

FIVE STAR QUALITY CARE INC

Form 10-Q

August 07, 2008

[Table of Contents](#)

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 2008

**OR**

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

Commission File Number 001-16817

**FIVE STAR QUALITY CARE, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Maryland**

(State or Other Jurisdiction of Incorporation or  
Organization)

**04-3516029**

(IRS Employer Identification No.)

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**400 Centre Street, Newton, Massachusetts 02458**  
(Address of Principal Executive Offices) (Zip Code)

**617-796-8387**

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated 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 check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Number of registrant's shares of common stock, \$0.01 par value outstanding as of August 6, 2008: 31,844,394.

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Table of Contents

FIVE STAR QUALITY CARE, INC.

FORM 10-Q

JUNE 30, 2008

INDEX

|                                                                                                             | <b>Page</b> |
|-------------------------------------------------------------------------------------------------------------|-------------|
| <b><u>PART I Financial Information</u></b>                                                                  |             |
| <b><u>Item 1. Condensed Consolidated Financial Statements (unaudited)</u></b>                               |             |
| <u>Condensed Consolidated Balance Sheet June 30, 2008 and December 31, 2007</u>                             | 1           |
| <u>Condensed Consolidated Statement of Income Three and Six Months Ended June 30, 2008 and 2007</u>         | 2           |
| <u>Condensed Consolidated Statement of Cash Flows Six Months Ended June 30, 2008 and 2007</u>               | 3           |
| <u>Notes to Condensed Consolidated Financial Statements</u>                                                 | 4           |
| <b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b> | 17          |
| <b><u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u></b>                            | 26          |
| <b><u>Item 4. Controls and Procedures</u></b>                                                               | 27          |
| <u>Warning Concerning Forward Looking Statements</u>                                                        | 28          |
| <b><u>PART II Other Information</u></b>                                                                     |             |
| <b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>                           | 29          |
| <b><u>Item 4. Submission of Matters to a Vote of Security Holders</u></b>                                   | 29          |
| <b><u>Item 6. Exhibits</u></b>                                                                              | 29          |
| <u>Signatures</u>                                                                                           | 32          |

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

Table of Contents**Part I. Financial Information****Item 1. Condensed Consolidated Financial Statements**

## FIVE STAR QUALITY CARE, INC.

## CONDENSED CONSOLIDATED BALANCE SHEET

(in thousands, except share data)

(unaudited)

|                                                                                                                   | June 30,<br>2008 | December 31,<br>2007 |
|-------------------------------------------------------------------------------------------------------------------|------------------|----------------------|
| <b>ASSETS</b>                                                                                                     |                  |                      |
| Current assets:                                                                                                   |                  |                      |
| Cash and cash equivalents                                                                                         | \$ 45,884        | \$ 30,999            |
| Accounts receivable, net of allowance of \$5,697 and \$4,836 at June 30, 2008 and December 31, 2007, respectively | 60,998           | 58,803               |
| Prepaid expenses                                                                                                  | 3,983            | 9,041                |
| Investment securities:                                                                                            |                  |                      |
| Investments in trading securities                                                                                 |                  | 61,800               |
| Investments in available for sale securities                                                                      | 6,892            | 7,455                |
| Restricted cash                                                                                                   | 3,758            | 3,655                |
| Restricted investments                                                                                            | 3,719            | 3,946                |
| Other current assets                                                                                              | 10,181           | 7,140                |
| Assets of discontinued operations                                                                                 | 2,040            | 3,178                |
| Total current assets                                                                                              | 137,455          | 186,017              |
| Property and equipment, net                                                                                       | 132,444          | 131,705              |
| Investments in trading securities                                                                                 | 70,484           |                      |
| Restricted cash                                                                                                   | 2,995            | 2,568                |
| Restricted investments                                                                                            | 10,128           | 10,375               |
| Goodwill and other intangible assets                                                                              | 22,544           | 21,877               |
| Other long term assets                                                                                            | 4,795            | 7,912                |
|                                                                                                                   | \$ 380,845       | \$ 360,454           |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                                                                       |                  |                      |
| Current liabilities:                                                                                              |                  |                      |
| Accounts payable                                                                                                  | \$ 17,311        | \$ 19,135            |
| Accrued expenses                                                                                                  | 18,182           | 15,222               |
| Accrued compensation and benefits                                                                                 | 38,171           | 30,103               |
| Due to Senior Housing Properties Trust ( Senior Housing )                                                         | 13,495           | 11,242               |
| Mortgage notes payable                                                                                            | 187              | 200                  |
| Accrued real estate taxes                                                                                         | 7,217            | 7,352                |
| Security deposit liability                                                                                        | 12,895           | 13,361               |
| Other current liabilities                                                                                         | 8,436            | 7,229                |

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|                                                                                                                                                                            |            |            |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|------------|
| Liabilities of discontinued operations                                                                                                                                     | 421        | 219        |
| Total current liabilities                                                                                                                                                  | 116,315    | 104,063    |
| Long term liabilities:                                                                                                                                                     |            |            |
| Mortgage notes payable                                                                                                                                                     | 15,706     | 15,810     |
| Convertible senior notes                                                                                                                                                   | 126,500    | 126,500    |
| Continuing care contracts                                                                                                                                                  | 3,093      | 3,159      |
| Other long term liabilities                                                                                                                                                | 27,681     | 24,100     |
| Total long term liabilities                                                                                                                                                | 172,980    | 169,569    |
| Commitments and contingencies                                                                                                                                              |            |            |
| Shareholders' equity:                                                                                                                                                      |            |            |
| Preferred stock, par value \$0.01; 1,000,000 shares authorized, none issued                                                                                                |            |            |
| Common stock, par value \$0.01; 50,000,000 shares authorized, 31,844,394 and 31,818,144 shares issued and outstanding at June 30, 2008 and December 31, 2007, respectively | 318        | 318        |
| Additional paid-in capital                                                                                                                                                 | 286,979    | 286,734    |
| Accumulated deficit                                                                                                                                                        | (191,003)  | (196,109)  |
| Unrealized loss on investments                                                                                                                                             | (4,744)    | (4,121)    |
| Total shareholders' equity                                                                                                                                                 | 91,550     | 86,822     |
|                                                                                                                                                                            | \$ 380,845 | \$ 360,454 |

See accompanying notes.

