

CAPITAL SENIOR LIVING CORP
Form 10-Q
November 09, 2012
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

OR

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

For the transition period from to

Commission file number: 1-13445

Capital Senior Living Corporation

(Exact Name of Registrant as Specified in its Charter)

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Delaware (State or Other Jurisdiction of Incorporation or Organization)	75-2678809 (I.R.S. Employer Identification No.)
14160 Dallas Parkway, Suite 300, Dallas, Texas (Address of Principal Executive Offices)	75254 (Zip Code)
(972) 770-5600 (Registrant's Telephone Number, Including Area Code)	
NONE (Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)	

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of November 5, 2012, the Registrant had 28,189,024 outstanding shares of its Common Stock, \$0.01 par value, per share.

Table of Contents

CAPITAL SENIOR LIVING CORPORATION

INDEX

	Page Number
<u>Part I. Financial Information</u>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated Balance Sheets – September 30, 2012 and December 31, 2011</u>	3
<u>Consolidated Statements of Operations and Comprehensive (Loss) Income – Three and Nine Months Ended September 30, 2012 and 2011</u>	4
<u>Consolidated Statements of Cash Flows – Nine Months Ended September 30, 2012 and 2011</u>	5
<u>Notes to Unaudited Consolidated Financial Statements</u>	6
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	17
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	27
<u>Item 4. Controls and Procedures</u>	27
<u>Part II. Other Information</u>	
<u>Item 1. Legal Proceedings</u>	28
<u>Item 1A. Risk Factors</u>	28
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	28
<u>Item 3. Defaults Upon Senior Securities</u>	28
<u>Item 4. Mine Safety Disclosures</u>	29
<u>Item 5. Other Information</u>	29
<u>Item 6. Exhibits</u>	29
<u>Signature</u>	30
Certifications	

Table of Contents**Part I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****CAPITAL SENIOR LIVING CORPORATION****CONSOLIDATED BALANCE SHEETS**

(in thousands)

	September 30, 2012 (unaudited)	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 48,298	\$ 22,283
Restricted cash	9,196	9,102
Accounts receivable, net	3,709	4,526
Accounts receivable from affiliates	846	708
Federal and state income taxes receivable		5,438
Deferred taxes	1,643	1,479
Property tax and insurance deposits	9,322	11,395
Prepaid expenses and other	3,809	6,068
Total current assets	76,823	60,999
Property and equipment, net	435,832	365,459
Deferred taxes	12,044	5,782
Investments in unconsolidated joint ventures	1,050	1,070
Other assets, net	35,636	29,016
Total assets	\$ 561,385	\$ 462,326
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 1,931	\$ 2,297
Accounts payable to affiliates	243	314
Accrued expenses	22,410	19,086
Current portion of notes payable	8,173	8,196
Current portion of deferred income	6,946	8,740
Current portion of capital lease and financing obligations	827	50
Federal and state income taxes payable	3,166	
Customer deposits	1,479	1,530
Total current liabilities	45,175	40,213
Deferred income	20,548	26,175
Capital lease and financing obligations, net of current portion	42,354	31
Other long-term liabilities	1,726	1,826
Notes payable, net of current portion	281,721	224,940
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$.01 par value:		
Authorized shares 15,000; no shares issued or outstanding		
Common stock, \$.01 par value:	285	280

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Authorized shares	65,000; issued and outstanding shares	28,189 and 27,699 in 2012 and 2011, respectively		
Additional paid-in capital			137,494	135,301
Retained earnings			33,016	34,494
Treasury stock, at cost	350 shares		(934)	(934)
Total shareholders equity			169,861	169,141
Total liabilities and shareholders equity			\$ 561,385	\$ 462,326

See accompanying notes to consolidated financial statements.

Table of Contents**CAPITAL SENIOR LIVING CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE (LOSS) INCOME****(unaudited, in thousands, except per share data)**

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Revenues:				
Resident and health care revenue	\$ 76,577	\$ 66,928	\$ 223,161	\$ 186,773
Affiliated management services revenue	176	141	492	738
Community reimbursement revenue	1,259	1,122	3,605	4,839
Total revenues	78,012	68,191	227,258	192,350
Expenses:				
Operating expenses (exclusive of facility lease expense and depreciation and amortization expense shown below)	46,791	40,975	134,186	112,714
General and administrative expenses	3,288	3,270	10,923	9,557
Facility lease expense	13,819	13,723	41,179	38,767
Stock-based compensation expense	602	430	1,843	1,020
Depreciation and amortization	9,214	4,775	24,970	11,916
Community reimbursement expense	1,259	1,122	3,605	4,839
Total expenses	74,973	64,295	216,706	178,813
Income from operations	3,039	3,896	10,552	13,537
Other income (expense):				
Interest income	369	18	436	82
Interest expense	(4,847)	(2,978)	(12,699)	(8,429)
(Loss) Gain on disposition of assets, net	(14)	187	(19)	181
Equity in losses of unconsolidated joint ventures, net	(26)	(223)	(241)	(619)
(Loss) Income before benefit (provision) for income taxes	(1,479)	900	(1,971)	4,752
Benefit (Provision) for income taxes	542	(390)	493	(2,073)
Net (loss) income	\$ (937)	\$ 510	\$ (1,478)	\$ 2,679
Per share data:				
Basic net (loss) income per share	\$ (0.03)	\$ 0.02	\$ (0.05)	\$ 0.10
Diluted net (loss) income per share	\$ (0.03)	\$ 0.02	\$ (0.05)	\$ 0.10
Weighted average shares outstanding basic	27,383	27,026	27,331	26,971
Weighted average shares outstanding diluted	27,383	27,072	27,331	27,050
Comprehensive (loss) income	\$ (937)	\$ 510	\$ (1,478)	\$ 2,679

See accompanying notes to consolidated financial statements.

Table of Contents

CAPITAL SENIOR LIVING CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in thousands)

	Nine Months Ended	
	September 30,	
	2012	2011
Operating Activities		
Net (loss) income	\$ (1,478)	\$ 2,679
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	24,970	11,917
Amortization of deferred financing charges	518	252
Amortization of deferred lease costs and lease intangibles	452	1,615
Deferred income	(2,505)	(1,632)
Deferred income taxes	(6,426)	(4,708)
Loss (Gain) on disposition of assets, net	19	(181)
Equity in losses of unconsolidated joint ventures	241	619
Provision for bad debts	550	123
Stock-based compensation expense	1,843	1,020
Changes in operating assets and liabilities:		
Accounts receivable	266	(986)
Accounts receivable from affiliates	(138)	360
Property tax and insurance deposits	2,073	1,256
Prepaid expenses and other	2,259	866
Other assets	3,117	(4,485)
Accounts payable	(437)	71
Accrued expenses	3,324	2,470
Federal and state income taxes receivable/payable	8,604	556
Customer deposits	(51)	359
Net cash provided by operating activities	37,201	12,171
Investing Activities		
Capital expenditures	(9,096)	(7,137)
Cash paid for acquisitions	(75,595)	(53,450)
Proceeds from Spring Meadows Transaction		15,844
Proceeds from disposition of assets	19	
Contributions to unconsolidated joint ventures	(241)	(471)
Distributions from unconsolidated joint ventures	21	1,442
Net cash used in investing activities	(84,892)	(43,772)
Financing Activities		
Proceeds from notes payable	81,888	38,464
Repayments of notes payable	(6,837)	(5,123)
Increase in restricted cash	(94)	(2,759)
Cash payments for capital lease and financing obligations	(230)	(109)
Cash proceeds from the issuance of common stock	127	985
Excess tax benefits on stock option exercised	228	122
Deferred financing charges paid	(1,376)	(513)
Net cash provided by financing activities	73,706	31,067
Increase (Decrease) in cash and cash equivalents	26,015	(534)

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Cash and cash equivalents at beginning of period	22,283	31,248
Cash and cash equivalents at end of period	\$ 48,298	\$ 30,714
Supplemental Disclosures		
Cash paid during the period for:		
Interest	\$ 11,826	\$ 8,136
Income taxes	\$ 777	\$ 6,255
Non-cash operating, investing, and financing activities during the period:		
Intangible assets acquired through capital lease and financing obligations	\$ 11,794	\$
Property and equipment acquired through capital lease and financing obligations	\$ 13,243	\$
Notes payable assumed through capital lease and financing obligations	\$ 18,293	\$

See accompanying notes to consolidated financial statements.

