

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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2007

OR

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

Commission File Number 001-16817

FIVE STAR QUALITY CARE, INC.

(Exact Name of Registrant as Specified in its Charter)

Maryland

(State or Other Jurisdiction of Incorporation or
Organization)

04-3516029

(IRS Employer Identification No.)

400 Centre Street, Newton, Massachusetts 02458

(Address of Principal Executive Offices)

617-796-8387

(Registrant's Telephone Number Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

FIVE STAR QUALITY CARE, INC.

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

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

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

FIVE STAR QUALITY CARE, INC.

CONSOLIDATED BALANCE SHEET

(dollars in thousands, except share amounts)

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

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

See accompanying notes.

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FIVE STAR QUALITY CARE, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(dollars in thousands, except per share amounts)

(unaudited)

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

See accompanying notes.

FIVE STAR QUALITY CARE, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(dollars in thousands)

(unaudited)

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

See accompanying notes.

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FIVE STAR QUALITY CARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share amounts)

(unaudited)

Note 1. Basis of Presentation and Organization

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

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

Note 2. Property and Equipment

Property and equipment, at cost, consists of:

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

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

Note 3. Comprehensive Income (Loss)

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

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

Note 4. Financial Data By Segment

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

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

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

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

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

Six months ended June 30, 2007

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

Six months ended June 30, 2006

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

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

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

Note 5. Income Taxes

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

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

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

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

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

Note 6. Earnings Per Share

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

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

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

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

Note 7. Acquisitions

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

Note 8. Line of Credit

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

Note 9. Mortgages Payable

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

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

Note 10. Convertible Senior Notes due 2026

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

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

Note 11. Related Party Transactions

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

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

Note 12. Discontinued Operations

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

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

Note 13. Guarantor Financial Information

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

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

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

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

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

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

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

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

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

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

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

Condensed Consolidating Balance Sheet
As of June 30, 2007

	Parent	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS					
Current assets:					
Cash and cash equivalents	\$	\$ 2,990	\$ 39,496	\$	\$ 42,486
Accounts receivable, net					