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FIVE STAR QUALITY CARE INC

Form 8-K/A

January 09, 2003

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 8-K/A

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

Date of Report (Date of earliest event reported): October 25, 2002

FIVE STAR QUALITY CARE, INC.
(Exact name of registrant as specified in charter)

| | | |
|--|-----------------------------|--|
| Maryland | 001-16817 | 04-3516029 |
| State or other jurisdiction of incorporation) | (Commission file number) | (I.R.S. employer identification number) |

| | |
|--|------------|
| 400 Centre Street, Newton, Massachusetts | 02458 |
| (Address of principal executive offices) | (Zip code) |

Registrant's telephone number, including area code: 617-796-8387

This Current Report on Form 8-K/A amends and restates, in its entirety, the Current Report on Form 8-K (dated October 25, 2002), which was filed with the Securities and Exchange Commission on November 12, 2002.

Item 2. Acquisition or Disposition of Assets.

On October 25, 2002, Five Star Quality Care, Inc. ("we," "us" or "Five Star," which term includes our consolidated subsidiaries unless the context requires otherwise), Senior Housing Properties Trust ("Senior Housing"), Constellation Health Services, Inc. and certain of its subsidiaries (collectively "CHSI") completed the transactions contemplated by a Purchase and Sale Agreement dated August 26, 2002, between Senior Housing and CHSI, as

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amended by the First Amendment to Purchase and Sale Agreement dated October 25, 2002, among Five Star, Senior Housing and CHSI (as amended, the "Purchase Agreement"). Under the Purchase Agreement, we and SNH acquired assets of CHSI consisting of 15 senior living communities that have an aggregate of 1,016 units, as more fully described below.

We acquired seven senior living communities directly from CHSI (collectively, the "Five Star Communities"). Senior Housing acquired eight other senior living communities (the "Leased Communities") and we acquired certain operating assets and liabilities of the Leased Communities and entered into a lease with Senior Housing for the Leased Communities.

We and Senior Housing are jointly and severally liable for the obligations and liabilities under the Purchase Agreement. Except as otherwise provided in our lease for the Leased Communities, we and Senior Housing have agreed that we will each have all of the rights and remedies, perform all of the obligations, and assume the liabilities, each under the Purchase Agreement, relating to the Five Star Communities and the Leased Communities, respectively.

The purchase price paid to CHSI pursuant to the Purchase Agreement was \$77.15 million, comprised of cash and the assumption of certain liabilities relating to the 15 senior living communities. We paid \$27 million of the Purchase Agreement's total purchase price by assuming \$15.8 million of HUD insured mortgage debt encumbering one of the Five Star Communities and by paying CHSI the balance of \$11.2 million in cash.

Simultaneously with the closing under the Purchase Agreement: (i) we sold to Senior Housing our senior living community located in Overland Park, Kansas, for approximately \$12.7 million in cash; and (ii) we leased from Senior Housing the Leased Communities and the property located in Overland Park, Kansas.

The material terms of our lease with Senior Housing for the Leased Communities and Overland Park are substantially the same as our existing leases with Senior Housing, except as follows: We are required to pay to Senior Housing for the Leased Communities and Overland Park minimum rent equal to \$6.285 million per year. In addition, starting in 2005, we are required to pay additional rent with respect to each lease year in an amount equal to four percent (4%) of net patient revenues at each leased facility in excess of net patient revenues at such facility during 2004. The initial term of the lease is for 17 years, expiring December 31, 2019. We have the option to renew the lease for all, but not less than all, of the Leased Communities and Overland Park for one renewal term of 15 years thereafter.

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We intend to continue to operate the 15 CHSI communities acquired as senior living communities.

All of our directors, except for Dr. Bruce M. Gans, are trustees of Senior Housing. Our president and treasurer are also employees of Reit Management & Research LLC ("RMR"), the investment manager to Senior Housing. RMR also provides certain administrative services to us. Gerard M. Martin and Barry M. Portnoy, our two managing directors, are directors and 50% owners of RMR. Substantially all of our properties are leased from Senior Housing. Messrs. Martin and Portnoy also own the building in which our headquarters are located, and we lease the headquarters under a lease expiring in 2011. We have previously disclosed other relationships between us, Messrs. Martin and Portnoy and Senior Housing in our Annual Report on Form 10-K for the year ended December 31, 2001.

WARNING REGARDING FORWARD LOOKING STATEMENTS

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THIS CURRENT REPORT ON FORM 8-K CONTAINS FORWARD LOOKING STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND FEDERAL SECURITIES LAWS, INCLUDING STATEMENTS REGARDING FIVE STAR'S INTENTION TO CONTINUE TO OPERATE THE NEWLY ACQUIRED COMMUNITIES AS SENIOR LIVING COMMUNITIES. FIVE STAR MAY BE UNABLE OR UNWILLING TO CONTINUE TO OPERATE THE NEWLY ACQUIRED COMMUNITIES AS SENIOR LIVING COMMUNITIES. SIMILARLY, THE OPERATION OF THE NEWLY ACQUIRED COMMUNITIES OR OTHER ASPECTS OF FIVE STAR'S BUSINESS MAY PRODUCE OPERATING LOSSES WHICH MAKE IT IMPOSSIBLE FOR FIVE STAR TO PAY RENT TO SENIOR HOUSING. FORWARD LOOKING STATEMENTS ARE EXPRESSIONS OF FIVE STAR'S CURRENT BELIEFS AND EXPECTATIONS, BUT THEY ARE NOT GUARANTEED. INVESTORS SHOULD NOT PLACE UNDUE RELIANCE UPON FORWARD LOOKING STATEMENTS.

Item 7. Financial Statements, Pro Forma Financial Information and Exhibits.

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Report of Independent Accountants

To Constellation Health Services, Inc.