Table of Contents

CAPITAL SENIOR LIVING CORPORATION

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

1. BASIS OF PRESENTATION

Capital Senior Living Corporation, a Delaware corporation (together with its subsidiaries, the Company), is one of the largest operators of senior living communities in the United States in terms of resident capacity. The Company owns, operates, develops and manages senior living communities throughout the United States. As of September 30, 2012, the Company operated 91 senior living communities in 23 states with an aggregate capacity of approximately 12,600 residents, including 41 senior living communities which the Company either owned or in which the Company had an ownership interest and 50 senior living communities that the Company leased. As of September 30, 2012, the Company also operated one home care agency. The accompanying consolidated financial statements include the financial statements of Capital Senior Living Corporation and its wholly owned subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation. The Company accounts for significant investments in unconsolidated companies, in which the Company has significant influence, using the equity method of accounting.

The accompanying consolidated balance sheet, as of December 31, 2011, has been derived from audited consolidated financial statements of the Company for the year ended December 31, 2011, and the accompanying unaudited consolidated financial statements, as of and for the three and nine month periods ended September 30, 2012 and 2011, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to those rules and regulations. For further information, refer to the financial statements and notes thereto for the year ended December 31, 2011, included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 12, 2012.

In the opinion of the Company, the accompanying consolidated financial statements contain all adjustments (all of which were normal recurring accruals) necessary to present fairly the Company's financial position as of September 30, 2012, results of operations for the three and nine month periods ended September 30, 2012 and 2011, and cash flows for the nine month periods ended September 30, 2012 and 2011. The results of operations for the three and nine month periods ended September 30, 2012, are not necessarily indicative of the results for the year ending December 31, 2012.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Investments in Unconsolidated Joint Ventures

The Company accounts for its investments in unconsolidated joint ventures under the equity method of accounting. As of September 30, 2012, the Company owns member interests in three joint ventures. The Company has not consolidated these joint venture interests because the Company has concluded that the other members of each joint venture have substantive kick-out rights or substantive participating rights. Under the equity method of accounting the Company records its investments in unconsolidated joint ventures at cost and adjusts such investments for its share of earnings and losses of the joint ventures.

Development Agreement Guarantees

The Company, on its three joint venture developments, has guarantees that the communities will be completed and operated at the budgeted costs approved by the joint venture members. These costs include the hard and soft construction costs and operating costs until each community reaches breakeven. The budgeted costs include contingency reserves for potential cost overruns and other unforeseen costs. The terms of these guarantees generally do not provide for a limitation on the maximum potential future payments. These joint venture communities are currently in lease up and one of the joint ventures had exhausted its lease up reserve. The Company will be required to fund any operating deficits until the joint venture reaches breakeven for three consecutive months. Any amounts funded by the Company under this commitment, up to \$0.5 million, may be recoverable from the joint venture in the event of liquidation. As of September 30, 2012, the Company has recognized deficit charges of approximately \$1.2 million under these development agreement guarantees. During the third quarter of fiscal 2011, the Company met the breakeven requirements of the development agreement guarantees for two of these joint venture developments resulting in full satisfaction and termination of these respective guarantees.

Table of Contents*Lease Accounting*

The Company determines whether to account for its leases as either operating, capital or financing leases depending on the underlying terms of each lease agreement. This determination of classification is complex and requires significant judgment relating to certain information including the estimated fair value and remaining economic life of the community, the Company's cost of funds, minimum lease payments and other lease terms. As of September 30, 2012, the Company leased 50 senior living communities, 48 of which the Company classified as operating leases and two of which the Company classified as capital lease and financing obligations. The Company incurs lease acquisition costs and amortizes these costs over the term of the respective lease agreement. Certain leases entered into by the Company qualified as sale/leaseback transactions and as such any related gains have been deferred and are being amortized over the respective lease term. Facility lease expense in the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income includes rent expense plus amortization expense relating to leasehold acquisition costs offset by the amortization of deferred gains and lease incentives.

The Company has a non-cancelable lease which expires in 2013 for ten 12-passenger Ford Minibuses that are used to transport residents of certain communities. The lease is classified as a capital lease because it contains a bargain purchase option which resulted in the Company initially recording a capital lease obligation for \$247,000 of which \$43,000 remained outstanding at September 30, 2012.

There are various financial covenants and other restrictions in the Company's lease agreements. Under the terms of certain lease agreements, the Company had previously deposited additional cash collateral of approximately \$3.4 million with a certain landlord which was returnable to the Company once certain performance targets were reached. However, the Company negotiated a lease modification with this landlord during the second quarter of fiscal 2012 and all of the additional cash collateral initially deposited by the Company was returned to the Company. For additional information, refer to Note 4, FACILITY LEASE TRANSACTIONS. The Company was in compliance with all lease covenants at September 30, 2012.

Income Taxes

At September 30, 2012, the Company had recorded on its consolidated balance sheet net deferred tax assets of approximately \$13.7 million. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The effective tax rates for the first nine month periods and third quarters of fiscal 2012 and 2011 differ from the statutory tax rates due to state income taxes and permanent tax differences. The Company is impacted by the Texas Margin Tax (TMT), which effectively imposes tax on modified gross revenues for communities within the State of Texas. The Company consolidated 35 Texas communities in the third quarter of fiscal 2012 and 29 Texas communities in the third quarter of fiscal 2011 and the TMT increased the overall provision for income taxes. Management regularly evaluates the future realization of deferred tax assets and provides a valuation allowance, if considered necessary, based on such evaluation. As part of the evaluation, management has evaluated future expectations of net income. The Company believes based upon this analysis that the realization of the net deferred tax assets is reasonably assured and therefore has not provided for a valuation allowance. However, the benefits of the net deferred tax assets might not be realized if actual results differ from expectations.

The Company evaluates uncertain tax positions through consideration of accounting and reporting guidance on criteria, measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition that is intended to provide better financial-statement comparability among different companies. The Company is required to recognize a tax benefit in its financial statements for an uncertain tax position only if management's assessment is that such position is more likely than not (i.e., a greater than 50% likelihood) to be upheld on audit based only on the technical merits of the tax position. The Company's policy is to recognize interest related to unrecognized tax benefits as interest expense and penalties as income tax expense. The Company is not subject to income tax examinations for tax years prior to 2006.

Net Income Per Share

Basic net income per common share is computed by dividing net income remaining after allocation to unvested restricted shares by the weighted average number of common shares outstanding for the period. Except when the effect would be anti-dilutive, the calculation of diluted net income per common share includes the net impact of unvested restricted shares and shares that could be issued under outstanding stock options.

Table of Contents

The following table sets forth the computation of basic and diluted net (loss) income per share (in thousands, except for per share amounts):

	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Net (loss) income	\$ (937)	\$ 510	\$ (1,478)	\$ 2,679
Net (loss) income allocated to unvested restricted shares	27	(12)	43	(58)
Undistributed net (loss) income allocated to common shares	\$ (910)	\$ 498	\$ (1,435)	\$ 2,621
Weighted average shares outstanding basic	27,383	27,026	27,331	26,971
Effects of dilutive securities:				
Employee equity compensation plans		46		79
Weighted average shares outstanding diluted	27,383	27,072	27,331	27,050
Basic net (loss) income per share	\$ (0.03)	\$ 0.02	\$ (0.05)	\$ 0.10
Diluted net (loss) income per share	\$ (0.03)	\$ 0.02	\$ (0.05)	\$ 0.10

Awards of unvested restricted stock representing approximately 800,000 and 628,000 shares were outstanding for the three months ended September 30, 2012 and 2011, respectively, and awards of unvested restricted stock representing approximately 806,000 and 597,000 shares were outstanding for the nine months ended September 30, 2012 and 2011, respectively, and were included in the computation of allocable net income.

Treasury Stock

The Company accounts for treasury stock under the cost method and includes treasury stock as a component of stockholders' equity.