Table of Contents

## FIVE STAR QUALITY CARE, INC.

## CONDENSED CONSOLIDATED STATEMENT OF INCOME

(in thousands, except share data)

(unaudited)

|                                                       | Three months ended June 30, |            | Six months ended June 30, |            |
|-------------------------------------------------------|-----------------------------|------------|---------------------------|------------|
|                                                       | 2008                        | 2007       | 2008                      | 2007       |
| <b>Revenues:</b>                                      |                             |            |                           |            |
| Senior living revenue                                 | \$ 228,442                  | \$ 200,601 | \$ 445,369                | \$ 397,664 |
| Hospital revenue                                      | 24,421                      | 25,219     | 49,165                    | 51,348     |
| Pharmacy revenue                                      | 18,281                      | 14,318     | 35,487                    | 28,153     |
| Total revenues                                        | 271,144                     | 240,138    | 530,021                   | 477,165    |
| <b>Operating expenses:</b>                            |                             |            |                           |            |
| Senior living wages and benefits                      | 111,795                     | 103,901    | 220,889                   | 205,836    |
| Other senior living operating expenses                | 58,668                      | 48,501     | 112,089                   | 98,412     |
| Hospital expenses                                     | 22,615                      | 23,373     | 45,207                    | 46,997     |
| Pharmacy expenses                                     | 17,347                      | 13,524     | 33,550                    | 27,115     |
| Rent expense                                          | 39,275                      | 31,963     | 74,719                    | 64,228     |
| General and administrative                            | 11,722                      | 10,887     | 22,855                    | 20,946     |
| Depreciation and amortization                         | 3,647                       | 3,238      | 7,282                     | 6,389      |
| Total operating expenses                              | 265,069                     | 235,387    | 516,591                   | 469,923    |
| Operating income                                      | 6,075                       | 4,751      | 13,430                    | 7,242      |
| Interest and other income                             | 1,302                       | 1,410      | 3,796                     | 2,830      |
| Interest expense                                      | (1,600)                     | (1,677)    | (3,194)                   | (3,455)    |
| Unrealized loss on investments in trading securities  | (1,096)                     |            | (4,366)                   |            |
| Gain on extinguishment of debt                        |                             | 934        |                           | 4,491      |
| Income from continuing operations before income taxes | 4,681                       | 5,418      | 9,666                     | 11,108     |
| Provision for income taxes                            | (444)                       | (275)      | (1,010)                   | (483)      |
| Income from continuing operations                     | 4,237                       | 5,143      | 8,656                     | 10,625     |
| Loss from discontinued operations                     | (748)                       | (1,063)    | (3,550)                   | (1,781)    |
| Net income                                            | \$ 3,489                    | \$ 4,080   | \$ 5,106                  | \$ 8,844   |
| Weighted average shares outstanding basic             | 31,831                      | 31,694     | 31,825                    | 31,689     |
| Weighted average shares outstanding diluted           | 41,562                      | 41,425     | 41,556                    | 41,420     |
| <b>Basic income per share from:</b>                   |                             |            |                           |            |
| Continuing operations                                 | \$ 0.13                     | \$ 0.16    | \$ 0.27                   | \$ 0.34    |
| Discontinued operations                               | (0.02)                      | (0.03)     | (0.11)                    | (0.06)     |
| Net income per share                                  | \$ 0.11                     | \$ 0.13    | \$ 0.16                   | \$ 0.28    |
| <b>Diluted income per share from:</b>                 |                             |            |                           |            |
| Continuing operations                                 | \$ 0.13                     | \$ 0.15    | \$ 0.26                   | \$ 0.32    |

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|                         |    |        |    |        |    |        |    |        |
|-------------------------|----|--------|----|--------|----|--------|----|--------|
| Discontinued operations |    | (0.02) |    | (0.02) |    | (0.09) |    | (0.04) |
| Net income per share    | \$ | 0.11   | \$ | 0.13   | \$ | 0.17   | \$ | 0.28   |

See accompanying notes.

Table of Contents

FIVE STAR QUALITY CARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

(unaudited)

|                                                                                             | Six months ended June 30, |           |
|---------------------------------------------------------------------------------------------|---------------------------|-----------|
|                                                                                             | 2008                      | 2007      |
| Cash flows from operating activities:                                                       |                           |           |
| Net income                                                                                  | \$ 5,106                  | \$ 8,844  |
| Adjustments to reconcile net income to cash provided by operating activities:               |                           |           |
| Depreciation and amortization                                                               | 7,282                     | 6,389     |
| Gain on extinguishment of debt                                                              |                           | (4,491)   |
| Loss from discontinued operations                                                           | 3,550                     | 1,781     |
| Unrealized loss on investments in trading securities                                        | 4,366                     |           |
| Provision for losses on receivables, net                                                    | 861                       | 1,185     |
| Changes in assets and liabilities:                                                          |                           |           |
| Accounts receivable                                                                         | (2,765)                   | 5,729     |
| Prepaid expenses and other assets                                                           | 5,335                     | 10,665    |
| Investment securities                                                                       | (12,487)                  | 11,663    |
| Accounts payable and accrued expenses                                                       | (2,161)                   | (5,780)   |
| Accrued compensation and benefits                                                           | 8,068                     | 10,582    |
| Due to Senior Housing                                                                       | 2,253                     | 972       |
| Other current and long term liabilities                                                     | 2,821                     | 838       |
| Cash provided by operating activities                                                       | 22,229                    | 48,377    |
| Net cash used in discontinued operations                                                    | (398)                     | (1,726)   |
| Cash flows from investing activities:                                                       |                           |           |
| Deposits into restricted cash and investment accounts, net                                  | (434)                     | (2,094)   |
| Acquisition of property and equipment                                                       | (36,862)                  | (36,665)  |
| Assumption of net working capital (exclusive of cash) of acquired senior living communities | 3,204                     |           |
| Proceeds from disposition of property and equipment held for sale                           | 27,263                    | 17,110    |
| Cash used in investing activities                                                           | (6,829)                   | (21,649)  |
| Cash flows from financing activities:                                                       |                           |           |
| Repayments of mortgage note payable                                                         | (117)                     | (28,757)  |
| Cash used in financing activities                                                           | (117)                     | (28,757)  |
| Change in cash and cash equivalents                                                         | 14,885                    | (3,755)   |
| Cash and cash equivalents at beginning of period                                            | 30,999                    | 46,241    |
| Cash and cash equivalents at end of period                                                  | \$ 45,884                 | \$ 42,486 |
| Supplemental cash flow information:                                                         |                           |           |
| Cash paid for interest                                                                      | \$ 2,654                  | \$ 3,063  |
| Cash paid for income taxes                                                                  | \$ 1,428                  | \$ 291    |
| Non-cash investing and financing activities:                                                |                           |           |
| Issuance of common stock                                                                    | \$ 245                    | \$ 180    |

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|                                     |    |    |       |
|-------------------------------------|----|----|-------|
| Real estate acquisition             | \$ | \$ | 5,025 |
| Assumption of mortgage note payable | \$ | \$ | 4,559 |

See accompanying notes.