In our opinion, the accompanying combined balance sheets and the related combined statements of operations, changes in owner equity and cash flows, present fairly, in all material respects, the financial position of Constellation Health Services Facilities (the "Company") at November 30, 2001, and the results of its operations and its cash flows for the twelve months then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of

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material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

January 6, 2003

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Constellation Health Services Facilities
Combined Balance Sheets

| | November 30, 2001 |
|--|----------------------|
| ----- | |
| Assets | |
| Current assets: | |
| Cash and cash equivalents | \$ 2,290,257 |
| Accounts receivable, (net of allowance of \$15,000 and \$18,116, respectively) | 686,176 |
| Prepaid expenses | 872,752 |
| | ----- |
| Total current assets | 3,849,185 |
| | ----- |
| Senior living facilities, net | 73,500,000 |
| Restricted cash | 731,481 |
| Other assets | 1,243,040 |
| | ----- |
| Total assets | \$79,323,706 |
| | ----- |
| Liabilities and Owner Equity | |
| Current liabilities: | |
| Current portion of long-term debt | \$20,146,174 |
| Accounts payable | 588,309 |
| Accrued expenses | 662,740 |
| Accrued interest | 274,995 |
| | ----- |
| Total current liabilities | 21,672,218 |
| | ----- |
| Long-term debt, less current portion | 20,912,059 |
| Other liabilities | 181,667 |
| | ----- |

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| | |
|------------------------------------|--------------|
| Total liabilities | 42,765,944 |
| Commitments and contingencies | |
| Owner equity | 36,557,762 |
| Total liabilities and owner equity | \$79,323,706 |

The accompanying notes are an integral part of these combined financial statements.

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Constellation Health Services Facilities
Combined Statements of Operations

| | Twelve Months Ended November 30, 2001 | Nine Months Ended August 31, 2001 (unaudited) | |
|--|--|---|-------|
| Revenue: | | | |
| Rental and other | \$ 32,551,096 | \$ 24,178,075 | \$ 25 |
| Interest | 216,936 | 106,022 | |
| Total revenue | 32,768,032 | 24,284,097 | 25 |
| Expenses: | | | |
| Salaries and wages | 16,500,512 | 12,312,597 | 12 |
| Facility operations | 3,101,268 | 2,582,501 | 2 |
| Interest | 3,002,567 | 2,366,108 | 1 |
| Property management fees | 1,660,175 | 1,234,027 | 1 |
| Utilities | 1,285,795 | 986,098 | |
| General and administrative | 969,221 | 731,219 | |
| Marketing | 875,876 | 708,984 | |
| Real estate tax | 807,533 | 659,093 | |
| Insurance | 386,758 | 266,506 | |
| Repairs and maintenance | 430,980 | 326,113 | |
| Ground lease | 131,405 | 97,658 | |
| Professional fees | 120,466 | 97,648 | |
| Depreciation and amortization | 3,912,926 | 2,830,608 | |
| Provision for impairment on senior living facilities | 9,598,698 | -- | |
| Total expenses | 42,784,180 | 25,199,160 | 22 |
| Income (loss) before income taxes | (10,016,148) | (915,063) | 2 |
| Income tax benefit (expense) | -- | -- | |

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| | | | |
|-------------------|-----------------|--------------|-------|
| Net income (loss) | \$ (10,016,148) | \$ (915,063) | \$ 2 |
| | ===== | ===== | ===== |

The accompanying notes are an integral part of these combined financial statements.

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Constellation Health Services Facilities
 Combined Statement of Changes in Owner Equity

| | Total |
|--|---------------|
| Balance at November 30, 2000 | \$ 44,878,910 |
| Net loss for the twelve months ended November 30, 2001 | (10,016,148) |
| Contributions | 1,695,000 |
| | ----- |
| Balance as of November 30, 2001 | \$ 36,557,762 |
| | ===== |
| Net income for the nine months ended August 31, 2002 (unaudited) | 2,992,202 |
| | ----- |
| Balance at August 31, 2002 (unaudited) | \$ 39,549,964 |
| | ===== |

The accompanying notes are an integral part of these combined financial statements.

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Constellation Health Services Facilities
 Combined Statements of Cash Flows

| | Twelve Months Ended November 30, 2001 | Nine Mo Ended August 2001 (unaudit |
|--|--|--|
| Cash Flows from Operating Activities | | |
| Net income | (\$10,016,148) | \$ (915,063) |
| Adjustments to reconcile net loss to net cash provided | | \$ |

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| | | |
|---|--------------|--------------|
| by operating activities: | | |
| Depreciation and amortization | 3,912,926 | 2,830,608 |
| Provision for impairment | 9,598,698 | -- |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 284,879 | 48,879 |
| Accounts payable/accrued expenses | (896,662) | (540,124) |
| Prepaid expenses | (331,523) | (442,811) |
| Accrued interest | (30,046) | (42,191) |
| Other assets | 340,479 | 225,452 |
| Other liabilities | 15,646 | 2,866 |
| | ----- | ----- |
| Net cash provided by operating activities | 2,878,249 | 1,167,636 |
| | ----- | ----- |
| Cash Flows from Investing Activities | | |
| Purchases of senior living property and equipment | (488,334) | (128,446) |
| Restricted cash | (37,182) | (11,871) |
| | ----- | ----- |
| Net cash used in investing activities | (525,516) | (140,317) |
| | ----- | ----- |
| Cash Flows from Financing Activities | | |
| Borrowings from/(payments to) affiliate | 6,384,673 | (1,250,000) |
| Principal payments on debt | (8,396,065) | (623,298) |
| Contributions | 1,695,000 | 1,695,000 |
| | ----- | ----- |
| Net cash used in financing activities | (316,392) | (178,298) |
| | ----- | ----- |
| Increase in cash and cash equivalents | 2,036,341 | 849,021 |
| Cash and cash equivalents, beginning of period | 253,916 | 253,916 |
| | ----- | ----- |
| Cash and cash equivalents, end of period | \$ 2,290,257 | \$ 1,102,937 |
| | ===== | ===== |
| Supplemental Disclosures | | |
| Cash paid for interest | \$ 3,032,613 | \$ 2,408,299 |
| | | \$ |

The accompanying notes are an integral part of these combined financial statements.