Reclassifications

Certain reclassifications have been made to prior year quarterly amounts to conform to year end and current year presentation. Assets are classified as held for sale when the Company has committed to selling the asset and believes that it will be disposed of within one year. The Company periodically reevaluates assets held for sale to determine if the assets are still recorded at the lower of fair value, net of cost of disposal, or carrying value and whether the assets continue to meet the criteria to be classified as held for sale. Based on this evaluation, at December 31, 2011 the Company reclassified one parcel of land valued at \$0.4 million that was previously classified as held for sale to property and equipment within the Company's Consolidated Balance Sheets, which had no impact on total assets.

Recently Issued Accounting Guidance

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2011-04, *Fair Value Measurement* (ASU 2011-04), which amended Accounting Standards Codification (ASC) 820 to clarify existing guidance and minimize differences between U.S. GAAP and International Financial Reporting Standards (IFRS). ASU 2011-04 requires entities to provide information about valuation techniques and unobservable inputs used in fair value measurements and provide additional disclosures for classes of assets and liabilities disclosed at fair value. The Company adopted ASU 2011-04 as of January 1, 2012, which did not have a material impact on our financial statements.

In June 2011, the FASB issued Accounting Standards Update No. 2011-05, *Statement of Comprehensive Income* (ASU 2011-05), which requires entities to present net income and other comprehensive income in either a single continuous statement or in two separate, but consecutive, statements of income and comprehensive income. ASU 2011-05 was effective for the Company January 1, 2012, and the update did not impact the reported results of operations of the Company.

3. TRANSACTIONS WITH AFFILIATES

SHPII/CSL

In November 2004, the Company with Senior Housing Partners II, L.P. (SHPII) formed four joint ventures (collectively, SHPII/CSL) that owned four senior living communities (the Spring Meadows Communities). SHPII/CSL was owned 95% by SHPII, a fund managed by Prudential Real Estate Investors (Prudential), and 5% by the Company. The Company had contributed

Table of Contents

\$1.3 million for its interests in SHPII/CSL. The Company accounted for its investment in SHPII/CSL under the equity method of accounting and the Company recognized earnings in the equity of SHPII/CSL of \$0.1 million during the nine month period ended September 30, 2011. In addition, the Company earned \$0.3 million in management fees on the Spring Meadows Communities during the nine month period ended September 30, 2011.

On April 8, 2011, SHPII/CSL closed the sale of the Spring Meadows Communities to Health Care REIT, Inc. (HCN). Upon closing the sale, the Company leased the four Spring Meadows Communities from HCN (the Spring Meadows Transaction). The lease has an initial term of 15 years, with one 15-year renewal extension available at the Company's option. The initial lease rate is 7.25% and is subject to certain conditional lease escalation clauses. The Company incurred \$0.9 million in lease acquisition costs which have been deferred and are being amortized over the initial 15-year lease term. The Company has accounted for this lease as an operating lease. As a result of this transaction, the Company received cash proceeds, including incentive distributions, from the sale by SHPII/CSL of approximately \$17.0 million, net of closing costs, resulting in a gain to the Company of approximately \$16.1 million which has been deferred and is being recognized in the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income as a reduction in facility lease expense over the initial 15-year lease term.

SHPIII/CSL Miami

In May 2007, the Company with Senior Housing Partners III, L.P. (SHPIII) formed SHPIII/CSL Miami, L.L.C. (SHPIII/CSL Miami) to develop a senior housing community in Miamisburg, Ohio. Under the joint venture and related agreements, the Company earns development and management fees and may receive incentive distributions. The Company has contributed \$0.8 million to SHPIII/CSL Miami for its 10% interest. The Company accounts for its investment in SHPIII/CSL Miami under the equity method of accounting and recognized losses in the equity of SHPIII/CSL Miami of \$(0.2 million) and \$(0.6 million) during the nine month periods ended September 30, 2012 and 2011, respectively. In addition, the Company earned \$0.1 million in management fees on the SHPIII/CSL Miami community in each of the nine month periods ended September 30, 2012 and 2011. As of September 30, 2012, the Company has not met the breakeven requirements of the development agreement guarantee for this joint venture development.

SHPIII/CSL Richmond Heights

In November 2007, the Company with SHPIII formed SHPIII/CSL Richmond Heights, L.L.C. (SHPIII/CSL Richmond Heights) to develop a senior housing community in Richmond Heights, Ohio. Under the joint venture and related agreements, the Company earns development and management fees and may receive incentive distributions. The Company has contributed \$0.8 million to SHPIII/CSL Richmond Heights for its 10% interest. The Company accounts for its investment in SHPIII/CSL Richmond Heights under the equity method of accounting and recognized earnings (losses) in the equity of SHPIII/CSL Richmond Heights of \$8,700 and \$(41,600) during the nine month periods ended September 30, 2012 and 2011, respectively. In addition, the Company earned \$0.2 million and \$0.1 million in management fees on the SHPIII/CSL Richmond Heights community during the nine month periods ended September 30, 2012 and 2011, respectively.

The Company contributed land to SHPIII/CSL Richmond Heights as a capital contribution during formation of the joint venture in November 2007 resulting in a \$0.2 million gain to the Company. The gain had been deferred when the land was initially contributed to SHPIII/CSL Richmond Heights due to the continuing involvement of the Company as a result of a development agreement guarantee. The Company met the breakeven requirements of the development agreement guarantee during the third quarter of fiscal 2011 resulting in full satisfaction and termination of the guarantee and recognition of the deferred gain as a component of gain on disposition of assets, net, within the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income.

SHPIII/CSL Levis Commons

In December 2007, the Company with SHPIII formed SHPIII/CSL Levis Commons, L.L.C. (SHPIII/CSL Levis Commons) to develop a senior housing community near Toledo, Ohio. Under the joint venture and related agreements, the Company earns development and management fees and may receive incentive distributions. The Company has contributed \$0.8 million to SHPIII/CSL Levis Commons for its 10% interest. The Company accounts for its investment in SHPIII/CSL Levis Commons under the equity method of accounting and recognized losses in the equity of SHPIII/CSL Levis Commons of \$(6,900) and \$(47,300) during the nine month periods ended September 30, 2012 and 2011, respectively. In addition, the Company earned \$0.2 million and \$0.1 million in management fees on the SHPIII/CSL Levis Commons community during the nine month periods ended September 30, 2012 and 2011, respectively. During the third quarter of fiscal 2011, the Company met the breakeven requirements of the development agreement guarantee for this joint venture development resulting in full satisfaction and termination of the guarantee.

Table of Contents**4. FACILITY LEASE TRANSACTIONS**

Effective June 27, 2012, the Company closed a lease modification transaction with Ventas, Inc. (Ventas) which resulted in the Company exchanging two of its owned communities for one of the communities in the existing Ventas lease portfolio and simultaneously leasing back the two communities exchanged (the Ventas Lease Transaction). This transaction was the result of negotiations for a solution to the anticipation of the Company not meeting certain lease coverage ratio requirements for its lease portfolio of ten properties with Ventas. The two communities previously owned by the Company are located in East Lansing, Michigan (the East Lansing Community) and Raleigh, North Carolina (the Raleigh Community) and were exchanged for a community located in Merrillville, Indiana (the Towne Centre Community). All three communities continue to be operated by the Company. In conjunction with this transaction, Ventas assumed approximately \$18.3 million of existing mortgage debt with Berkadia Commercial Mortgage (Berkadia) and the Company received the Towne Centre Community unencumbered. All of the leased communities in the Ventas lease portfolio were modified to be coterminous with the East Lansing and Raleigh Community leases expiring on September 30, 2020, with two 5-year renewal extensions available at the Company s option, eliminate property-level lease covenants, and contain substantially similar terms and conditions. These leases were re-evaluated by the Company at the modification date and continue to be treated as operating leases. Under the terms of the original lease agreements with Ventas, the Company had previously deposited additional cash collateral of approximately \$3.4 million which was returnable to the Company once certain performance targets were reached. However, due to the rebalanced lease portfolio meeting the lease coverage ratio requirements, the Company negotiated the return of these deposits as a condition to the lease modification. Additionally, due to the extension of the lease terms for the Ventas lease portfolio to fiscal 2020, the rights of Ventas to reset the underlying values of the leased communities were deferred for five years. Pursuant to Accounting Standards Codification (ASC) 840, Leases, the Company performed a sale/leaseback analysis to determine whether the East Lansing Community and Raleigh Community could be removed from its Consolidated Balance Sheet. Based upon the analysis performed, the Company concluded certain aspects of the lease modification would be considered forms of continuing involvement which precludes the Company from derecognizing these assets from its Consolidated Balance Sheet under sale/leaseback accounting criteria. Therefore, the Company recorded financing obligations equal to the fair market value of the communities exchanged and the mortgage debt assumed by Ventas. At the end of the lease term, including exercise of any renewal options, the net remaining financing obligation less the net carrying value of the leased assets will be recognized as a non-cash gain on sale of the East Lansing Community and Raleigh Community. Rental payments under these leases will not be reflected as a component of facility lease expense but will be recognized as a reduction of the financing obligation and interest expense based upon the Company s incremental borrowing rate at the time the transaction was closed. As a result of this transaction, for which the purchase accounting is preliminary as it is subject to final valuation adjustments, the Company recorded additions to property and equipment of approximately \$13.2 million and other assets, primarily consisting of lease intangibles, of approximately \$11.8 million within the Company s Consolidated Balance Sheets which will be depreciated or amortized over the estimated useful lives. The additions to property and equipment were reduced by approximately \$4.9 million which represented the unamortized portion of the deferred gain previously recognized by the Company when the Towne Centre Community had been sold in fiscal 2006. Lease intangibles consist of the fair value of in-place leases associated with the Towne Centre Community and the fair value attributable to Ventas deferring its right to reset the underlying values of the lease portfolio five years until fiscal 2020.