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

**Note 1. Basis of Presentation and Organization**

The accompanying condensed consolidated financial statements of Five Star Quality Care, Inc. and its subsidiaries have been prepared without audit. Certain information and disclosures required by generally accepted accounting principles for complete financial statements have been condensed or omitted. We believe the disclosures made are adequate to make the information presented not misleading. However, the accompanying financial statements should be read in conjunction with the financial statements and notes contained in our Annual Report on Form 10-K for the year ended December 31, 2007. In the opinion of our management, all adjustments, which include only normal recurring adjustments, considered necessary for a fair presentation have been included. All material intercompany transactions and balances have been eliminated. Our operating results for interim periods are not necessarily indicative of the results that may be expected for the full year.

As of June 30, 2008, we leased, owned or operated 182 senior living communities containing 19,814 living units, including 133 primarily independent and assisted living communities with 15,405 living units and 49 skilled nursing facilities with 4,409 living units. Of our 133 primarily independent and assisted living communities, we leased 116 communities containing 14,144 living units from Senior Housing, our former parent, and we owned or leased from parties other than Senior Housing 17 communities with 1,261 living units. We leased 47 of our 49 skilled nursing facilities from Senior Housing. Our 182 communities include 5,602 independent living apartments, 8,002 assisted living suites and 6,210 skilled nursing units. We also operated six institutional pharmacies, one of which provides mail order pharmaceuticals to the general public, and two rehabilitation hospitals that we leased from Senior Housing. Our two rehabilitation hospitals had 321 beds available for inpatient services, three satellite locations and 18 affiliated outpatient clinics. Included in the above counts are two assisted living senior living communities containing 173 living units and two pharmacies which have previously been reclassified to discontinued operations.

**Note 2. New Accounting Pronouncements**

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

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

effect that the adoption of FSP 14-1 will have on our consolidated financial statements.

**Note 3. Property and Equipment**

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

|                                   | June 30, 2008 | December 31,<br>2007 |
|-----------------------------------|---------------|----------------------|
| Land                              | \$ 7,519      | \$ 7,196             |
| Buildings and improvements        | 104,723       | 99,945               |
| Furniture, fixtures and equipment | 55,577        | 55,660               |
|                                   | 167,819       | 162,801              |
| Accumulated depreciation          | (35,375)      | (31,096)             |
|                                   | \$ 132,444    | \$ 131,705           |

**Table of Contents**

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

As of June 30, 2008 and December 31, 2007, we had assets classified as held for sale of \$29,144 and \$25,222, respectively, included in our property and equipment that we intend to sell to Senior Housing as permitted by our leases.

**Note 4. Comprehensive Income**

Comprehensive income for the three and six months ended June 30, 2008 and 2007 is summarized below:

|                                | Three months ended June 30, |          | Six months ended June 30, |          |
|--------------------------------|-----------------------------|----------|---------------------------|----------|
|                                | 2008                        | 2007     | 2008                      | 2007     |
| Net income                     | \$ 3,489                    | \$ 4,080 | \$ 5,106                  | \$ 8,844 |
| Unrealized loss on investments | (1,463)                     | (850)    | (623)                     | (893)    |
| Comprehensive income           | \$ 2,026                    | \$ 3,230 | \$ 4,483                  | \$ 7,951 |

**Note 5. Financial Data By Segment**

Our reportable segments consist of our senior living community business and our rehabilitation hospital business. In the senior living community segment, we operate independent living and congregate care communities, assisted living communities and skilled nursing facilities. Our rehabilitation hospital segment provides inpatient medical rehabilitation services at two hospital locations and three satellite locations and outpatient medical rehabilitation services at 18 affiliated outpatient clinics. We do not consider our pharmacy operations to be a material, separately reportable segment of our business but we report our pharmacy revenues and expense as separate items within our corporate and other activities. All of our operations and assets are located in the United States.

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

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

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|                                                      | Senior Living<br>Communities | Rehabilitation<br>Hospitals | Corporate<br>and Other (1) | Total      |
|------------------------------------------------------|------------------------------|-----------------------------|----------------------------|------------|
| <b>Three months ended June 30, 2008</b>              |                              |                             |                            |            |
| Revenues                                             | \$ 228,442                   | \$ 24,421                   | \$ 18,281                  | \$ 271,144 |
| Segment expenses:                                    |                              |                             |                            |            |
| Operating expenses                                   | 170,463                      | 22,615                      | 17,347                     | 210,425    |
| Rent expense                                         | 36,594                       | 2,681                       |                            | 39,275     |
| Depreciation and amortization                        | 2,447                        | 309                         | 891                        | 3,647      |
| Total segment expenses                               | 209,504                      | 25,605                      | 18,238                     | 253,347    |
| Segment operating profit (loss)                      | 18,938                       | (1,184)                     | 43                         | 17,797     |
| General and administrative expenses (2)              |                              |                             | (11,722)                   | (11,722)   |
| Operating income (loss)                              | 18,938                       | (1,184)                     | (11,679)                   | 6,075      |
| Interest and other income                            | 485                          |                             | 817                        | 1,302      |
| Interest expense                                     | (327)                        |                             | (1,273)                    | (1,600)    |
| Unrealized loss on investments in trading securities |                              |                             | (1,096)                    | (1,096)    |
| Provision for income taxes                           |                              |                             | (444)                      | (444)      |
| Income (loss) from continuing operations             | \$ 19,096                    | \$ (1,184)                  | \$ (13,675)                | \$ 4,237   |
| Total Assets as of June 30, 2008                     | \$ 250,021                   | \$ 20,925                   | \$ 109,899                 | \$ 380,845 |