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Constellation Health Services Facilities
Notes to the Combined Financial Statements

1. Basis of Presentation

Constellation Health Service, Inc., ("Constellation") is a wholly owned subsidiary of Constellation Real Estate Group, Inc. ("CREG"), which is a wholly owned subsidiary of Constellation Holdings, Inc., which is a wholly owned subsidiary of Constellation Enterprises, Inc. which is a wholly owned subsidiary of Constellation Energy Group, Inc. ("CEG").

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During the twelve months ended November 30, 2001 and during the nine month periods ended August 31, 2002 and 2001, the activities of Constellation included the ownership and management of fifteen senior living communities with 1,016 independent living apartments and assisted living units (the "Communities"). The majority of these fifteen communities were developed between 1997 and 1999 and are located in the Baltimore-Washington corridor.

On October 25, 2002, Constellation sold its entire ownership interest in its independent and assisted living portfolio. A group consisting of Senior Housing Properties Trust, a publicly traded real estate investment trust and Five Star Quality Care, Inc., a publicly traded owner/operator of health care facilities purchased the Constellation portfolio for an aggregate price of approximately \$77,150,000.

The accompanying combined financial statements present the "carved-out" financial position, results of operations and cash flows of the Communities which are referred to in these combined financial statements as Constellation Health Services Facilities (the "Company"). The assets and liabilities contained herein are presented at historical cost. The combined financial statements presented may not be indicative of the results that would have been achieved had the Company operated as a non-affiliated entity.

The combined financial statements as of August 31, 2002 and for the nine months ended August 31, 2002 and 2001 are unaudited. In the opinion of management, all adjustments, consisting only of normal, recurring adjustments, necessary for a fair presentation of such combined financial statements have been included. The results of operations for the nine months ended August 31, 2002 are not necessarily indicative of the Company's future results of operations for the full year ended November 30, 2002.

2. Summary of Significant Accounting Policies

Principles of Combination

The combined financial statements include the accounts of the Communities extracted from the books and records of Constellation.

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original maturity of three months or less to be cash and cash equivalents. The majority of these funds are deposited in overnight investments at several lending institutions and are subject to credit risk. The amounts reflected in these financial statements only reflect cash and cash equivalents that are in accounts dedicated to the Company.

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Constellation Health Services Facilities Notes to the Combined Financial Statements

Senior Living Facilities

Senior living facilities consist of investments in the ownership of fifteen senior living housing communities. Senior housing facilities are stated at depreciated cost. Development costs and major renovations were capitalized as a component of costs, and routine maintenance and repairs were charged to expense as incurred.

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The senior living facilities are subject to the requirements of Statement of Financial Accounting Standards (FAS) No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of," and are evaluated for impairment through a review of undiscounted expected future cash flows. If the sum of the undiscounted expected future cash flows is less than the carrying amount of the asset, an impairment loss is recognized.

In the fourth quarter of 2001, the Company decided to sell all of its senior living facilities in 2002. The Constellation recognized a provision for impairment in the twelve month period ended November 30, 2001 related to the senior living facilities of \$9,598,698, which was determined based upon the excess of the carrying value of the Constellation senior living facilities over their fair value.

Fair value was determined by various means, including discussions with outside investment bankers and prospective buyers, and the opinions of the Company's management.

Depreciation is computed using the straight-line method. The estimated useful lives are as follows:

| | Estimated Useful Lives |
|-----------------------------------|------------------------------|
| Senior living buildings | 40 years |
| Furniture, fixtures and equipment | 3-10 years |

Restricted Cash

The Company has restricted funds, consisting of tenant security deposits, an interest bearing reserve for capital replacements kept in accordance with the terms of the property management agreement and mortgage escrow deposits.

Revenue Recognition

Individual units in the Communities are leased under leases with terms of generally one year or less. Rental revenue is recognized on a monthly basis under the terms of the lease when earned.

Income Taxes

Constellation is taxable as a so called "C" corporation and files a consolidated federal income tax return on a calendar year basis with CEG. For purposes of these combined financial statements, the Company has provided for income taxes on a separate return basis whereby current income taxes are based upon the Company's estimated taxable income or loss and deferred taxes are provided for the expected future tax effects of estimated temporary differences between the carrying amounts and the tax bases of its assets and liabilities. As a result of tax losses in current or prior periods there is no current tax provision benefit for the year ended November 30, 2001 or the nine month periods ended August 31, 2000. A full valuation allowance has been provided to deferred tax balances as of November 30, 2001 and August 31, 2002 as it is more likely than not that such amounts will not be realized.

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Use of Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. These estimates involve judgments with respect to, among other things, various future economic factors which are difficult to predict and are beyond the control of the Company. Therefore, actual amounts could differ from these estimates.

Allocated Costs

CEG provides various services to the Company including finance, legal, planning and human resources. The methods of allocating these centralized costs to the Company include revenues, assets, headcount and other bases. The Company's management believes the allocation of these costs to be reasonable.

Recent Accounting Pronouncements

In October 2001, the FASB issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets". This Statement supersedes SFAS No. 121 and requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less costs to sell. SFAS No. 144 retains the fundamental provisions of SFAS 121 for (a) recognition and measurement of the impairment of long-lived assets to be held and used, and (b) measurement of long-lived assets to be disposed of by sale, but broadens the definition of what constitutes a discontinued operation and how the results of a discontinued operation are to be measured and presented. This Statement was effective at the beginning of 2002. The Company has reviewed the provisions of SFAS 144 and believes that the impact of adoption will not be material to its financial position, results of operations and cash flows.

In April 2002, the FASB issued SFAS No. 145 "Rescission of FAS No. 4, 44, and 64, Amendment of FAS 13, and Technical Corrections". This Statement rescinds FASB No. 4, "Reporting Gains and Losses from Extinguishment of Debt", and an amendment of that Statement, FASB No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements". This Statement amends FASB No. 13, "Accounting for Leases". This Statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings or describe their applicability under changed conditions. This statement will be effective for the Company's fiscal year ending 2003. The Company has reviewed the provision of FASB 145 and believes that the impact of adoption will not be material to its financial position, results of operations and cash flow.