5. ACQUISITIONS*Fiscal 2012*

Effective April 30, 2012, the Company closed the acquisition of one senior living community located in Irving, Texas, for approximately \$19.2 million (the Remington Transaction). The community consists of 128 independent living units. The Company incurred approximately \$0.1 million in transaction costs related to this acquisition which have been included in general and administrative expenses within the Company s Consolidated Statements of Operations and Comprehensive (Loss) Income. The Company obtained financing through Fannie Mae for approximately \$11.8 million of the acquisition price at a fixed rate of 4.48% with a 10-year term, with the balance of the acquisition price paid from the Company s existing cash resources.

Effective March 30, 2012, the Company closed the acquisition of one senior living community located in Jeffersonville, Indiana, for approximately \$15.3 million (the Riverbend Transaction). The community consists of 97 assisted living units. The Company incurred approximately \$0.1 million in transaction costs related to this acquisition which have been included in general and administrative expenses within the Company s Consolidated Statements of Operations and Comprehensive (Loss) Income. The Company obtained financing through Fannie Mae for approximately \$11.5 million of the acquisition price at a fixed rate of 4.76% with a 10-year term, with the balance of the acquisition price paid from the Company s existing cash resources.

Table of Contents

Effective March 30, 2012, the Company closed the acquisition of four senior living communities located in Arlington, College Station, Conroe and Stephenville, Texas, for approximately \$34.1 million. The four properties acquired are part of a five property transaction with the fifth property located in Corpus Christi, Texas, which closed on October 17, 2012 (the Esperanza Transaction). The four communities acquired consist of 45 independent living units and 211 assisted living units. The Company incurred approximately \$0.2 million in transaction costs related to this acquisition which have been included in general and administrative expenses within the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income. The Company obtained financing through Fannie Mae for approximately \$26.1 million of the acquisition price at a fixed rate of 4.69% with a 10-year term, with the balance of the acquisition price paid from the Company's existing cash resources.

Effective March 1, 2012, the Company closed the acquisition of a senior living community located in Granbury, Texas, for approximately \$7.0 million (the Granbury Transaction). The community consists of 82 assisted living units. The Company incurred approximately \$0.2 million in transaction costs related to this acquisition which have been included in general and administrative expenses within the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income. The Company obtained financing through Fannie Mae for approximately \$5.4 million of the acquisition price at a fixed rate of 4.38% with a 10-year term, with the balance of the acquisition price paid from the Company's existing cash resources.

As a result of these acquisitions during the first nine months of fiscal 2012, for which the purchase accounting is preliminary as it is subject to final valuation adjustments, the Company recorded additions to property and equipment of approximately \$67.8 million and other assets, primarily consisting of in-place lease intangibles, of approximately \$7.5 million within the Company's Consolidated Balance Sheets which will be depreciated or amortized over the estimated useful lives.

Fiscal 2011

Effective October 19, 2011, the Company closed the acquisition of three senior living communities, one located in Columbus, North Carolina, and two located in Anderson, South Carolina, for approximately \$30.0 million (the Pulliam Transaction). These communities consist of 56 independent living units and 141 assisted living units. The Company incurred approximately \$0.4 million in transaction costs related to this acquisition which have been included in general and administrative expenses within the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income. The Company obtained financing through Fannie Mae for approximately \$22.1 million of the acquisition price at a fixed rate of 4.92% with a 10-year term, with the balance of the acquisition price paid from the Company's existing cash resources.

Effective August 1, 2011, the Company closed the acquisition of a senior living community located in Macedonia, Ohio, for approximately \$27.3 million (the Summit Point Transaction). This community consists of 100 independent living units and 50 assisted living units. The Company incurred approximately \$0.2 million in transaction costs related to this acquisition which have been included in general and administrative expenses within the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income. The Company obtained interim financing through KeyBank on August 1, 2011, for approximately \$19.0 million of the acquisition price at a variable rate of LIBOR plus 2.25% with a maturity date of December 31, 2011, with the balance of the acquisition price paid from the Company's existing cash resources. The Company obtained long-term fixed rate financing through Fannie Mae on September 27, 2011, for approximately \$19.0 million to replace the KeyBank interim loan at a fixed rate of 4.92% with a 10-year term.

Effective July 29, 2011, the Company closed the acquisition of two senior living communities located in Anderson, Indiana, and Rochester, Indiana, for approximately \$16.0 million (the Keystone Woods and Wynnfield Crossing Transaction). These communities consist of 109 assisted living units. The Company incurred approximately \$0.3 million in transaction costs related to this acquisition which have been included in general and administrative expenses within the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income. The Company obtained financing through Fannie Mae on July 29, 2011, for approximately \$6.75 million of the acquisition price for the property located in Rochester, Indiana, at a fixed rate of 5.69% with a 10-year term, with the balance of the acquisition price paid from the Company's existing cash resources. The Company obtained financing through Fannie Mae on September 27, 2011, for approximately \$4.8 million of the acquisition price for the property located in Anderson, Indiana, at a fixed rate of 4.97% with a 10-year term, with the balance being paid from the Company's existing cash resources.

Effective July 15, 2011, the Company closed the acquisition of a senior living community located in Kokomo, Indiana, for approximately \$10.2 million (the GreenTree at Kokomo Transaction). This community consists of 78 assisted living units. The Company incurred approximately \$0.1 million in transaction costs related to this acquisition which have been included in general and administrative expenses within the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income. The Company obtained financing through Fannie Mae on July 29, 2011, for approximately \$6.75 million of the acquisition price at a fixed rate of 5.69% with a 10-year term, with the balance of the acquisition price paid from the Company's existing cash resources.

Table of Contents

As a result of these acquisitions during fiscal 2011, the Company recorded additions to property and equipment of approximately \$75.1 million and other assets, primarily consisting of in-place lease intangibles, of approximately \$8.3 million within the Company's Consolidated Balance Sheets which will be depreciated or amortized over the estimated useful lives.

6. DEBT TRANSACTIONS

On June 27, 2012, in conjunction with the Ventas Lease Transaction, existing mortgage debt of approximately \$18.3 million was assumed by Ventas with no further obligation to the Company. Approximately \$0.1 million of unamortized deferred loan costs were written off in connection with the debt assumption by Ventas.

On June 21, 2012, the Company completed supplemental financing of approximately \$20.2 million with Freddie Mac at a fixed rate of 4.39% on eight communities with existing mortgage debt maturing in July 2015. The supplemental loans are cross-collateralized and cross-defaulted with each other and with the original mortgage debt. The Company incurred approximately \$0.6 million in deferred financing costs related to these loans, which is being amortized over the remaining loan terms.