Table of Contents

## FIVE STAR QUALITY CARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

|                                                      | Senior Living<br>Communities | Rehabilitation<br>Hospitals | Corporate<br>and Other (1) | Total      |
|------------------------------------------------------|------------------------------|-----------------------------|----------------------------|------------|
| <b>Three months ended June 30, 2007</b>              |                              |                             |                            |            |
| Revenues                                             | \$ 200,601                   | \$ 25,219                   | \$ 14,318                  | \$ 240,138 |
| Segment expenses:                                    |                              |                             |                            |            |
| Operating expenses                                   | 152,402                      | 23,373                      | 13,524                     | 189,299    |
| Rent expense                                         | 29,394                       | 2,569                       |                            | 31,963     |
| Depreciation and amortization                        | 2,290                        | 277                         | 671                        | 3,238      |
| Total segment expenses                               | 184,086                      | 26,219                      | 14,195                     | 224,500    |
| Segment operating profit (loss)                      | 16,515                       | (1,000)                     | 123                        | 15,638     |
| General and administrative expenses (2)              |                              |                             | (10,887)                   | (10,887)   |
| Operating profit (loss)                              | 16,515                       | (1,000)                     | (10,764)                   | 4,751      |
| Interest and other income                            | 426                          |                             | 984                        | 1,410      |
| Interest expense                                     | (319)                        |                             | (1,358)                    | (1,677)    |
| Gain on extinguishment of debt                       | 934                          |                             |                            | 934        |
| Provision for income taxes                           |                              |                             | (275)                      | (275)      |
| Income (loss) from continuing operations             | \$ 17,556                    | \$ (1,000)                  | \$ (11,413)                | \$ 5,143   |
| Total Assets as of June 30, 2007                     | \$ 259,839                   | \$ 23,820                   | \$ 68,807                  | \$ 352,466 |
| <b>Six months ended June 30, 2008</b>                |                              |                             |                            |            |
| Revenues                                             | \$ 445,369                   | \$ 49,165                   | \$ 35,487                  | \$ 530,021 |
| Segment expenses:                                    |                              |                             |                            |            |
| Operating expenses                                   | 332,978                      | 45,207                      | 33,550                     | 411,735    |
| Rent expense                                         | 69,388                       | 5,331                       |                            | 74,719     |
| Depreciation and amortization                        | 4,887                        | 617                         | 1,778                      | 7,282      |
| Total segment expenses                               | 407,253                      | 51,155                      | 35,328                     | 493,736    |
| Segment operating profit (loss)                      | 38,116                       | (1,990)                     | 159                        | 36,285     |
| General and administrative expenses (2)              |                              |                             | (22,855)                   | (22,855)   |
| Operating income (loss)                              | 38,116                       | (1,990)                     | (22,696)                   | 13,430     |
| Interest and other income                            | 1,768                        |                             | 2,028                      | 3,796      |
| Interest expense                                     | (633)                        |                             | (2,561)                    | (3,194)    |
| Unrealized loss on investments in trading securities |                              |                             | (4,366)                    | (4,366)    |
| Provision for income taxes                           |                              |                             | (1,010)                    | (1,010)    |
| Income (loss) from continuing operations             | \$ 39,251                    | \$ (1,990)                  | \$ (28,605)                | \$ 8,656   |
| <b>Six months ended June 30, 2007</b>                |                              |                             |                            |            |
| Revenues                                             | \$ 397,664                   | \$ 51,348                   | \$ 28,153                  | \$ 477,165 |
| Segment expenses:                                    |                              |                             |                            |            |
| Operating expenses                                   | 304,248                      | 46,997                      | 27,115                     | 378,360    |
| Rent expense                                         | 59,097                       | 5,131                       |                            | 64,228     |
| Depreciation and amortization                        | 4,521                        | 493                         | 1,375                      | 6,389      |

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|                                          |           |            |             |           |
|------------------------------------------|-----------|------------|-------------|-----------|
| Total segment expenses                   | 367,866   | 52,621     | 28,490      | 448,977   |
| Segment operating profit (loss)          | 29,798    | (1,273)    | (337)       | 28,188    |
| General and administrative expenses (2)  |           |            | (20,946)    | (20,946)  |
| Operating income (loss)                  | 29,798    | (1,273)    | (21,283)    | 7,242     |
| Interest and other income                | 781       |            | 2,049       | 2,830     |
| Interest expense                         | (773)     |            | (2,682)     | (3,455)   |
| Gain on extinguishment of debt           | 4,491     |            |             | 4,491     |
| Provision for income taxes               |           |            | (483)       | (483)     |
| Income (loss) from continuing operations | \$ 34,297 | \$ (1,273) | \$ (22,399) | \$ 10,625 |

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

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(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 affecting home office activities.

**Note 6. Income Taxes**

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. At December 31, 2007, our net operating loss carry forwards, totaled approximately \$183,000; these will begin to expire in 2023 if unused.

For the six months ended June 30, 2008, we recognized tax expenses of \$444, which includes \$383 of alternative minimum taxes and certain state taxes that are payable without regard to our tax loss carry forwards. Tax expense also includes \$61 related to a non cash deferred tax liability arising from the amortization of goodwill for tax purposes but not for book purposes. We may recognize this deferred tax liability as a reduction in the income tax provision if, in some future period, we expense the related items of goodwill for book purposes as the result of its sale, other disposition or impairment.

**Note 7. Earnings Per Share**

Basic earnings per share for the periods ended June 30, 2008 and 2007 are computed using the weighted average number of shares outstanding during those periods. Diluted earnings per share for the period ended June 30, 2008 reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income applicable to common shareholders that would result from the assumed issuance upon conversion of our 3.75% convertible senior notes, or the Notes (See Note 11). The effect of conversion of our Notes on loss from discontinued operations per share is anti-dilutive for the six months ended June 30, 2008 and 2007, respectively.

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

| Three Months Ended June 30,                   |                  |        |           |            |        |           |
|-----------------------------------------------|------------------|--------|-----------|------------|--------|-----------|
|                                               | 2008             |        |           | 2007       |        |           |
|                                               | Income<br>(loss) | Shares | Per Share |            |        |           |
| Income from continuing operations             | \$ 4,237         | 31,831 | \$ 0.13   | \$ 5,143   | 31,694 | \$ 0.16   |
| Conversion of the Notes                       | 1,115            | 9,731  |           | 1,245      | 9,731  |           |
| Diluted earnings from continuing operations   | \$ 5,352         | 41,562 | \$ 0.13   | \$ 6,388   | 41,425 | \$ 0.15   |
| Diluted earnings from discontinued operations | \$ (748)         | 41,562 | \$ (0.02) | \$ (1,063) | 41,425 | \$ (0.02) |

  

| Six Months Ended June 30,                     |                  |        |           |            |        |           |
|-----------------------------------------------|------------------|--------|-----------|------------|--------|-----------|
|                                               | 2008             |        |           | 2007       |        |           |
|                                               | Income<br>(loss) | Shares | Per Share |            |        |           |
| Income from continuing operations             | \$ 8,656         | 31,825 | \$ 0.27   | \$ 10,625  | 31,689 | \$ 0.34   |
| Conversion of the Notes                       | 2,230            | 9,731  |           | 2,486      | 9,731  |           |
| Diluted earnings from continuing operations   | \$ 10,886        | 41,556 | \$ 0.26   | \$ 13,111  | 41,420 | \$ 0.32   |
| Diluted earnings from discontinued operations | \$ (3,550)       | 41,556 | \$ (0.09) | \$ (1,781) | 41,420 | \$ (0.04) |

Table of Contents

## FIVE STAR QUALITY CARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

**Note 8. Fair Values of Assets and Liabilities**

As required, we adopted SFAS 157 effective January 1, 2008 for assets and liabilities we measure on a recurring basis. Although the adoption of SFAS 157 did not materially impact our financial condition, results of operations, or cash flow, we are now required to provide additional disclosures as part of our financial statements. We measure fair value at the price that would be received upon sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 prioritizes the assumptions that market participants would use in pricing the asset or liability, or the inputs, into three broad levels. This fair value hierarchy gives the highest priority, or Level 1, to quoted prices in active markets for identical assets or liabilities and the lowest priority, or Level 3, to assumptions that are unobservable. Observable inputs that do not meet the criteria of Level 1, and include quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets and liabilities in markets that are not active, are categorized as Level 2. Level 3 inputs are those that reflect our own assumptions about the assumptions market participants would use in pricing the asset or liability, based on what we believe is the best information available in the circumstances. Valuation techniques for assets and liabilities measured using Level 3 inputs may include methodologies such as the market approach, the income approach or the cost approach, and may use unobservable inputs such as projections, estimates and management's interpretation of current market data. These unobservable inputs are only utilized to the extent that observable inputs are not available, or for which we believe it is not cost effective for us to obtain.