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Constellation Health Services Facilities Notes to the Combined Financial Statements

3. Senior Living Facilities, Net

Senior living facilities, net of accumulated depreciation and adjusted for impairment, consists of the following:

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| | November 30, 2001 | August 31, 2002 (unaudited) |
|--------------------------------|----------------------|-----------------------------------|
| Land | \$ 4,956,559 | \$ 4,956,559 |
| Buildings and improvements | 84,149,757 | 84,870,225 |
| Furniture and equipment | 8,763,891 | 8,868,856 |
| | ----- | ----- |
| | 97,870,207 | 98,695,640 |
| Less: accumulated depreciation | (14,771,509) | (14,771,509) |
| Less: provision for impairment | (9,598,698) | (9,598,698) |
| | ----- | ----- |
| Senior living facilities, net | \$ 73,500,000 | \$ 74,325,433 |
| | ----- | ----- |

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Constellation Health Services Facilities
Notes to the Combined Financial Statements

4. Debt Obligations

Debt obligations consisted of the following:

| | November 30, 2001 | August 2002 (Unaudi |
|--|----------------------|---------------------------|
| Note payable - lending institution; collateralized by related land and buildings; interest payable monthly at LIBOR plus 2.25%; matures May 2003. | \$ 1,025,703 | \$ 1,01 |
| Note payable - lending institution; collateralized by related land and buildings; interest payable monthly at LIBOR plus 2.0%; matures August 2004. | 5,618,293 | 5,53 |
| Note payable - lending institution; collateralized by related land and buildings; interest payable monthly at LIBOR plus 1.75%; matures June 1, 2003. | 6,464,324 | 6,15 |
| Note payable - lending institution; collateralized by buildings; interest payable monthly at 9.65%; matures February 2028. | 9,431,873 | 9,38 |
| Note payable - lending institution; collateralized by buildings; interest payable monthly at 8.0%; matures November 2033. | 6,483,367 | 6,43 |
| Related party borrowings - CEG; these unsecured borrowings are payable on the date CEG retires the debt and bear interest at CEG's weighted average interest rate which was 5.78% in 2001. | 12,034,673 | 11,00 |
| | ----- | ----- |

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| | | |
|--|---------------|----------|
| Total debt obligations | \$ 41,058,233 | \$ 39,51 |
| | ===== | ===== |
| Less current portion | (20,146,174) | (18,93 |
| | ----- | ----- |
| Total long-term debt, less current portion | \$ 20,912,059 | \$ 20,58 |
| | ===== | ===== |

The aggregate maturities of debt during the years subsequent to November 30, 2001 are as follows:

| | |
|--------------|---------------|
| Year ended | |
| November 30, | |
| 2002 | \$ 20,146,174 |
| 2003 | 252,191 |
| 2004 | 5,549,136 |
| 2005 | 168,552 |
| 2006 | 184,488 |
| Thereafter | 14,757,692 |
| | ----- |
| | \$ 41,058,233 |
| | ===== |

Constellation Health Services Facilities
Notes to the Combined Financial Statements

The Company is liable for the payment and performance of all debt obligations. Certain notes payable require the Company to be in compliance with certain debt covenants. The more restrictive covenants include the requirements to maintain: 1) interest coverage ratios of not less than 1.25 to 1; and 2) loan to value ratios of not more than 75%. At November 30, 2001, the Company was in violation of debt covenants on two of the notes payable and accordingly the outstanding balances of \$1,025,703 and \$6,464,324, respectively, have been classified as current liabilities in the combined financial statements.

The weighted average interest rate on external variable rate debt obligations was 6.34% for the twelve months ended November 30, 2001. The weighted average interest rate on total debt obligations was 7.02% for the twelve months ended November 30, 2001. The LIBOR rate was 2.15% at November 30, 2001.

5. Fair Value of Financial Statements

SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," requires disclosing fair value of financial instruments which are recognized or unrecognized in the balance sheet. The fair value of the financial instruments disclosed herein is not necessarily representative of the amount that could be realized or settled, nor does the fair value amount consider the tax consequences of realization or settlement.

For certain financial instruments, including cash and cash equivalents, receivables, accounts payable, accrued expenses and other assets and liabilities, it was assumed that the carrying amount approximated fair value because of the near term maturities of such obligations. The fair

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value of long-term debt was determined based on current rates at which the Company could borrow funds with similar remaining maturities, which approximates its carrying value.

6. Transactions with Affiliates

The Company incurred costs of \$564,192, \$431,230 and \$619,319 for certain services provided or overhead costs incurred by CEG for the twelve months ended November 30, 2001 and the nine months ended August 31, 2001 and 2002, respectively.

7. Commitments and Contingencies

The Company is party to various legal actions and administrative proceedings and subject to various claims arising in the normal course of business. The Company believes that the disposition of these matters will not have a material adverse effect on the financial condition, results of operations or liquidity of the Company.

The Company has entered into ground lease agreements on two of the senior living facilities. Ground lease expense for the twelve months ended November 30, 2001 and the nine months ended August 31, 2001 and 2002 was \$131,405, \$97,658 and \$105,561, respectively.

