements. We measure fair value at the price that would be received upon sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 prioritizes the assumptions that market participants would use in pricing the asset or liability, or the inputs, into three broad levels. This fair value hierarchy gives the highest priority, or Level 1, to quoted prices in active markets for identical assets or liabilities and the lowest priority, or Level 3, to assumptions that are unobservable. Observable inputs that do not meet the criteria of Level 1, and include quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets and liabilities in markets that are not active, are categorized as Level 2. Level 3 inputs are those that reflect our own assumptions about the assumptions market participants would use in pricing the asset or liability, based on what we believe is the best information available in the circumstances. Valuation techniques for assets and liabilities measured using Level 3 inputs may include methodologies such as the market approach, the income approach or the cost approach, and may use unobservable inputs such as projections, estimates and management s interpretation of current market data. These unobservable inputs are only utilized to the extent that observable inputs are not available, or which we believe are not available without expenditures that we have determined not to incur.

The table below presents the assets and liabilities measured at fair value on a recurring basis at September 30, 2008 categorized by the level of inputs used in the valuation of each asset.

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

(unaudited)

Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Long lived assets held for sale (1)	$ 26,798	$ 26,798	$	$
Investments in trading securities (2)	68,751			68,751
Investments in available for sale securities (3)	16,482	16,482		
Total assets	$ 112,031	$ 43,280	$	$ 68,751

(1) Long lived assets held for sale consist of property and equipment we expect to sell to Senior Housing as permitted by our leases and are reported at fair value utilizing Level 1 inputs. We determined that these asset costs approximate fair value since we have either recently acquired the assets or the assets are part of ongoing construction projects and we expect to sell these assets to Senior Housing at their recorded value.

(2) Our investments in trading securities consist of auction rate securities, which are primarily bonds issued by various entities to fund student loans pursuant to the Federal Family Education Loan Program. Due to events in the credit markets, auctions for our auction rate securities failed during the first quarter of 2008 and there is currently no market, or a very illiquid market, in which we might sell these securities. We therefore report our auction rate securities at fair value utilizing Level 3 inputs. We measured the fair value of these securities by reference to a statement provided by our broker that was calculated with the assistance of a valuation model. This model considered, among other items, the collateral underlying the investments, the creditworthiness of the counterparty, the timing of expected future cash flows including possible refinancing of the securities and a determination of the appropriate discount rate. The analysis also included a comparison, when possible, to other observable market data with characteristics similar to our auction rate securities. We reviewed the components of, and calculations made under, our broker s model. Due to the declines in fair value for our auction rate securities during the nine months ended September 30, 2008, we have recorded an unrealized loss of $6,099.

On March 31, 2008, we reclassified our auction rate securities from current to non-current investments due to our belief that the market for student loan collateralized instruments may take in excess of twelve months to recover.

(3) Investments in available for sale securities consist of preferred securities and variable rate demand obligations and are reported in our balance sheet as current investments in available for sale securities of $7,141, current restricted investments of $2,472 and long term restricted investments of $6,869. These securities are carried at fair value utilizing Level 1 inputs based on quoted market prices with changes in fair value recorded in other comprehensive income. When a change in fair value is deemed temporary, we record a corresponding credit or charge to other comprehensive income for any unrealized gains or losses. If we determine that any future valuation adjustment was other than temporary, we would record a charge to earnings. During the three months ended September 30, 2008, we have recorded an other than temporary loss of $3,019, due to several notable bankruptcies and government actions involving the companies that issued the securities we hold.