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

| Description                                      | Total      | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--------------------------------------------------|------------|----------------------------------------------------------------------------|--------------------------------------------------------|----------------------------------------------------|
| Long lived assets held for sale (1)              | \$ 29,144  | \$ 29,144                                                                  | \$                                                     | \$                                                 |
| Investments in trading securities (2)            | 70,484     |                                                                            |                                                        | 70,484                                             |
| Investments in available for sale securities (3) | 20,739     | 20,739                                                                     |                                                        |                                                    |
| Total assets                                     | \$ 120,367 | \$ 49,883                                                                  | \$                                                     | \$ 70,484                                          |

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

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(2) Our investments in trading securities consist of auction rate securities, which are primarily bonds issued by various entities to fund student loans pursuant to the Federal Family Education Loan Program. Due to events in the credit markets, auctions for our auction rate securities failed during the first quarter of 2008 and, as a result there is currently no market for the sale of these securities. We therefore report our auction rate securities at fair value utilizing Level 3 inputs. We measured the fair value of these securities by reference to a statement provided by our broker that was calculated with the assistance of a valuation model. This model considered, among other items, the collateral underlying the investments, the creditworthiness of the counterparty, the timing of expected future cash flows including possible refinancing of the securities and a determination of the appropriate discount rate. The analysis also included a comparison, when possible, to other observable market data with characteristics similar to our auction rate securities. We reviewed the components of, and calculations made under, our broker's model. Due to the declines in fair value for our auction rate securities during the six months ended June 30, 2008, we have recorded an unrealized loss of \$4,366.

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

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

(3) Investments in available for sale securities consist of corporate bonds, preferred securities and variable rate demand obligations and are reported in our balance sheet as current investments in available for sale securities of \$6,892, current restricted investments of \$3,719 and long term restricted investments of \$10,128. These securities are carried at fair value utilizing Level 1 inputs based on quoted market prices with changes in fair value recorded in other comprehensive income. When a change in fair value is deemed temporary, we record a corresponding credit or charge to other comprehensive income for any unrealized gains or losses. If we determine that any future valuation adjustment was other than temporary, we would record a charge to earnings.

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

|                                        |    | Investments in<br>trading<br>securities |
|----------------------------------------|----|-----------------------------------------|
| Balance, at January 1, 2008            | \$ |                                         |
| Transfers into Level 3                 |    | 74,850                                  |
| Change in value recognized in earnings |    | (3,270)                                 |
| Balance, at March 31, 2008             |    | 71,580                                  |
| Change in value recognized in earnings |    | (1,096)                                 |
| Balance, at June 30, 2008              | \$ | 70,484                                  |

**Note 9. Line of Credit**

We have a \$40,000 revolving bank credit facility for general business purposes, including acquisitions and working capital, which is currently scheduled to expire in May 2009. The amount we are able to borrow at any time is subject to limitation based upon qualifying collateral. We are the borrower under this revolving credit facility and certain of our subsidiaries guarantee our obligations under the facility, which is secured by our and our guarantor subsidiaries' accounts receivable, deposit accounts and related assets. The facility contains covenants requiring us to maintain collateral, minimum net worth and certain other financial ratios; this facility also places limits on our ability to incur or assume debt or create liens with respect to certain of our assets and has other customary provisions. In certain circumstances and subject to available collateral and lender approvals, the maximum amount which we may borrow under this credit facility may be increased to \$80,000. The termination date of this facility may be extended twice, in each case by twelve months upon our payment of extension fees and other conditions, including lender's approvals. As of June 30, 2008 and August 6, 2008, no amounts were outstanding under this credit facility. As of June 30, 2008 and

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August 6, 2008, we believe we were and are in compliance with all applicable covenants under this credit facility. Interest expense and other associated costs related to this facility were \$34 and \$113 for the three months ended June 30, 2008 and 2007, respectively, and \$83 and \$196 for the six months ended June 30, 2008 and 2007, respectively.

### **Note 10. Mortgages Payable**

At June 30, 2008, four of our communities were encumbered by five United States Department of Housing and Urban Development, or HUD, insured mortgages totaling \$15,893. 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 maturities of the mortgages. The mortgage premium balance included in the mortgage notes payable as of June 30, 2008 was \$749.

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

Mortgage interest expense, including premium amortization, was \$327 and \$319 for the three months ended June 30, 2008 and 2007, respectively, and \$633 and \$773 for the six months ended June 30, 2008 and 2007, respectively.

**Note 11. Convertible Senior Notes due 2026**

In October 2006, we issued \$126,500 principal amount of Convertible Senior Notes due in 2026. Our net proceeds from this offering were approximately \$122,600. These Notes are convertible into our common shares at any time. The initial conversion rate, which is subject to adjustment, is 76.9231 common shares per \$1 principal amount of notes, which represents an initial conversion price of \$13.00 per share. Interest expense and other associated costs on the notes were \$1,239 and \$1,245 for the three months ended June 30, 2008 and 2007, respectively, and \$2,478 and \$2,486 for the six months ended June 30, 2008 and 2007, respectively. The Notes are guaranteed by certain of our domestic wholly owned subsidiaries (see Note 14). These Notes mature on October 15, 2026; we may prepay the Notes at anytime after October 20, 2011 and the Note holders may require that we purchase all or a portion of these Notes on each of October 15, 2013, October 15, 2016 and October 15, 2021. We issued these Notes pursuant to an indenture which contains various customary covenants. We believe we are in compliance with all applicable covenants of the indenture.

**Note 12. Related Person Transactions**

We lease 163 of our 182 senior living communities and the two rehabilitation hospitals that we operated on June 30, 2008 from Senior Housing for total annual minimum rent of \$153,243. In addition to the minimum rent, we paid \$877 and \$616 in percentage rent to Senior Housing for the three months ended June 30, 2008 and 2007, respectively and \$1,896 and \$1,168 for the six months ended June 30, 2008 and 2007, respectively.

Included in the 163 communities we lease from Senior Housing are 19 senior living communities with 1,743 units which Senior Housing acquired and we began to operate during the first quarter of 2008. Twenty-one of these communities are assisted living communities (one of which offers some skilled nursing services and one of which offers some independent living services) and one is a continuing care retirement community which offers independent living, assisted living and skilled nursing services. Our rent payable to Senior Housing for these 19 communities is \$21,790 per year, plus future increases calculated as a percentage of the revenue increases for all of these communities after 2009. We added nine of these communities to one of our existing leases with Senior Housing which has a term ending in 2022, with renewal options thereafter. We added the remaining 10 of these communities to another existing lease with Senior Housing which has a term ending in 2024, with renewal options thereafter.