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(b) Pro Forma Financial Information.

| | |
|---|-------|
| Unaudited Pro Forma Consolidated Balance Sheet at September 30, 2002 | 16 |
| Unaudited Pro Forma Consolidated Statement of Operations for the year ended December 31, 2001 | 17 |
| Unaudited Pro Forma Consolidated Statement of Operations for the nine months ended September 30, 2002 | 18 |
| Notes to Unaudited Pro Forma Consolidated Financial Statements | 19-25 |

INTRODUCTION TO UNAUDITED PRO FORMA FINANCIAL STATEMENTS

The unaudited pro forma balance sheet at September 30, 2002, presents the financial position of Five Star Quality Care, Inc. ("Five Star") as if (1) its acquisition of seven facilities (the "Acquired Constellation Facilities") from Constellation Health Services, Inc. and certain of its subsidiaries (collectively "Constellation Health Services"), (2) its lease of eight facilities (the "Leased Constellation Facilities" and together with the Acquired Constellation Facilities, the "Constellation Facilities") from Senior Housing Properties Trust ("Senior Housing") that Senior Housing acquired from Constellation Health Services and (3) the sale/leaseback of Five Star's facility located in Overland Park, Kansas with Senior Housing had been completed as of September 30, 2002, as described in the notes thereto. The unaudited pro forma statement of operations for the nine months ended September 30, 2002, presents the results of operations of Five Star as if the transactions described above involving the Constellation Facilities, the Overland Park, Kansas facility transaction and Five Star's April 1, 2002 acquisition of senior living facilities had been completed as of January 1, 2001, as described in the notes

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thereto. The unaudited pro forma statement of operations for the year ended December 31, 2001, presents the results of operations of Five Star as if the events described in the immediately preceding sentence, its merger with FSQ, Inc., the commencement of Five Star's lease of 31 facilities from Senior Housing managed by Marriott Senior Living Services, Inc., its offering of 3,823,300 shares of its common stock, and its spin-off from Senior Housing had been completed as of January 1, 2001, as described in the notes thereto.

These unaudited pro forma financial statements do not represent Five Star's financial condition or results of operations for any future date or period. Actual future results will likely be materially different from these pro forma results. Differences could arise from many factors, including, but not limited to, those related to our operations as a separate public company, competition in our business, the impact of changes to rates under Medicare and Medicaid reimbursement programs, our ability to successfully attract residents to our facilities, our financing, acquisition or disposition of facilities, percentage rent under our various leases, our ability to control operating expenses and changes to our capital structure and other changes. These unaudited pro forma financial statements should be read in conjunction with our audited financial statements and the related management's discussion and analysis of financial condition and results of operations included in our Annual Report on Form 10-K for the year ended December 31, 2001, as well as our unaudited financial statements and the related management's discussion and analysis of financial condition and results of operations included in our Quarterly Reports on Form 10-Q for the quarters ended March 31, June 30 and September 30, 2002. In addition, in conjunction with these unaudited pro forma financial statements, you should read the financial statements of the Constellation Health Services Facilities, contained elsewhere in this Form 8-K/A, and the financial statements of CSL Group, Inc. and Subsidiaries as Partitioned For Sale to SNH/CSL Properties Trust, ILM II Senior Living, Inc. and ILM II Lease Corporation, each included in our Registration Statement on Form S-1, File No. 333-83648.

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Five Star Quality Care, Inc.
 Unaudited Pro Forma Consolidated Balance Sheet
 At September 30, 2002
 (amounts in thousands, except per share amounts)

| | | Adjustments | |
|---|--------------------------|---------------------|---------|
| Historical | Overland Park Sale | Constell Acquisi | |
| | (A) | (B) | |
| ASSETS | | | |
| Current assets: | | | |
| Cash | \$ 12,005 | \$ 12,700 | \$ (13) |
| Accounts receivable, net | 37,972 | -- | |
| Due from Marriott Senior Living Services | 4,620 | -- | |
| Prepaid expenses and other current assets | 4,370 | -- | |
| | ----- | ----- | ----- |
| Total current assets | 58,967 | 12,700 | (12) |
| Restricted cash | 4,378 | -- | |
| Fixed assets, net | 53,083 | (12,663) | 28 |

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| | | | |
|--|------------|-------|-------|
| Total assets | \$ 116,428 | \$ 37 | \$ 16 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | |
| Current liabilities: | | | |
| Accounts payable and accrued expenses | \$ 23,170 | \$ -- | \$ |
| Accrued compensation | 5,465 | -- | |
| Accrued real estate taxes | 6,202 | -- | |
| Due to affiliates, net | 747 | -- | |
| Other liabilities | 880 | -- | |
| Total current liabilities | 36,464 | -- | |
| Long term liabilities | 14,948 | 37 | |
| Mortgages payable | -- | -- | 15 |
| Shareholders' equity: | | | |
| Common stock, par value \$0.01 per share | 85 | -- | |
| Additional paid in capital | 78,926 | -- | |
| Accumulated deficit | (13,995) | -- | |
| Total shareholders' equity | 65,016 | -- | |
| Total liabilities and shareholders' equity | \$ 116,428 | \$ 37 | \$ 16 |

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Five Star Quality Care, Inc.
 Unaudited Pro Forma Consolidated Statement of Operations
 For the Year ended December 31, 2001
 (amounts in thousands, except per share amounts)

| | Historical | Spin-Off and FSQ Adjustments | Lease of 31 Marri Historical |
|---|------------|------------------------------------|---------------------------------|
| | ----- | ----- | ----- (H) |
| Revenues | \$ 229,235 | \$ -- | \$ 277,499 |
| EXPENSES | | | |
| Property level operating costs and expenses | 211,850 | -- | 185,042 |
| Depreciation and amortization | 1,274 | (868) (C) | 24,155 |
| General and administrative | 15,627 | (3,298) (D) | 20,115 |
| Rent | -- | 7,000 (E) | -- |
| Impairment | -- | -- | -- |
| FF&E rent | -- | -- | -- |