Based on market conditions, our valuation methodology for investments in trading securities and investments in available for sale securities changed. Accordingly, these securities changed from Level 1 to Level 3 within SFAS 157 s hierarchy. The table below presents the change in fair value measurements that used Level 3 inputs during the three and nine months ended September 30, 2008:

		Investments in trading securities
Balance at January 1, 2008	$	
Transfers into Level 3		74,850
Change in value recognized in earnings		(3,270)
Balance at March 31, 2008		71,580
Change in value recognized in earnings		(1,096)
Balance at June 30, 2008		70,484
Transfers into Level 3		
Change in value recognized in earnings		(1,733)
Balance at September 30, 2008	$	68,751

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

(unaudited)

Note 9. Line of Credit

We have a $40,000 revolving bank credit facility for general business purposes, including acquisitions and working capital, which is currently scheduled to expire in May 2009. The amount we are able to borrow at any time is subject to limitation 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; this facility also places limits on our ability to incur or assume debt or create liens with respect to certain of our assets and has other customary provisions. In certain circumstances and subject to available collateral and lender approvals, the maximum amount which we may borrow under this credit facility may be increased to $80,000. The termination date of this facility may be extended twice, in each case by twelve months upon our payment of extension fees and other conditions, including lender s approvals. As of September 30, 2008 and November 6, 2008, no amounts were outstanding under this credit facility. As of September 30, 2008 and November 6, 2008, we believe we were and are in compliance with all applicable covenants under this credit facility. Interest expense and other associated costs related to this facility were $85 and $0 for the three months ended September 30, 2008 and 2007, respectively, and $168 and $318 for the nine months ended September 30, 2008 and 2007, respectively.

Note 10. Mortgages Payable

At September 30, 2008, three of our communities were encumbered by United States Department of Housing and Urban Development, or HUD, insured mortgages totaling $12,625. The weighted average interest rate on these loans was 6.2%. 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.

In September 2008, we prepaid two HUD mortgages that were secured by one of our senior living communities. We paid $2,393 in principal and interest to retire these two mortgages, and no prepayment penalty was required. Because we had recorded these mortgages at a premium to their face value under applicable accounting rules, we recognized a net gain of $743 in connection with this early extinguishment of debt. Mortgage interest expense, including premium amortization, was $245 and $226 for the three months ended September 30, 2008 and 2007, respectively, and $724 and $882 for the nine months ended September 30, 2008 and 2007, respectively.

Note 11. Convertible Senior Notes due 2026

In October 2006, we issued $126,500 principal amount of Convertible Senior Notes due in 2026. 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 $1,252 and $1,238 for the three months ended September 30, 2008 and 2007, respectively, and $3,730 and $3,719 for the nine months ended September 30, 2008 and 2007, respectively. The Notes are guaranteed by certain of our domestic wholly owned subsidiaries (see Note 14). These Notes mature on October 15, 2026; we may prepay the Notes 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 September 30, 2008 and November 6, 2008, we believe we are in compliance with all applicable covenants of this indenture.

Note 12. Related Person Transactions

We lease 180 of our 202 senior living communities and the two rehabilitation hospitals that we operated on September 30, 2008 from Senior Housing for total annual minimum rent of $168,188. In addition to the minimum rent, we paid $794 and $877 in percentage rent to Senior Housing for the three months ended September 30, 2008 and 2007, respectively, and $2,691 and $1,896 for the nine months ended September 30, 2008 and 2007, respectively.

Included in the 180 communities we lease from Senior Housing are 19 senior living communities with 1,743 units which Senior Housing acquired and we began to operate during the first quarter of 2008. Twenty-one of these communities are assisted living communities (one of which offers some skilled nursing services and one of which

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

(unaudited)

offers some independent living services) and one is a continuing care retirement community which offers independent living, assisted living and skilled nursing services. Our rent payable to Senior Housing for these 19 communities is $21,790 per year, plus future increases calculated as a percentage of the revenue increases for all of these communities after 2009. We added nine of these communities to one of our existing leases with Senior Housing which has a term ending in 2022, with renewal options thereafter. We added the remaining 10 of these communities to another existing lease with Senior Housing which has a term ending in 2024, with renewal options thereafter.

On June 30, 2008, we and Senior Housing realigned our three principal combination leases. The aggregate rent payable by us to Senior Housing is unchanged as a result of this lease realignment. Rent expense for future sales of property improvements to Senior Housing, if and as Senior Housing purchases improvements to the leased properties, will be set at the greater of 8.0% per annum or the 10 year Treasury rate plus 300 basis points.