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During the six months ended June 30, 2008, as permitted by our leases with Senior Housing, we sold to Senior Housing, at cost, \$27,263 of improvements made to properties leased from Senior Housing, and our annual rent payable to Senior Housing increased by \$2,431.

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

### **Note 13. Discontinued Operations**

In March 2007, we agreed with Senior Housing that it should sell two assisted living communities in Pennsylvania, which we lease from Senior Housing. We and Senior Housing are in the process of selling these assisted living communities and, upon their sale, our annual minimum rent payable to Senior Housing will decrease by 9.5% of the net proceeds of the sale to Senior Housing, in accordance with the terms of our lease with Senior Housing. In December 2007, we decided to sell one institutional pharmacy located in California and our mail order pharmacy located in Nebraska. As of June 30, 2008, we have disposed of substantially all of our assets and liabilities related to the assisted living communities which we expect to sell. The assets and liabilities related to the two pharmacies that we expect to sell are presented separately in the consolidated balance sheet. We have reclassified the consolidated statement of income for all periods presented to show the results of operations of the communities and pharmacies which have been sold or are expected to be sold as discontinued. Below is a summary of the operating

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

results of these discontinued operations included in the financial statements for the three and six months ended June 30, 2008 and 2007:

|          | Three months ended June 30,<br>2008 |         | 2007 |         | Six months ended June 30,<br>2008 |         | 2007 |         |
|----------|-------------------------------------|---------|------|---------|-----------------------------------|---------|------|---------|
| Revenues | \$                                  | 3,023   | \$   | 3,374   | \$                                | 5,994   | \$   | 6,539   |
| Expenses |                                     | (3,771) |      | (4,437) |                                   | (9,544) |      | (8,320) |
| Net loss | \$                                  | (748)   | \$   | (1,063) | \$                                | (3,550) | \$   | (1,781) |

**Note 14. Guarantor Financial Information**

Our 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 us, our guarantor subsidiaries and our non-guarantor subsidiaries for all periods presented are stated below:

**CONDENSED CONSOLIDATING STATEMENT OF INCOME**

**For the Three Months Ended June 30, 2008**

|                                        | Parent | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|----------------------------------------|--------|---------------------------|-----------------------------------|--------------|--------------|
| Revenues:                              |        |                           |                                   |              |              |
| Senior living revenue                  | \$     | \$ 87,073                 | \$ 141,369                        | \$           | \$ 228,442   |
| Hospital revenue                       |        |                           | 24,421                            |              | 24,421       |
| Pharmacy revenue                       |        |                           | 18,281                            |              | 18,281       |
| Total revenues                         |        | 87,073                    | 184,071                           |              | 271,144      |
| Operating expenses:                    |        |                           |                                   |              |              |
| Senior living wages and benefits       |        | 37,460                    | 74,335                            |              | 111,795      |
| Other senior living operating expenses |        | 22,270                    | 36,398                            |              | 58,668       |
| Hospital expenses                      |        |                           | 22,615                            |              | 22,615       |
| Pharmacy expenses                      |        |                           | 17,347                            |              | 17,347       |
| Rent expense                           |        | 17,334                    | 21,941                            |              | 39,275       |
| General and administrative expenses    |        |                           | 11,722                            |              | 11,722       |

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|                                                       |          |          |            |            |          |
|-------------------------------------------------------|----------|----------|------------|------------|----------|
| Depreciation and amortization                         |          | 1,199    | 2,448      |            | 3,647    |
| Total operating expenses                              |          | 78,263   | 186,806    |            | 265,069  |
| Operating income                                      |          | 8,810    | (2,735)    |            | 6,075    |
| Interest and other income                             |          |          | 1,302      |            | 1,302    |
| Interest expense                                      |          |          | (1,600)    |            | (1,600)  |
| Gain on extinguishment of debt                        |          |          | (1,096)    |            | (1,096)  |
| Equity in earnings of subsidiaries                    | 3,489    |          |            | (3,489)    |          |
| Income from continuing operations before income taxes | 3,489    | 8,810    | (4,129)    | (3,489)    | 4,681    |
| Provision for income taxes                            |          |          | (444)      |            | (444)    |
| Income from continuing operations                     | 3,489    | 8,810    | (4,573)    | (3,489)    | 4,237    |
| Loss from discontinued operations                     |          |          | (748)      |            | (748)    |
| Net income (loss)                                     | \$ 3,489 | \$ 8,810 | \$ (5,321) | \$ (3,489) | \$ 3,489 |

Table of Contents

## FIVE STAR QUALITY CARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

**CONDENSED CONSOLIDATING STATEMENT OF INCOME****For the Three Months Ended June 30, 2007**

|                                                       | Parent   | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|-------------------------------------------------------|----------|---------------------------|-----------------------------------|--------------|--------------|
| <b>Revenues:</b>                                      |          |                           |                                   |              |              |
| Senior living revenue                                 | \$       | \$ 84,988                 | \$ 115,613                        | \$           | \$ 200,601   |
| Hospital revenue                                      |          |                           | 25,219                            |              | 25,219       |
| Pharmacy revenue                                      |          |                           | 14,318                            |              | 14,318       |
| Total revenues                                        |          | 84,988                    | 155,150                           |              | 240,138      |
| <b>Operating expenses:</b>                            |          |                           |                                   |              |              |
| Senior living wages and benefits                      |          | 38,242                    | 65,659                            |              | 103,901      |
| Other senior living operating expenses                |          | 24,536                    | 23,965                            |              | 48,501       |
| Hospital expenses                                     |          |                           | 23,373                            |              | 23,373       |
| Pharmacy expenses                                     |          |                           | 13,524                            |              | 13,524       |
| Rent expense                                          |          | 16,613                    | 15,350                            |              | 31,963       |
| General and administrative expenses                   |          |                           | 10,887                            |              | 10,887       |
| Depreciation and amortization                         |          | 1,198                     | 2,040                             |              | 3,238        |
| Total operating expenses                              |          | 80,589                    | 154,798                           |              | 235,387      |
| Operating income                                      |          | 4,399                     | 352                               |              | 4,751        |
| Interest and other income                             |          |                           | 1410                              |              | 1,410        |
| 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                     | 1,019                             | (4,080)      | 5,418        |
| Provision for income taxes                            |          |                           | (275)                             |              | (275)        |
| Income from continuing operations                     | 4,080    | 4,399                     | 744                               | (4,080)      | 5,143        |
| Loss from discontinued operations                     |          |                           | (1,063)                           |              | (1,063)      |
| Net income (loss)                                     | \$ 4,080 | \$ 4,399                  | \$ (319)                          | \$ (4,080)   | \$ 4,080     |