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| | | | |
|--------------------------------------|---------|------------|-----------|
| Interest, net | (43) | 43 (F) | 19,335 |
| | ----- | ----- | ----- |
| Total expenses | 228,708 | 2,877 | 248,647 |
| Income (loss) before income taxes | 527 | (2,877) | 28,852 |
| Provision (benefit) for income taxes | -- | (823) | 10,098 |
| | ----- | ----- | ----- |
| Net Income | \$ 527 | \$ (2,054) | \$ 18,754 |
| | ===== | ===== | ===== |
| Weighted Average Shares Outstanding | 4,374 | 250 (G) | |
| Earnings per Share | \$ 0.12 | | |

| | April 1, 2002, Acquisition | | Overland Park | Octo Ac |
|---|-------------------------------|-------------|------------------|------------|
| | Historical | Adjustments | Sale / Leaseback | Historic |
| | ----- | ----- | ----- | ----- |
| | (O) | | | (U) |
| Revenues | \$ 14,217 | \$ -- | \$ -- | \$ 32,768 |
| EXPENSES | | | | |
| Property level operating costs and expenses | 8,505 | -- | -- | 24,360 |
| Depreciation and amortization | 313 | 722 (P) | (360) (S) | 3,912 |
| General and administrative | 1,462 | (1,377) (Q) | -- | 1,780 |
| Rent | 4,579 | (4,579) (R) | 1,268 (T) | 131 |
| Impairment | -- | -- | -- | 9,599 |
| FF&E rent | -- | -- | -- | -- |
| Interest, net | -- | -- | -- | 3,003 |
| | ----- | ----- | ----- | ----- |
| Total expenses | 14,859 | (5,234) | 908 | 42,785 |
| Income (loss) before income taxes | (642) | 5,234 | (908) | (10,017) |
| Provision (benefit) for income taxes | (225) | 1,832 | (318) | (3,506) |
| | ----- | ----- | ----- | ----- |
| Net Income | \$ (417) | \$ 3,402 | \$ (590) | \$ (6,511) |
| | ===== | ===== | ===== | ===== |
| Weighted Average Shares Outstanding | | | | |
| Earnings per Share | | | | |

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Five Star Quality Care, Inc.
 Unaudited Pro Forma Consolidated Statement of Operations
 For the nine months ended September 30, 2002
 (amounts in thousands, except per share amounts)

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| | Historical ----- | April 1, 2002, Acquisition and Overland Park Sale / Leaseback ----- | O Ac ----- Histo ----- (A |
|---|---------------------|---|--|
| Revenues: | | | |
| Revenues from residents | \$ 382,315 | \$ 3,627 (AB) | \$ 25, |
| Expenses: | | | |
| Property level operating expenses | 307,491 | 2,316 (AB) | 19, |
| Management fee to Marriott | 12,354 | -- | -- |
| Rent expense | 56,596 | 951 (AC) | 1, |
| General and administrative | 11,248 | 22 (AD) | 1, |
| Depreciation | 1,240 | (180) (AE) | -- |
| Impairment of assets | 150 | -- | -- |
| Restructuring costs | 122 | -- | -- |
| Interest expense | -- | -- | 1, |
| Spin off and merger expense, non recurring | 2,829 | -- | -- |
| | ----- | ----- | ----- |
| Total expenses | 392,030 | 3,109 | 22, |
| Loss from continuing operations before income taxes | (9,715) | 518 | 2, |
| Provision for income taxes | -- | -- | -- |
| | ----- | ----- | ----- |
| Loss from contiuing operations | (9,715) | 518 | 2, |
| Loss from discontinued operations | (3,491) | -- | -- |
| | ----- | ----- | ----- |
| Net loss | \$ (13,206) | \$ 518 | \$ 2, |
| | ===== | ===== | ===== |
| Weighted Average Shares Outstanding | 7,254 | | |
| Basic and diluted loss per share from: | | | |
| Continuing operations | \$ (1.34) | | |
| Discontinued operations | (0.48) | | |
| | ----- | | |
| Net loss per share | \$ (1.82) | | |
| | ===== | | |

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Five Star Quality Care, Inc.

NOTES TO UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share and per share amounts)

Pro Forma Consolidated Balance Sheet Adjustments

- A. Represents the sale of our Overland Park, Kansas facility to Senior Housing for cash on October 25, 2002. The adjustments represent cash received and elimination of the book value of the facility as of

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October 25, 2002. Simultaneously with the sale, we leased this facility back from Senior Housing and used cash to purchase other facilities in a related transaction (see note B). Adjustments are calculated as follows:

| | | |
|-----------------------------------|----|--------|
| Cash received | \$ | 12,700 |
| Book value as of October 25, 2002 | | 12,663 |
| | | ----- |
| Deferred gain on sale of asset | \$ | 37 |
| | | ===== |

B. On October 25, 2002, we acquired the Acquired Constellation Facilities along with certain of their operating assets and liabilities from Constellation Health Services. In addition to this acquisition, on October 25, 2002, we entered into a lease with Senior Housing for the Leased Constellation Facilities that were purchased by Senior Housing from Constellation Health Services. In connection with this lease, we acquired certain operating assets and liabilities of the Leased Constellation Facilities. To finance this transaction we assumed two HUD insured mortgages and paid the balance in cash, calculated as follows:

| | |
|---|----------|
| Fixed assets | \$28,699 |
| Accounts receivable acquired | 499 |
| Other assets acquired | 505 |
| Accounts payable and accrued expenses assumed | (190) |
| Accrued compensation assumed | (266) |
| Other liabilities assumed | (220) |
| Mortgages payable assumed | (15,978) |
| | ----- |
| Cash paid | \$13,049 |
| | ===== |

Pro Forma Consolidated Statement of Operations for the year ended December 31, 2001 Adjustments

C. As part of our spin-off from Senior Housing, we transferred real and personal property to Senior Housing, and then leased that property from Senior Housing. In addition, certain ancillary property was transferred by Senior Housing to us. This adjustment represents the elimination of historical depreciation expense from the real and personal property transferred by us to Senior Housing net of the depreciation expense from the ancillary property transferred to us, and the addition of depreciation expense related to fixed assets acquired by us in the FSQ, Inc. merger, calculated as follows:

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| | |
|--|------------|
| Elimination of historical depreciation expense on assets transferred from us, net of depreciation expense on assets transferred to us..... | \$ (1,096) |
| Addition of FSQ, Inc. depreciation..... | 228 |
| | ----- |
| Total adjustment..... | \$ (868) |
| | ===== |

D. In connection with the stabilization of our facilities' operations which we assumed from former tenants of Senior Housing, we incurred