On May 31, 2012, the Company renewed certain insurance policies and entered into a finance agreement totaling approximately \$1.4 million. The finance agreement has a fixed interest rate of 2.6% with principal being repaid over an 11-month term.

On April 30, 2012, the Company obtained approximately \$11.8 million of mortgage debt on one senior living community with Fannie Mae. The new mortgage loan has a ten-year term with a 4.48% fixed interest rate and the principal amortized over a 30-year term. The Company incurred approximately \$0.1 million in deferred financing costs related to this loan, which is being amortized over ten years.

On March 30, 2012, the Company obtained approximately \$11.5 million of mortgage debt on one senior living community with Fannie Mae. The new mortgage loan has a ten-year term with a 4.76% fixed interest rate and the principal amortized over a 30-year term. The Company incurred approximately \$0.1 million in deferred financing costs related to these loans, which is being amortized over ten years.

On March 30, 2012, the Company obtained approximately \$26.1 million of mortgage debt on four senior living communities with Fannie Mae. The new mortgage loans are cross-collateralized and cross-defaulted and each have a ten-year term with interest rates fixed at 4.69% and the principal amortized over a 30-year term. The Company incurred approximately \$0.3 million in deferred financing costs related to these loans, which is being amortized over ten years.

On March 8, 2012, the Company completed supplemental financing of approximately \$5.6 million with Fannie Mae at a fixed rate of 4.47% on three communities with existing mortgage debt maturing in June 2017. The supplemental loans are cross-collateralized and cross-defaulted with each other and with the original mortgage debt. The Company incurred approximately \$0.2 million in deferred financing costs related to these loans, which is being amortized over the remaining loan terms.

On March 1, 2012, the Company obtained approximately \$5.4 million of mortgage debt on one senior living community with Fannie Mae. The new mortgage loan has a ten-year term and a 4.38% fixed interest rate and the principal amortized over a 30-year term. The Company incurred approximately \$0.1 million in deferred financing costs related to these loans, which is being amortized over ten years.

On December 1, 2011, the Company renewed certain insurance policies and entered into a finance agreement totaling approximately \$3.5 million. The finance agreement has a fixed interest rate of 2.264% with principal being repaid over a 15-month term.

On October 31, 2011, the Company renewed certain insurance policies and entered into a finance agreement totaling approximately \$0.5 million. The finance agreement has a fixed interest rate of 2.87% with principal being repaid over an 11-month term.

On October 19, 2011, the Company obtained approximately \$22.1 million of mortgage debt on three senior living communities with Fannie Mae. The new mortgage loans are cross-collateralized and cross-defaulted and each have a ten-year term with interest rates fixed at 4.92% and the principal amortized over a 30-year term. The Company incurred approximately \$0.3 million in deferred financing costs related to these loans, which is being amortized over ten years.

Table of Contents

On September 27, 2011, the Company obtained approximately \$23.8 million of mortgage debt on two senior living communities with Fannie Mae. The new mortgage loans each have a ten-year term with interest rates fixed at 4.92% for approximately \$19.0 million of the mortgage debt and 4.97% for approximately \$4.8 million of the mortgage debt and with the principal amortized over a 30-year term on each loan. The \$4.8 million mortgage loan is cross-collateralized and cross-defaulted with the mortgage loans obtained by the Company with Fannie Mae on July 29, 2011. The Company incurred approximately \$0.3 million in deferred financing costs related to these loans, which is being amortized over ten years.

On August 1, 2011, in conjunction with the acquisition of one senior living community, the Company obtained interim financing through KeyBank for approximately \$19.0 million at a variable interest rate of LIBOR plus 2.25% with a maturity date of December 31, 2011. The Company obtained long-term fixed rate financing through Fannie Mae on September 27, 2011, to replace this loan.

On July 29, 2011, the Company obtained approximately \$13.5 million of mortgage debt on two senior living communities with Fannie Mae. The new mortgage loans each have a ten-year term with interest rates fixed at 5.69% and the principal amortized over a 30-year term. The loans are cross-collateralized and cross-defaulted with each other and with the \$4.8 million mortgage loan obtained by the Company with Fannie Mae on September 27, 2011. The Company incurred approximately \$0.2 million in deferred financing costs related to these loans, which is being amortized over ten years. In conjunction with the acquisition of these senior living communities the Company assumed approximately \$0.1 million in promissory notes for three vehicles that are used for transportation of employees and residents. The blended interest rate is 7.55% and the outstanding balance has been included within the Company's Consolidated Balance Sheets as a component of notes payable.

On May 31, 2011, the Company renewed certain insurance policies and entered into a finance agreement totaling approximately \$1.2 million. The finance agreement has a fixed interest rate of 2.945% with principal being repaid over a 10-month term.

On March 25, 2011, in connection with the Spring Meadows Transaction, the Company issued standby letters of credit, totaling approximately \$2.6 million, for the benefit of HCN on certain leases between HCN and the Company.

On September 10, 2010, the Company issued standby letters of credit, totaling approximately \$2.2 million, for the benefit of HCN on certain leases between HCN and the Company.

On April 16, 2010, the Company issued standby letters of credit, totaling approximately \$1.7 million, for the benefit of HCN on certain leases between HCN and the Company.

The senior housing communities owned by the Company and encumbered by mortgage debt are provided as collateral under their respective loan agreements. At September 30, 2012, and December 31, 2011, these communities carried a total net book value of approximately \$388.7 million and \$339.4 million, respectively, with total mortgage loans outstanding of approximately \$287.6 million and \$229.3 million, respectively.

In connection with the Company's loan commitments and capital lease and financing obligations described above, the Company incurred financing charges that were deferred and amortized over the life of the respective notes or leases. At September 30, 2012, and December 31, 2011, the Company had gross deferred loan and capital lease and financing obligation costs of approximately \$6.1 million and \$4.3 million, respectively. Accumulated amortization was approximately \$2.0 million and \$1.9 million at September 30, 2012, and December 31, 2011, respectively.

The Company must maintain certain levels of tangible net worth and comply with other restrictive covenants under the terms of certain promissory notes. The Company was in compliance with all of its debt covenants at September 30, 2012 and December 31, 2011.

7. EQUITY

Preferred Stock

The Company is authorized to issue preferred stock in series and to fix and state the voting powers and such designations, preferences and relative participating, optional or other special rights of the shares of each such series and the qualifications, limitations and restrictions thereof. Such action may be taken by the Board without stockholder approval. The rights, preferences and privileges of holders of common stock are subject to the rights of the holders of preferred stock. No preferred stock was outstanding as of September 30, 2012.

Table of Contents*Share Repurchases*

On January 22, 2009, the Company's board of directors approved a share repurchase program that authorized the Company to purchase up to \$10.0 million of the Company's common stock. Purchases may be made from time to time using a variety of methods, which may include open market purchases, privately negotiated transactions or block trades, or by any combination of such methods, in accordance with applicable insider trading and other securities laws and regulations. The size, scope and timing of any purchases will be based on business, market and other conditions and factors, including price, regulatory and contractual requirements or consents, and capital availability. The repurchase program does not obligate the Company to acquire any particular amount of common stock and the share repurchase authorization has no stated expiration date. Shares of stock repurchased under the program will be held as treasury shares. Pursuant to this authorization, during fiscal 2009, the Company purchased 349,800 shares at an average cost of \$2.67 per share for a total cost to the Company of approximately \$0.9 million. All such purchases were made in open market transactions. The Company has not purchased any additional shares of its common stock pursuant to the Company's share repurchase program subsequent to fiscal 2009.

8. STOCK-BASED COMPENSATION

The Company recognizes compensation expense for share-based stock awards to employees, including grants of employee stock options and awards of restricted stock, in the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income based on their fair values.

On May 8, 2007, the Company's stockholders approved the 2007 Omnibus Stock and Incentive Plan for Capital Senior Living Corporation (the 2007 Plan), which provides for, among other things, the grant of restricted stock awards and stock options to purchase shares of the Company's common stock. The 2007 Plan authorizes the Company to issue up to 2.6 million shares of common stock and the Company has reserved 1.0 million shares of common stock for future issuance pursuant to awards under the 2007 Plan. Effective May 8, 2007, the 1997 Omnibus Stock and Incentive Plan (as amended, the 1997 Plan) was terminated and no additional shares will be granted under the 1997 Plan. The Company has reserved 0.5 million shares of common stock for future issuance upon the exercise of stock options that remain outstanding pursuant to the 1997 Plan.

