

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.

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-Q

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

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-Q

FIVE STAR QUALITY CARE, INC.

FORM 10-Q

JUNE 30, 2007

INDEX

| | Page |
|---|-------------|
| PART I | |
| <u>Financial Information</u> | |
| <u>Item 1. Consolidated Financial Statements (unaudited)</u> | |
| <u>Consolidated Balance Sheet June 30, 2007 and December 31, 2006</u> | 1 |
| <u>Consolidated Statements of Operations Three and Six Months Ended June 30, 2007 and 2006</u> | 2 |
| <u>Consolidated Statement of Cash Flows Six Months Ended June 30, 2007 and 2006</u> | 3 |
| <u>Notes to Consolidated Financial Statements</u> | 4 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 16 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 23 |
| <u>Item 4. Controls and Procedures</u> | 24 |
| <u>Warning Concerning Forward Looking Statements</u> | 25 |
| PART II | |
| <u>Other Information</u> | |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 26 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 26 |
| <u>Item 6. Exhibits</u> | 26 |
| <u>Signatures</u> | 27 |

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 |

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-Q

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

See accompanying notes.

1

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.

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-Q

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.

3

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

4

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-Q

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

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

Note 7. Acquisitions

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

Note 8. Line of Credit

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

Note 9. Mortgages Payable

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

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

Note 10. Convertible Senior Notes due 2026

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

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

Note 11. Related Party Transactions

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

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

Note 12. Discontinued Operations

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

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

Note 13. Guarantor Financial Information

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

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

| | Parent | Guarantor Subsidiaries | Non- Guarantor Subsidiaries | Eliminations | Consolidated |
|--|--------|---------------------------|-----------------------------------|--------------|--------------|
| 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 | | | | | |

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-Q

| | | | | | |
|---|------------|---|------------|-----------|------------|
| 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 |
| Provision for income taxes | | | | 85,532 | (82,909 |
| (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 | | 12,499 | 48,378 | | 60,877 |
| Restricted cash and investments | | 2,940 | 6,693 | | 9,633 |
| Investments in trading securities | | | 38,771 | | 38,771 |
| Prepaid expenses and other current assets | | 4,465 | 15,594 | | 20,059 |
| Total current assets | | 22,894 | 148,932 | | 171,826 |
| Property and equipment, net | | 25,767 | 107,005 | | 132,772 |
| Investment in subsidiary and long term receivable from (to) subsidiaries | 200 | | 200 | (400 |) |
| Restricted cash and investments | | 3,082 | 13,905 | | 16,987 |
| Intercompany | 228,837 | | | (228,837 |) |
| Goodwill and other intangible assets | | | 22,477 | | 22,477 |
| Other long term assets | | | 8,404 | | 8,404 |
| | \$ 229,037 | \$ 51,743 | \$ 300,923 | \$ (229,237 |) \$ 352,466 |

LIABILITIES AND SHAREHOLDERS EQUITY

Current liabilities:

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

Long term liabilities:

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

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

Condensed Consolidating Balance Sheet
As of December 31, 2006

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

LIABILITIES AND SHAREHOLDERS EQUITY

Current liabilities:

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

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

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

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

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

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

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

RESULTS OF OPERATIONS

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-Q

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

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

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

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

Senior living communities:

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

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

Rehabilitation hospitals:

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

Corporate and Other (1):

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

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

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

Consolidated:

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

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

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

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

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

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

Rehabilitation hospitals:

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

Corporate and other:

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

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

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

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

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

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

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

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

Senior living communities:

| (dollars in thousands, except per day amounts) | Six months ended June 30, | | \$ Variance | Change | |
|---|---------------------------|------------|-------------|--------|---|
| | 2007 | 2006 | | | |
| Senior living revenue | \$ 396,525 | \$ 363,437 | \$ 33,088 | 9 | % |
| Senior living wages and benefits | 204,872 | 185,319 | 19,553 | 11 | % |
| Other senior living operating expenses | 97,875 | 94,282 | 3,593 | 4 | % |
| Management fee to SLS | | 6,392 | (6,392) | -100 | % |
| Termination expense for certain SLS management agreements | | 89,833 | (89,833) | -100 | % |
| Rent expense | 58,898 | 51,453 | 7,445 | 14 | % |
| Depreciation and amortization | 4,500 | 3,614 | 886 | 25 | % |
| Interest expense | 969 | 1,510 | (541) | -36 | % |
| Gain on extinguishment of debt | 4,491 | | 4,491 | | |
| Senior living income from continuing operations | 33,902 | (68,966) | 102,868 | 149 | % |
| No. of communities (end of period) | 161 | 149 | 12 | 8 | % |
| No. of living units (end of period) | 18,007 | 16,618 | 1,389 | 8 | % |
| Occupancy | 90.1 | % 91.2 | % | 1.1 | % |
| Average daily rate | \$ 135 | \$ 133 | \$ 2 | 2 | % |
| Percent of net revenues from residents from Medicare | 16 | % 15 | % | 1 | % |
| Percent of net revenues from residents from Medicaid | 18 | % 19 | % | -1 | % |
| Percent of net revenues from residents from private and other sources | 66 | % 66 | % | | |

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

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

Rehabilitation hospitals:

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

Corporate and Other (1):

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

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

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

Consolidated:

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

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

Senior living communities:

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

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

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-Q

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

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

Rehabilitation hospitals:

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

Corporate and other:

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

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

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

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

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

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

LIQUIDITY AND CAPITAL RESOURCES

Assets and Liabilities

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

Our Leases with Senior Housing

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

21

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

Our Revenues

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

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

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

Debt Instruments and Covenants

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

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

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

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

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

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

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

Seasonality

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

Related Party Transactions

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

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

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

Item 4. Controls and Procedures

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

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

WARNING CONCERNING FORWARD LOOKING STATEMENTS

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

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

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

YOU SHOULD NOT PLACE UNDUE RELIANCE UPON FORWARD LOOKING STATEMENTS.

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

Part II. Other Information

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

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

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

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

Item 6. Exhibits

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

26

SIGNATURES

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-Q

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

FIVE STAR QUALITY CARE, INC.

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

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

27