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certain costs which are not expected to recur. Also, as required by real estate investment trust ("REIT") tax rules applicable to Senior Housing and us during 2001, we engaged FSQ, Inc. to manage our facilities, and FSQ, Inc. purchased certain services from Reit Management & Research LLC ("Reit Management"). Since our acquisition of FSQ, Inc. we manage our facilities directly and have entered into a shared services agreement with Reit Management to purchase the services previously provided by Reit Management to FSQ, Inc. The net adjustment to our general and administrative costs is intended to reflect these charges and is calculated as follows:

| | | |
|--|-----------|------------|
| Elimination of costs related to Senior Housing's repossession of certain facilities and our stabilization of operations which are not expected to recur (1)..... | | \$ (4,167) |
| Elimination of management fees paid to FSQ, Inc. during 2001..... | | (11,460) |
| Addition of FSQ, Inc. expenses..... | | 10,954 |
| Shared services fee: | | |
| Pro forma revenues..... | \$229,235 | |
| Contract rate..... | 0.6% | 1,375 |
| | ----- | |
| Total adjustment..... | | \$ (3,298) |
| | | ===== |

(1) These costs represent primarily payments to third parties to convert financial and patient data maintained by previous operators to our systems.

E. Our lease for 56 facilities requires minimum rent payments of \$7,000 per year to Senior Housing. In addition to minimum rent under this lease, beginning in 2004 we must pay percentage rent payments equal to three percent (3%) of net patient revenues at each leased facility in excess of net patient revenues at such facility during 2003.

F. Represents elimination of interest, net on mortgage debts and related compensating cash balances on properties transferred to Senior Housing, which debts Senior Housing assumed as part of the spin-off.

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G. Represents shares issued as consideration in the FSQ, Inc. merger.

H. Represents the 2001 historical operating revenues and facility operating expenses for the 31 Marriott facilities which we began to lease on January 11, 2002. The 31 Marriott facilities' results are accounted for on the basis of 13 four-week periods per fiscal year. Amounts presented as 2001 and related adjustments represent the period from December 30, 2000, through December 28, 2001. General and administrative expenses include management fees paid to Marriott under the terms of its management agreements.

I. Represents the elimination of historical depreciation and amortization expense related to the 31 Marriott facilities. These facilities were acquired by Senior Housing and leased to us. Accordingly, depreciation and amortization expense will be incurred by Senior Housing.

J. Represents the elimination of historical expenses incurred by the former owner of the 31 Marriott facilities, and the addition of our

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shared services agreement fee applicable to the operations:

| | | |
|--|-----------|-----------|
| Elimination of corporate expenses of seller... | | \$(1,972) |
| Shared services fee: | | |
| Pro forma revenues..... | \$277,499 | |
| Contract rate..... | 0.6% | 1,665 |
| | | |
| Total adjustment..... | | \$(307) |
| | | ===== |

K. Our lease for the 31 Marriott facilities requires minimum rent payments of \$63,000 per annum. In addition to minimum rent under this lease, beginning in 2003 we must make percentage rent payments to Senior Housing in an amount equal to five percent (5%) of net patient revenues at each leased facility in excess of net patient revenues at such facility during 2002.

L. Represents deposits made into reserves for capital improvements in accordance with the management agreements for the 31 Marriott facilities and which, under our lease with Senior Housing, were paid to Senior Housing as additional rent. Pursuant to an amendment to our lease with Senior Housing effective October 1, 2002, these deposits are retained by us and not paid to Senior Housing and as such are not recorded by us as rent expense.

M. Represents the elimination of historical interest expense related to the 31 Marriott facilities. Incident to its acquisition of the 31 Marriott facilities, Senior Housing prepaid or assumed this debt and the obligation for this expense.

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N. Represents our issuance of 3,823,300 shares in March and April 2002 pursuant to an underwritten public offering.

O. Represents historical operating revenues and facility operating expenses of the five facilities we acquired on April 1, 2002. Amounts presented are for the seller's fiscal year ended November 30, 2001.

P. Represents elimination of historical depreciation expense and the addition of our estimated depreciation expense for the five facilities we acquired on April 1, 2002, calculated as follows:

| | | |
|---|-------|---------|
| Elimination of historical depreciation expense on five facilities acquired..... | | \$(313) |
| Addition of estimated depreciation expense based on purchase price for five facilities..... | 1,035 | |
| | | |
| Total adjustment..... | | \$722 |
| | | ===== |

Q. Represents the elimination of historically incurred corporate level general and administrative costs of the seller of the five facilities we acquired on April 1, 2002, and the addition of our shared services agreement fee applicable to the operations:

| | | |
|--|--|-----------|
| Elimination of seller's corporate level general and administrative expenses..... | | \$(1,462) |
|--|--|-----------|

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| | | |
|-------------------------|--------|------------|
| Shared services fee: | | |
| Pro forma revenues..... | 14,217 | |
| Contract rate..... | 0.6% | 85 |
| | | ----- |
| Total adjustment..... | | \$ (1,377) |
| | | ===== |

- R. Represents the elimination of historically incurred rental expense. These five facilities were purchased by us without a lease obligation.
- S. Represents elimination of annual pro forma depreciation expense related to our Overland Park, Kansas facility sold October 25, 2002 (see note A).
- T. The Leased Constellation Facilities and the Overland Park, Kansas facility are leased from Senior Housing for minimum rent of approximately \$6,300 per year. For purposes of this pro forma presentation, we have allocated \$1,268 of rent to the Overland Park, Kansas facility and the remaining \$5,105 is reflected in note X, below. In addition to minimum rent under this lease, beginning in 2005 we must make percentage rent payments to Senior Housing in an amount equal to four percent (4%) of net resident revenues in excess of net resident revenues during 2004.