Stock Options

The Company's stock option program is a long-term retention program that is intended to attract, retain and provide incentives for employees, officers and directors and to align more closely stockholder and employee interests. The Company's options generally vest over a period of one to five years and the related expense is amortized on a straight-line basis over the vesting period.

A summary of the Company's stock option activity and related information for the nine month period ended September 30, 2012, is presented below:

	Outstanding at Beginning of Period	Granted	Exercised	Forfeited	Outstanding at End of Period	Options Exercisable
Shares	285,100		16,170		268,930	268,930
Weighted average exercise price per share	\$ 6.28	\$	\$ 5.50	\$	\$ 6.33	\$ 6.33

The options outstanding and the options exercisable at September 30, 2012, each had an intrinsic value of \$2.2 million.

Restricted Stock

The Company may grant restricted stock awards to employees, officers, and directors in order to attract, retain, and provide incentives for such individuals and to align more closely stockholder and employee interests. For restricted stock awards without performance-based vesting conditions, the Company records compensation expense for the entire award on a straight-line basis over the requisite service period, which is generally a period of three to four years, but such awards are considered outstanding at the time of grant since the holders thereof are entitled to dividends and voting rights. For restricted stock awards with performance-based vesting conditions, total compensation expense is recognized over the requisite service period for each separately vesting tranche of the award as if the award is, in substance, multiple awards once the performance target is deemed probable of achievement. Performance goals are evaluated periodically and if such goals are not ultimately met or it is not probable the goals will be achieved, no compensation expense is recognized and any previously recognized compensation expense is

reversed.

Table of Contents

The Company recognizes compensation expense of a restricted stock award over its respective vesting or performance period based on the fair value of the award on the grant date, net of forfeitures. A summary of the Company's restricted stock awards activity and related information for the nine month period ended September 30, 2012, is presented below:

	Outstanding at				Outstanding at End of Period
	Beginning of Period	Issued	Vested	Forfeited	
Shares	626,442	482,191	301,350	7,500	799,783

The restricted stock outstanding at September 30, 2012, had an intrinsic value of \$11.6 million.

During the nine month period ended September 30, 2012, the Company awarded 482,191 shares of restricted common stock to certain employees and directors of the Company. The average market value of the common stock on the date of grant was \$7.83. These awards of restricted shares vest over a one to four-year period and had an intrinsic value of \$3.8 million on the date of issue.

Stock-Based Compensation

The Company uses the Black-Scholes option pricing model to estimate the grant date fair value of its stock options. The Black-Scholes model requires the input of certain assumptions including expected volatility, expected dividend yield, expected life of the option and the risk free interest rate. The expected volatility used by the Company is based primarily on an analysis of historical prices of the Company's common stock. The expected term of options granted is based primarily on historical exercise and vesting patterns on the Company's outstanding stock options. The risk free rate is based on zero-coupon U.S. Treasury yields in effect at the date of grant with the same period as the expected option life. The Company does not currently plan to pay dividends on its common stock and therefore has used a dividend yield of zero in determining the fair value of its awards. The option forfeiture rate assumptions used by the Company, which affect the expense recognized as opposed to the fair value of the awards, are based primarily on the Company's historical option forfeiture patterns. The Company issued no stock options during each of the first nine months of fiscal 2012 and 2011.

The Company has total stock-based compensation expense, excluding estimated forfeitures, of \$4.0 million, which was not recognized as of September 30, 2012, and expects this expense to be recognized over approximately a one to four-year period.

9. CONTINGENCIES

The Company has claims incurred in the normal course of its business. Most of these claims are believed by management to be covered by insurance, subject to normal reservations of rights by the insurance companies and possibly subject to certain exclusions in the applicable insurance policies. Whether or not covered by insurance, these claims, in the opinion of management, based on advice of legal counsel, should not have a material effect on the consolidated financial statements of the Company if determined adversely to the Company.

10. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts and fair values of financial instruments at September 30, 2012, and December 31, 2011, are as follows (in thousands):

	2012		2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$ 48,298	\$ 48,298	\$ 22,283	\$ 22,283
Restricted cash	9,196	9,196	9,102	9,102
Notes payable	289,894	286,609	233,136	237,536

The following methods and assumptions were used in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents and Restricted cash: The carrying amounts reported in the Company's Consolidated Balance Sheets for cash and cash equivalents and restricted cash approximate fair value.

Table of Contents

Notes payable: The fair value of notes payable is estimated using discounted cash flow analysis, based on current incremental borrowing rates for similar types of borrowing arrangements, which represent level 2 inputs as defined in the accounting standards codification.

11. SUBSEQUENT EVENTS

Effective October 23, 2012, the Company closed the acquisition of six senior living communities located in Indiana and Ohio, for approximately \$62.5 million. The communities consist of 440 assisted living units. The Company obtained financing for four of the communities through Fannie Mae for approximately \$26.4 million of the acquisition price at a fixed rate of 4.34% with a 10-year term with the balance of the acquisition price paid from the Company's existing cash resources. The Company obtained interim financing for one of the communities through Berkadia for \$6.4 million of the acquisition price at a variable rate of LIBOR plus 4.5%, which matures on February 10, 2013, with the balance of the acquisition price paid from the Company's existing cash resources. The Company has received a commitment for long-term fixed rate financing to replace the \$6.4 million Berkadia interim loan with similar terms and conditions as the other communities acquired. Due to a recent expansion, the Company also obtained interim financing for one of the communities through Berkadia for \$11.6 million of the acquisition price at a variable rate of LIBOR plus 4.5%, which matures on November 10, 2013, with the balance of the acquisition price paid from the Company's existing cash resources. This community, including the expansion, will be eligible for permanent financing within six months. The Company expects to obtain long-term fixed rate financing to replace the \$11.6 million Berkadia interim loan with similar terms and conditions as the other communities acquired. The Company has not yet completed its initial purchase price allocation for this transaction.

Effective October 23, 2012, the Company closed the acquisition of one senior living community located in Batesville, Indiana, for approximately \$4.0 million. The community consists of 41 assisted living units. The Company obtained financing through Fannie Mae for approximately \$2.6 million of the acquisition price at a fixed rate of 4.34% with a 10-year term with the balance of the acquisition price paid from the Company's existing cash resources. The Company has not yet completed its initial purchase price allocation for this transaction.

Effective October 17, 2012, the Company closed the acquisition of one senior living community located in Corpus Christi, Texas, for approximately \$6.4 million. The property acquired is part of the five property Esperanza Transaction of which the other four properties closed during the first quarter of fiscal 2012. The community consists of 50 assisted living units. The Company assumed mortgage debt insured by the U.S. Department of Housing and Urban Development (HUD) of approximately \$3.2 million of the acquisition price at a fixed rate of 4.48% with approximately a 33-year remaining term with the balance of the acquisition price paid from the Company's existing cash resources. The Company has not yet completed its initial purchase price allocation for this transaction.

Table of Contents**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

Certain information contained in this report constitutes Forward-Looking Statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which can be identified by the use of forward-looking terminology such as may, will, would, intend, could, believe, expect, anticipate, estimate or continue or the negative thereof or other variations thereon or comparable terminology. The Company cautions readers that forward-looking statements, including, without limitation, those relating to the Company's future business prospects, revenues, working capital, liquidity, capital needs, interest costs, and income, are subject to certain risks and uncertainties that could cause actual results to differ materially from those indicated in the forward-looking statements, due to several important factors herein identified. These factors include the Company's ability to find suitable acquisition properties at favorable terms, financing, licensing, business conditions, risks of downturn in economic conditions generally, satisfaction of closing conditions such as those pertaining to licensure, availability of insurance at commercially reasonable rates, and changes in accounting principles and interpretations, among others, and other risks and factors identified from time to time in the Company's reports filed with the Securities and Exchange Commission (SEC).