Included in the 180 senior living communities we lease from Senior Housing are seven assisted living communities located in Pennsylvania and New Jersey that were previously operated by NewSeasons Assisted Living Communities, Inc., or NewSeasons , under leases from Senior Housing. We began to lease these communities in July, 2008. In consideration of our lease assumption, NewSeasons paid us $10,000 and transferred title to certain personal property located at the communities. We have recorded this lease concession as a deferred credit on our balance sheet, which will be amortized as a reduction or rent expense over the remaining lease term. Simultaneously with our leasing these seven communities from Senior Housing, we purchased three other NewSeasons communities from Senior Housing with 278 units located in Pennsylvania and New Jersey for $21,350. We allocated the purchase price of these communities to land, building and equipment. The purchase price of these properties was equal to the seller s net book value which reflected the fair market value of these properties, based on appraisals by an independent appraiser. The remaining seven communities with 716 units are leased from Senior Housing for annual rent of approximately $7,600 per year. These ten communities complement our business strategy of focusing our operations in high quality senior living assets where residents pay for our services with private resources. All of the revenues of these communities come from residents private resources.

On August 1, 2008, we leased from Senior Housing two assisted living communities with a total of 112 living units which Senior Housing purchased from an unrelated party. Our rent payable to Senior Housing for these two communities is $1,200 per year, plus future increases calculated as a percentage of the revenue increase at these communities after 2010. We added these communities to our existing lease with Senior Housing which has a term ending in 2024, with renewal options thereafter. In addition, we purchased land adjacent to one of these communities for $890 for future development.

On September 1, 2008, we leased from Senior Housing eight independent living communities with a total of 451 living units which Senior Housing purchased from an unrelated party. Our rent payable to Senior Housing for these eight communities is $4,981 per year, plus future increases calculated as a percentage of the revenue increase at these communities after 2010. We added these communities to our existing lease with Senior Housing which has a term ending in 2024, with renewal options thereafter.

During the nine months ended September 30, 2008, as permitted by our leases with Senior Housing, we sold to Senior Housing, at cost, $42,061 of improvements made to properties leased from Senior Housing, and our annual rent payable to Senior Housing increased by $3,620.

Note 13. 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, in accordance with the terms of our lease with Senior Housing. In December 2007, we decided to sell one institutional pharmacy located in California and our mail order pharmacy located in Nebraska. As of September 30, 2008, we have disposed of substantially all of our assets and liabilities related to the assisted living communities which we expect to sell. The assets and liabilities related to the two pharmacies that we expect to sell are presented separately in the consolidated balance sheet. We have reclassified

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

(unaudited)

the consolidated statement of income for all periods presented to show the results of operations of the communities and pharmacies which have been sold or are expected to be sold as discontinued. Below is a summary of the operating results of these discontinued operations included in the financial statements for the three and nine months ended September 30, 2008 and 2007:

	Three months ended September 30, 2008	Three months ended September 30, 2007	Nine months ended September 30, 2008	Nine months ended September 30, 2007
Revenues	$ 2,866	$ 3,276	$ 8,860	$ 9,815
Expenses	(3,498)	(4,111)	(13,042)	(12,434)
Net loss	$ (632)	$ (835)	$ (4,182)	$ (2,619)

Note 14. Guarantor Financial Information

Our Notes are guaranteed by certain of our domestic wholly owned subsidiaries. These guarantees are full, unconditional and joint and several. Condensed consolidating financial information related to us, our guarantor subsidiaries and our non-guarantor subsidiaries for all periods presented are stated below:

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

For the Three Months Ended September 30, 2008

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenues:					
Senior living revenue	$	$ 88,374	$ 152,816	$	$ 241,190
Hospital revenue			23,938		23,938
Pharmacy revenue			16,814		16,814
Total revenues		88,374	193,568		281,942
Operating expenses:					
Senior living wages and benefits		38,383	82,321		120,704
Other senior living operating expenses		22,991	38,237		61,228
Hospital expenses			22,332		22,332
Pharmacy expenses			17,368		17,368

Rent expense	17,457	24,288	41,745
General and administrative expenses		11,948	11,948
Depreciation and amortization	1,135	2,556	3,691
Total operating expenses	79,966	199,050	279,016
Operating income	8,408	(5,482)	