**CONDENSED CONSOLIDATING STATEMENT OF INCOME****For the Six Months Ended June 30, 2008**

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

|                                                       | Parent   | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|-------------------------------------------------------|----------|---------------------------|-----------------------------------|--------------|--------------|
| Revenues:                                             |          |                           |                                   |              |              |
| Senior living revenue                                 | \$       | \$ 175,988                | \$ 269,381                        | \$           | \$ 445,369   |
| Hospital revenue                                      |          |                           | 49,165                            |              | 49,165       |
| Pharmacy revenue                                      |          |                           | 35,487                            |              | 35,487       |
| Total revenues                                        |          | 175,988                   | 354,033                           |              | 530,021      |
| Operating expenses:                                   |          |                           |                                   |              |              |
| Senior living wages and benefits                      |          | 75,346                    | 145,543                           |              | 220,889      |
| Other senior living operating expenses                |          | 43,691                    | 68,398                            |              | 112,089      |
| Hospital expenses                                     |          |                           | 45,207                            |              | 45,207       |
| Pharmacy expenses                                     |          |                           | 33,550                            |              | 33,550       |
| Rent expense                                          |          | 34,578                    | 40,141                            |              | 74,719       |
| General and administrative expenses                   |          |                           | 22,855                            |              | 22,855       |
| Depreciation and amortization                         |          | 2,421                     | 4,861                             |              | 7,282        |
| Total operating expenses                              |          | 156,036                   | 360,555                           |              | 516,591      |
| Operating income                                      |          | 19,952                    | (6,522)                           |              | 13,430       |
| Interest and other income                             |          |                           | 3,796                             |              | 3,796        |
| Interest expense                                      |          |                           | (3,194)                           |              | (3,194)      |
| Unrealized loss on investments in trading securities  |          |                           | (4,366)                           |              | (4,366)      |
| Equity in earnings of subsidiaries                    | 5,106    |                           |                                   | (5,106)      |              |
| Income from continuing operations before income taxes | 5,106    | 19,952                    | (10,286)                          | (5,106)      | 9,666        |
| Provision for income taxes                            |          |                           | (1,010)                           |              | (1,010)      |
| Income from continuing operations                     | 5,106    | 19,952                    | (11,296)                          | (5,106)      | 8,656        |
| Loss from discontinued operations                     |          |                           | (3,550)                           |              | (3,550)      |
| Net income (loss)                                     | \$ 5,106 | \$ 19,952                 | \$ (14,846)                       | \$ (5,106)   | \$ 5,106     |

Table of Contents

## FIVE STAR QUALITY CARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

**CONDENSED CONSOLIDATING STATEMENT OF INCOME****For the Six Months Ended June 30, 2007**

|                                                       | Parent   | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|-------------------------------------------------------|----------|---------------------------|-----------------------------------|--------------|--------------|
| <b>Revenues:</b>                                      |          |                           |                                   |              |              |
| Senior living revenue                                 | \$       | \$ 169,027                | \$ 228,637                        | \$           | \$ 397,664   |
| Hospital revenue                                      |          |                           | 51,348                            |              | 51,348       |
| Pharmacy revenue                                      |          |                           | 28,153                            |              | 28,153       |
| Total revenues                                        |          | 169,027                   | 308,138                           |              | 477,165      |
| <b>Operating expenses:</b>                            |          |                           |                                   |              |              |
| Senior living wages and benefits                      |          | 76,971                    | 128,865                           |              | 205,836      |
| Other senior living operating expenses                |          | 50,592                    | 47,820                            |              | 98,412       |
| Hospital expenses                                     |          |                           | 46,997                            |              | 46,997       |
| Pharmacy expenses                                     |          |                           | 27,115                            |              | 27,115       |
| Rent expense                                          |          | 33,237                    | 30,991                            |              | 64,228       |
| General and administrative expenses                   |          |                           | 20,946                            |              | 20,946       |
| Depreciation and amortization                         |          | 2,372                     | 4,017                             |              | 6,389        |
| Total operating expenses                              |          | 163,172                   | 306,751                           |              | 469,923      |
| Operating income                                      |          | 5,855                     | 1,387                             |              | 7,242        |
| Interest and other income                             |          | (8)                       | 2,838                             |              | 2,830        |
| 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                     | 5,261                             | (8,844)      | 11,108       |
| Provision for income taxes                            |          |                           | (483)                             |              | (483)        |
| Income from continuing operations                     | 8,844    | 5,847                     | 4,778                             | (8,844)      | 10,625       |
| Loss from discontinued operations                     |          |                           | (1,781)                           |              | (1,781)      |
| Net income                                            | \$ 8,844 | \$ 5,847                  | \$ 2,997                          | \$ (8,844)   | \$ 8,844     |

**CONDENSED CONSOLIDATING BALANCE SHEET****As of June 30, 2008**

|                                                                          | Parent     | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--------------------------------------------------------------------------|------------|---------------------------|-----------------------------------|--------------|--------------|
| <b>ASSETS</b>                                                            |            |                           |                                   |              |              |
| Current assets:                                                          |            |                           |                                   |              |              |
| Cash and cash equivalents                                                | \$         | \$ 8,124                  | \$ 37,760                         | \$           | \$ 45,884    |
| Accounts receivable, net                                                 |            | 658                       | 60,340                            |              | 60,998       |
| Restricted cash and investments                                          |            | 1,572                     | 5,905                             |              | 7,477        |
| Investment securities                                                    |            |                           | 6,892                             |              | 6,892        |
| Prepaid expenses and other current assets                                |            | 1,714                     | 12,450                            |              | 14,164       |
| Assets of discontinued operations                                        |            |                           | 2,040                             |              | 2,040        |
| Total current assets                                                     |            | 12,068                    | 125,387                           |              | 137,455      |
| Property and equipment, net                                              |            | 26,979                    | 105,465                           |              | 132,444      |
| Investment in subsidiary and long term receivable from (to) subsidiaries | 200        |                           | 200                               | (400)        |              |
| Restricted cash and investments                                          |            | 1,321                     | 11,802                            |              | 13,123       |
| Investments in trading securities                                        |            |                           | 70,484                            |              | 70,484       |
| Intercompany                                                             | 229,293    |                           |                                   | (229,293)    |              |
| Goodwill and other intangible assets                                     |            |                           | 22,544                            |              | 22,544       |
| Other long term assets                                                   |            |                           | 4,795                             |              | 4,795        |
|                                                                          | \$ 229,493 | \$ 40,368                 | \$ 340,677                        | \$ (229,693) | \$ 380,845   |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                              |            |                           |                                   |              |              |
| Current liabilities:                                                     |            |                           |                                   |              |              |
| Accounts payable and other current liabilities                           | \$         | \$ 19,227                 | \$ 96,901                         | \$           | \$ 116,128   |
| Mortgage notes payable                                                   |            |                           | 187                               |              | 187          |
| Total current liabilities                                                |            | 19,227                    | 97,088                            |              | 116,315      |
| Long term liabilities:                                                   |            |                           |                                   |              |              |
| Mortgage notes payable                                                   |            |                           | 15,706                            |              | 15,706       |
| Convertible senior notes                                                 |            |                           | 126,500                           |              | 126,500      |
| Notes payable to related parties                                         | 200        |                           |                                   | (200)        |              |
| Other long term liabilities                                              |            | 4,698                     | 26,076                            |              | 30,774       |
| Total long term liabilities                                              | 200        | 4,698                     | 168,282                           | (200)        | 172,980      |
| Total shareholders' equity                                               | 229,293    | 16,443                    | 75,307                            | (229,493)    | 91,550       |
|                                                                          | \$ 229,493 | \$ 40,368                 | \$ 340,677                        | \$ (229,693) | \$ 380,845   |