Overview

The following discussion and analysis addresses (i) the Company's results of operations for the three and nine month periods ended September 30, 2012 and 2011, and (ii) liquidity and capital resources of the Company, and should be read in conjunction with the Company's consolidated financial statements contained elsewhere in this report and the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The Company is one of the largest operators of senior living communities in the United States. The Company's operating strategy is to provide quality senior living services to its residents, while achieving and sustaining a strong, competitive position within its chosen markets, as well as to continue to enhance the performance of its operations. The Company provides senior living services to the elderly, including independent living, assisted living, skilled nursing and home care services.

As of September 30, 2012, the Company operated 91 senior living communities in 23 states with an aggregate capacity of approximately 12,600 residents, including 38 senior living communities that the Company owned, 3 senior living communities in which the Company had an ownership interest, and 50 senior living communities that the Company leased. As of September 30, 2012, the Company also operated one home care agency.

Significant Financial and Operational Highlights

The Company's operating strategy is to provide quality senior living communities and services to its residents, while achieving and sustaining a strong, competitive position within its chosen markets, as well as to continue to enhance the performance of its operations. The Company provides senior living services to the elderly, including independent living, assisted living, skilled nursing and home care services. Many of the Company's communities offer a continuum of care to meet its residents' needs as they change over time. This continuum of care, which integrates independent living and assisted living and is bridged by home care through independent home care agencies or the Company's home care agency, sustains residents' autonomy and independence based on their physical and mental abilities.

The Company primarily derives its revenue by providing senior living and healthcare services to the elderly and operating senior living communities under joint venture arrangements. Operating results from recent acquisitions have added to the Company's growing profitability. When comparing the first nine months of fiscal 2012 to the first nine months of fiscal 2011, the Company has generated total revenues of approximately \$227.3 million compared to total revenues of approximately \$192.4 million, respectively, representing an increase of approximately \$34.9 million, or 18.1%, of which approximately 98.2% were derived from resident and healthcare services during the first nine months of fiscal 2012 compared to 97.1% during the first nine months of fiscal 2011.

Effective June 27, 2012, the Company closed a lease modification transaction with Ventas which resulted in the Company exchanging two of its owned communities for one of the communities in the existing Ventas lease portfolio and simultaneously leasing back the two communities exchanged. This transaction was the result of negotiations for a permanent solution to the anticipation of the Company not meeting certain lease coverage ratio requirements for its lease portfolio of ten properties with Ventas. The East Lansing Community and Raleigh Community were exchanged for the Towne Centre Community. All three communities continue to be operated by the Company. In conjunction with this transaction, Ventas assumed approximately \$18.3 million of existing mortgage debt with Berkadia and the Company received the Towne Centre Community unencumbered. All of the leased communities in the Ventas

Table of Contents

lease portfolio were modified to be coterminous with the East Lansing and Raleigh Community leases expiring on September 30, 2020, with two 5-year renewal extensions available at the Company's option, eliminate property-level lease covenants, and contain substantially similar terms and structures. Under the terms of the lease agreements with Ventas, the Company had previously deposited additional cash collateral of approximately \$3.4 million which was returnable to the Company once certain performance targets were reached. However, due to the rebalanced lease portfolio meeting the lease coverage ratio requirements, the Company negotiated the return of these deposits as a condition to the lease modification. Additionally, due to the extension of the lease terms for the Ventas lease portfolio to fiscal 2020, the rights of Ventas to reset the underlying values of the leased communities were deferred for five years.

Effective April 30, 2012, the Company closed the acquisition of one senior living community located in Irving, Texas, for approximately \$19.2 million. The community consists of 128 independent living units. The Company obtained financing through Fannie Mae for approximately \$11.8 million of the acquisition price at a fixed rate of 4.48% with a 10-year term, with the balance of the acquisition price paid from the Company's existing cash resources.

Effective March 30, 2012, the Company closed the acquisition of one senior living community located in Jeffersonville, Indiana, for approximately \$15.3 million. The community consists of 97 assisted living units. The Company obtained financing through Fannie Mae for approximately \$11.5 million of the acquisition price at a fixed rate of 4.76% with a 10-year term, with the balance of the acquisition price paid from the Company's existing cash resources.

Effective March 30, 2012, the Company also closed the acquisition of four senior living communities located in Arlington, College Station, Conroe and Stephenville, Texas, for approximately \$34.1 million. The four properties acquired are part of a five property portfolio with the fifth property located in Corpus Christi, Texas, which closed on October 17, 2012. The four communities acquired consist of 45 independent living units and 211 assisted living units. The Company obtained financing through Fannie Mae for approximately \$26.1 million of the acquisition price at a fixed rate of 4.69% with a 10-year term, with the balance of the acquisition price paid from the Company's existing cash resources.

Effective March 1, 2012, the Company closed the acquisition of a senior living community located in Granbury, Texas, for approximately \$7.0 million. The community consists of 82 assisted living units. The Company obtained financing through Fannie Mae for approximately \$5.4 million of the acquisition price at a fixed rate of 4.38% with a 10-year term, with the balance of the acquisition price paid from the Company's existing cash resources.

The senior living industry continues to be impacted by challenging conditions in the housing, credit, and financial markets, generally resulting in lower than anticipated operating results. During the first nine months of fiscal 2012 and throughout fiscal 2011, in response to these conditions, the Company has continued to focus on maintaining an emphasis on occupancy increases, improvement in rental rates, expense management and growth in net operating income per unit, strategic acquisitions of senior living communities in regions where the Company has existing operations, and other opportunities to enhance cash flow and shareholder value.

Joint Venture Transactions and Management Contracts

As of September 30, 2012, the Company managed 3 communities owned by joint ventures in which the Company has a minority interest. For communities owned by joint ventures, the Company typically receives a management fee of 5% of gross revenues.

The Company's joint venture management fees are primarily based on a percentage of gross revenues. As a result, the cash flow and profitability of such contracts to the Company are more dependent on the revenues generated by such communities and less dependent on net cash flow than for owned or leased communities. The management contracts are generally terminable only for cause or upon the sale of a community, subject to the Company's right to offer to purchase such community.

SHPII/CSL Transactions

In November 2004, the Company formed SHPII/CSL with SHPII. SHPII/CSL was owned 95% by SHPII, a fund managed by Prudential, and 5% by the Company. Effective as of November 30, 2004, SHPII/CSL acquired the Spring Meadows Communities which currently comprise 628 units with a combined capacity of 758 residents. The Company contributed \$1.3 million for its interests in SHPII/CSL and accounted for its investment in SHPII/CSL under the equity method of accounting.

The Company was party to a series of property management agreements (the SHPII/CSL Management Agreements) with SHPII/CSL, which collectively owned and operated the Spring Meadows Communities. The SHPII/CSL Management Agreements extended until various dates through November 2014. The SHPII/CSL Management Agreements generally provided for management fees of 5% of gross revenue plus reimbursement for costs and expenses related to the communities.

Table of Contents

On April 8, 2011, SHPII/CSL closed the Spring Meadows Transaction. Upon closing the sale, the Company leased the four Spring Meadows Communities from HCN. The lease has an initial term of 15 years, with one 15-year renewal extension available at the Company's option. The initial lease rate is 7.25% and is subject to certain conditional lease escalation clauses. The Company incurred \$0.9 million in lease acquisition costs which have been deferred and are being amortized over the initial 15-year lease term. The Company has accounted for this lease as an operating lease. As a result of this transaction, the Company received cash proceeds, including incentive distributions, from the sale by SHPII/CSL of approximately \$17.0 million, net of closing costs, resulting in a gain to the Company of approximately \$16.1 million which has been deferred and is being recognized in the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income as a reduction in facility lease expense over the initial 15-year lease term.

SHPIII Transactions

In May 2007, the Company and SHPIII formed SHPIII/CSL Miami to develop a senior housing community in Miamisburg, Ohio. Under the joint venture and related agreements, the Company earns development and management fees and may receive incentive distributions. The senior housing community opened in August 2008 and currently consists of 101 independent living units and 45 assisted living units with a capacity of 196 residents. The Company has contributed \$0.8 million to SHPIII/CSL Miami for its 10% interest and accounts for its investment in SHPIII/CSL Miami under the equity method of accounting. As of September 30, 2012, the Company had not met the breakeven requirements of the development agreement guarantee for this joint venture development.