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- U. Represents historical operating revenues and facility operating expenses of the Constellation Facilities. Amounts presented are for the seller's fiscal year ended November 30, 2001.
- V. Represents the elimination of historical depreciation and amortization expense related to the Constellation Facilities. The amount is offset by depreciation that we will incur related to the Acquired Constellation Facilities. Adjustment is calculated as follows:

| | |
|---|------------|
| Elimination of historical depreciation and amortization..... | \$ (3,830) |
| Deprecation of Acquired Constellation Facilities based upon our purchase price of \$28,699 (see note B) and our estimated useful lives of 7-40 years..... | 815 |
| | === |
| Total adjustment..... | \$ (3,015) |
| | ===== |

- W. Represents the elimination of historical third party management fees related to the Constellation Facilities which we will not incur because of the termination of the related management contract as of the time we assumed operation of these facilities, October 25, 2002, for our own account. The amount is offset by known additional costs that we will incur as a result of our operation of the Constellation Facilities, primarily related to our addition of certain management personnel as a result of this transaction and the addition of our shared services agreement fee applicable to the operations:

| | |
|---|------------|
| Elimination of historical fees incurred on terminated contract..... | \$ (1,782) |
| Shared services fee: | |
| Pro forma revenues..... | \$32,768 |
| Contract rate..... | 0.6% |
| Other known increases in home office costs..... | 721 |
| | ----- |

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Total adjustment..... \$ (864)
=====

X. As described in note T, the Leased Constellation Facilities and the Overland Park, Kansas facility are leased from Senior Housing for minimum rent of approximately \$6,300 per year. As part of our transaction for the Acquired Constellation Facilities, a ground lease for which the seller was historically obligated was terminated. Pro forma adjustment is calculated as follows:

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| | |
|--|----------|
| Rent expense for the Leased Constellation Facilities and Overland Park, Kansas facility..... | \$ 6,285 |
| Less Overland Park, Kansas facility rent (see note T).... | (1,268) |
| Less terminated ground lease rent incurred by seller | (79) |
| | ----- |
| Total..... | \$ 4,938 |
| | ===== |

Y. Represents the elimination of impairment charges incurred by the seller of the Constellation Facilities for debts not assumed by us.

Z. Represents the elimination of certain historical interest expense related to the Constellation Facilities for debts not assumed by us.

AA. The pro forma tax provision is based on a blended federal and state income tax rate of 35%.

Pro Forma Consolidated Statement of Operations for the nine months ended September 30, 2002 Adjustments

AB. Adjustment represents the historical operating revenues and facility operating expenses of the acquired assets for the period January 1, 2002 to March 31, 2002. These properties were acquired by us on April 1, 2002.

AC. See note T. The corresponding amount of rent allocated for purposes of this presentation to the Overland Park, Kansas facility is \$951.

AD. Represents our shared services agreement fee applicable to the operations, calculated as 0.6% of revenue adjustment (note AB).

AE. Represents elimination of depreciation expense related to our Overland Park, Kansas facility for the period from our April 1, 2002, acquisition date to our October 25, 2002, sale/leaseback date.

AF. Represents historical operating revenues and facility operating expenses of the Constellation Facilities. Amounts presented are for the nine months ended August 31, 2002, the first nine months of the seller's fiscal year.

AG. As described in note T, the Leased Constellation Facilities and the Overland Park, Kansas facility are leased from Senior Housing for minimum rent of approximately \$6,300 per year or \$4,714 for a nine month period. As part of our transaction for the Acquired Constellation Facilities, a ground lease for which the seller was historically obligated was terminated. Proforma adjustment is calculated as follows:

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| | |
|---|----------|
| Rent expense for the Leased Constellation Facilities and Overland Park, Kansas facility..... | \$ 4,714 |
| Less Overland Park, Kansas facility rent (see note AC).. | (951) |
| Less terminated ground lease rent incurred by seller.... | (59) |
| | ----- |
| Total..... | \$ 3,074 |
| | ===== |

AH. Represents the elimination of historical third party management fees related to the Constellation Facilities which we will not incur because of the termination of the related management contract as of the time we assumed operation of these facilities, October 25, 2002, for our own account. The amount is offset by known additional costs that we will incur as a result of our operation of the Constellation Facilities, primarily related to our addition of certain management personnel as a result of this transaction and the addition of our shared services agreement fee applicable to the operations:

| | | |
|--|----------|------------|
| Elimination of historical fees incurred on terminated contract..... | | \$ (1,343) |
| Shared services fee: | | |
| Pro forma revenues..... | \$25,397 | |
| Contract rate..... | 0.6% | 152 |
| | ----- | |
| Other known increases in home office costs..... | | 541 |
| | | ----- |
| Total adjustment..... | | \$ (650) |
| | | ===== |

AI. Represents the depreciation of Acquired Constellation Facilities based upon our purchase price of \$28,699 (see note B) and our estimated useful lives of 7-40 years.

AJ. Represents the elimination of certain historical interest expense related to the Constellation Facilities for debts not assumed by us.

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(c) Exhibits.

- 2.1 Purchase and Sale Agreement, dated as of August 26, 2002, by and among Constellation Health Services, Inc. and certain of its subsidiaries, as Seller, and Constellation Real Estate Group, Inc., as Guarantor, and Senior Housing Properties Trust, as Buyer. (Incorporated by reference to Exhibit 2.1 to Five Star Quality Care, Inc.'s Current Report on Form 8-K, dated October 25, 2002).
- 2.2 First Amendment to Purchase and Sale Agreement, dated as of October 25, 2002, by and among Constellation Health Services, Inc. and certain of its subsidiaries, as Seller, and Senior Housing Properties Trust and Five Star Quality Care, Inc., collectively as Buyer. (Incorporated by reference to Exhibit 2.2 to Five Star Quality Care, Inc.'s Current Report on Form 8-K, dated October 25, 2002).
- 2.3 Lease Agreement, dated as of October 25, 2002, by and between SNH CHS Properties Trust, as Landlord, and FVE-CHS LLC, as Tenant. (Incorporated by reference to Exhibit 2.3 to Five Star Quality Care, Inc.'s Current Report on Form 8-K, dated October 25, 2002).

23 Consent of PricewaterhouseCoopers LLP.

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SIGNATURES

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

FIVE STAR QUALITY CARE, INC.

By: /s/ Bruce J. Mackey Jr.

Name: Bruce J. Mackey Jr.

Title: Treasurer and Chief Financial
Officer

Date: January 8, 2003