In November 2007, the Company and SHPIII formed SHPIII/CSL Richmond Heights to develop a senior housing community in Richmond Heights, Ohio. Under the joint venture and related agreements, the Company earns development and management fees and may receive incentive distributions. The senior housing community opened in April 2009 and currently consists of 96 independent living units and 45 assisted living units with a capacity of 197 residents. The Company has contributed \$0.8 million to SHPIII/CSL Richmond Heights for its 10% interest and accounts for its investment in SHPIII/CSL Richmond Heights under the equity method of accounting. The Company contributed land to SHP III/CSL Richmond Heights as a capital contribution during formation of the joint venture in November 2007 resulting in a \$0.2 million gain to the Company. The gain had been deferred when the land was initially contributed to SHP III/CSL Richmond Heights due to the continuing involvement of the Company as a result of a development agreement guarantee. The Company met the breakeven requirements of the development agreement guarantee during the third quarter of fiscal 2011 resulting in full satisfaction and termination of the guarantee and recognition of the deferred gain as a component of gain on disposition of assets, net, within the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income.

In December 2007, the Company and SHPIII formed SHPIII/CSL Levis Commons to develop a senior housing community near Toledo, Ohio. Under the joint venture and related agreements, the Company earns development and management fees and may receive incentive distributions. The senior housing community opened in April 2009 and currently consists of 101 independent living units and 45 assisted living units with a capacity of 197 residents. The Company has contributed \$0.8 million to SHPIII/CSL Levis Commons for its 10% interest and accounts for its investment in SHPIII/CSL Levis Commons under the equity method of accounting. During the third quarter of fiscal 2011, the Company met the breakeven requirements of the development agreement guarantee for this joint venture development resulting in full satisfaction and termination of the guarantee.

The Company is party to a series of property management agreements (the SHPIII/CSL Management Agreements) with SHPIII/CSL Miami, SHPIII/CSL Richmond Heights, and SHPIII/CSL Levis Commons (collectively SHPIII/CSL), which joint ventures are owned 90% by SHPIII, a fund managed by Prudential Investment Management, Inc. (Prudential Investment), and 10% by the Company, which collectively own and operate SHPIII/CSL. The SHPIII/CSL Management Agreements are for initial terms of ten years from the date the certificate of occupancy was issued and currently extend until various dates through January 2019. The SHPIII/CSL Management Agreements generally provide for management fees of 5% of gross revenue plus reimbursement for costs and expenses related to the communities.

Table of Contents**Facility Lease Transactions**

The Company currently leases 50 senior living communities from certain REITs, 48 of which are accounted for as operating leases and two of which are accounted for as capital lease and financing obligations. The lease terms are generally for 10-15 years with renewal options for 5-20 years at the Company's option. Under these agreements the Company is responsible for all operating costs, maintenance and repairs, insurance and property taxes. The following table summarizes each of the Company's lease agreements (dollars in millions):

Landlord	Date of Lease	Number of Communities	Value of Transaction	Term	Initial Lease Rate (1)	Lease Acquisition Costs (2)	Deferred Gains / Lease Concessions (3)
Ventas	September 30, 2005			(4)			
		6	\$ 84.6	(Two five-year renewals)	8%	\$ 1.4	\$ 4.6
Ventas	October 18, 2005			(4)			
		1	19.5	(Two five-year renewals)	8%	0.2	
Ventas	June 8, 2006			(4)			
		1	19.1	(Two five-year renewals)	8%	0.4	
Ventas	January 31, 2008			(4)			
		1	5.0	(Two five-year renewals)	7.75%	0.2	
Ventas	June 27, 2012			(4)			
		2	43.3	(Two five-year renewals)	6.75%	0.8	
HCP	May 1, 2006			(5)			
		3	54.0	(Two ten-year renewals) 10 years	8%	0.2	12.8
HCP	May 31, 2006			(5)			
		6	43.0	(Two ten-year renewals)	8%	0.2	0.6
HCP	December 1, 2006			(5)			
		4	51.0	(Two ten-year renewals)	8%	0.7	
HCP	December 14, 2006			(5)			
		1	18.0	(Two ten-year renewals)	7.75%	0.3	
HCP	April 11, 2007			(5)			
		1	8.0	(Two ten-year renewals) 15 years	7.25%	0.1	
HCN	April 16, 2010			(5)			
		5	48.5	(One 15-year renewal)	8.25%	0.6	0.8
HCN	May 1, 2010			(5)			
		3	36.0	(One 15-year renewal) 15 years	8.25%	0.2	0.4
HCN	September 10, 2010			(5)			
		12	104.6	(One 15-year renewal)	8.50%	0.4	2.0

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HCN	April 8, 2011			15 years			
		4	141.0	(One 15-year renewal)	7.25%	0.9	16.2
Subtotal						6.6	37.4
Accumulated amortization through September 30, 2012						(2.5)	
Accumulated deferred gains / lease concessions recognized through September 30, 2012							(12.8)
Net lease acquisition costs / deferred gains / lease concessions as of September 30, 2012						\$ 4.1	\$ 24.6

- (1) Initial lease rates are measured against agreed upon fair market values and are subject to conditional lease escalation provisions as set forth in each lease agreement.
- (2) Lease acquisition costs are being amortized over the respective initial lease terms.
- (3) Deferred gains of \$34.8 million and lease concessions of \$2.6 million are being recognized in the Company's Consolidated Statements of Operations and Comprehensive (Loss) Income as a reduction in facility lease expense over the respective initial lease terms. Lease concessions of \$0.6 million relate to the HCP transaction on May 31, 2006, and of \$2.0 million relate to the HCN/Signature Transaction on September 10, 2010.
- (4) Effective June 27, 2012, the Company closed the Ventas Lease Transaction. All of the leased communities in the Ventas lease portfolio were modified to be coterminous expiring on September 30, 2020, with two 5-year renewal extensions available at the Company's option.
- (5) On March 4, 2010, the Company executed a second amendment to the master lease agreement associated with nine of its leases with HCP to effectively combine the lessees into one master lease and extend the lease terms for the HCP lease portfolio through October 31, 2018.

There are various financial covenants and other restrictions in the Company's lease agreements. Under the terms of certain lease agreements, the Company had previously deposited additional cash collateral of approximately \$3.4 million with a certain landlord which was returnable to the Company once certain performance targets were reached. However, the Company negotiated a lease modification with this landlord during the second quarter of fiscal 2012 and all of the additional cash collateral initially deposited by the Company was returned to the Company. For additional information, refer to Note 4, FACILITY LEASE TRANSACTIONS within the Company's Notes To Unaudited Consolidated Financial Statements. The Company was in compliance with all lease covenants at September 30, 2012.

Website

The Company's Internet website www.capitalsenior.com contains an Investor Relations section, which provides links to the Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements, and Section 16 filings and any amendments to those reports and filings. These reports and filings are available free of charge through the Company's internet website as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC.

Table of Contents**Results of Operations**

The following table sets forth for the periods indicated selected Consolidated Statements of Operations and Comprehensive (Loss) Income data in thousands of dollars and expressed as a percentage of total revenues.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2011		2012		2011	
	\$	%	\$	%	\$	%	\$	%
Revenues:								
Resident and healthcare revenue	\$ 76,577	98.2	\$ 66,928	98.2	\$ 223,161	98.2	\$ 186,773	97.1
Affiliated management service revenue	176	0.2	141	0.2	492	0.2	738	0.4
Community reimbursement revenue	1,259	1.6	1,122	1.6	3,605	1.6	4,839	2.5
Total revenue	78,012	100.0	68,191	100.0	227,258	100.0	192,350	100.0
Expenses:								
Operating expenses (exclusive of depreciation and amortization shown below)								
General and administrative expenses	46,791	60.0	40,975	60.1	134,186	59.0	112,714	58.6
Facility lease expense	3,288	4.2	3,270	4.8	10,923	4.8	9,557	5.0
Stock-based compensation	13,819	17.7	13,723	20.1	41,179	18.1	38,767	20.2
Depreciation and amortization	602	0.8	430	0.6	1,843	0.8	1,020	0.5
Community reimbursement expense	9,214	11.8	4,775	7.0	24,970	11.0	11,916	6.2
Total expenses	74,973	96.1	64,295	94.3	216,706	95.4	178,813	93.0