Table of Contents

## FIVE STAR QUALITY CARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

**CONDENSED CONSOLIDATING BALANCE SHEET****As of December 31, 2007**

|                                                                             | Parent     | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|-----------------------------------------------------------------------------|------------|---------------------------|-----------------------------------|--------------|--------------|
| <b>ASSETS</b>                                                               |            |                           |                                   |              |              |
| Current assets:                                                             |            |                           |                                   |              |              |
| Cash and cash equivalents                                                   | \$         | \$ 5,422                  | \$ 25,577                         | \$           | \$ 30,999    |
| Accounts receivable, net                                                    |            | 11,209                    | 47,594                            |              | 58,803       |
| Investments                                                                 |            |                           | 69,255                            |              | 69,255       |
| Prepaid expenses and other current assets                                   |            | 5,021                     | 18,761                            |              | 23,782       |
| Assets of discontinued operations                                           |            |                           | 3,178                             | ,            | 3,178        |
| Total current assets                                                        |            | 21,652                    | 164,365                           |              | 186,017      |
| Property and equipment, net                                                 |            | 28,874                    | 102,831                           |              | 131,705      |
| Investment in subsidiary and long term<br>receivable from (to) subsidiaries | 200        |                           | 200                               | (400)        |              |
| Intercompany                                                                | 229,048    |                           |                                   | (229,048)    |              |
| Other long term assets                                                      |            |                           | 42,732                            |              | 42,732       |
|                                                                             | \$ 229,248 | \$ 50,526                 | \$ 310,128                        | \$ (229,448) | \$ 360,454   |
| <b>LIABILITIES AND SHAREHOLDERS<br/>EQUITY</b>                              |            |                           |                                   |              |              |
| Current liabilities:                                                        |            |                           |                                   |              |              |
| Accounts payable and other current liabilities                              | \$         | \$ 27,823                 | \$ 75,821                         | \$           | \$ 103,644   |
| Mortgage notes payable                                                      |            |                           | 200                               |              | 200          |
| Liabilities of discontinued operations                                      |            |                           | 219                               |              | 219          |
| Total current liabilities                                                   |            | 27,823                    | 76,240                            |              | 104,063      |
| Long term liabilities:                                                      |            |                           |                                   |              |              |
| Mortgage notes payable                                                      |            |                           | 15,810                            |              | 15,810       |
| Convertible senior notes                                                    |            |                           | 126,500                           |              | 126,500      |
| Notes payable to related parties                                            | 200        |                           |                                   | (200)        |              |
| Other long term liabilities                                                 |            | 15,161                    | 12,098                            |              | 27,259       |
| Total long term liabilities                                                 | 200        | 15,161                    | 154,408                           | (200)        | 169,569      |
| Total shareholders equity                                                   | 229,048    | 7,542                     | 79,480                            | (229,248)    | 86,822       |
|                                                                             | \$ 229,248 | \$ 50,526                 | \$ 310,128                        | \$ (229,448) | \$ 360,454   |



Table of Contents

## FIVE STAR QUALITY CARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**
**For the Six Months Ended June 30, 2008**

|                                                                                             | Parent   | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---------------------------------------------------------------------------------------------|----------|---------------------------|-----------------------------------|--------------|--------------|
| Cash flows from operating activities:                                                       |          |                           |                                   |              |              |
| Net income                                                                                  | \$ 5,106 | \$ 19,952                 | \$ (14,846)                       | \$ (5,106)   | \$ 5,106     |
| Undistributed equity in earnings of subsidiaries                                            | (5,106)  |                           |                                   | 5,106        |              |
| Adjustments to reconcile net income to cash provided by (used in) operating activities, net |          | (16,252)                  | 33,375                            |              | 17,123       |
| Net cash provided by (used in) operating activities                                         |          | 3,700                     | 18,529                            |              | 22,229       |
| Net cash used in discontinued operations                                                    |          |                           | (398)                             |              | (398)        |
| Cash flows from investing activities:                                                       |          |                           |                                   |              |              |
| Capital expenditures                                                                        |          | (15,612)                  | (21,250)                          |              | (36,862)     |
| Proceeds from the sale of property and equipment                                            |          | 15,101                    | 12,162                            |              | 27,263       |
| Other, net                                                                                  |          | (487)                     | 3,257                             |              | 2,770        |
| Net cash used in investing activities                                                       |          | (998)                     | (5,831)                           |              | (6,829)      |
| Cash flows from financing activities:                                                       |          |                           |                                   |              |              |
| Change in borrowings, net                                                                   |          |                           | (117)                             |              | (117)        |
| Net cash used in financing activities                                                       |          |                           | (117)                             |              | (117)        |
| Change in cash and cash equivalents                                                         |          | 2,702                     | 12,183                            |              | 14,885       |
| Cash and cash equivalents at beginning of period                                            |          | 5,422                     | 25,577                            |              | 30,999       |
| Cash and cash equivalents at end of period                                                  | \$       | \$ 8,124                  | \$ 37,760                         | \$           | \$ 45,884    |

**CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**
**For the Six Months Ended June 30, 2007**

|        |              |              |
|--------|--------------|--------------|
| Parent | Eliminations | Consolidated |
|--------|--------------|--------------|

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|                                                                                             | Guarantor<br>Subsidiaries |         | Non-<br>Guarantor<br>Subsidiaries |          |    |          |    |         |    |          |
|---------------------------------------------------------------------------------------------|---------------------------|---------|-----------------------------------|----------|----|----------|----|---------|----|----------|
| 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)  |    | 45,883   |    |         |    | 39,533   |
| Net cash provided by (used in) operating activities                                         |                           |         |                                   | (503)    |    | 48,880   |    |         |    | 48,377   |
| Net cash used in discontinued operations                                                    |                           |         |                                   |          |    | (1,726)  |    |         |    | (1,726)  |
| Cash flows from investing activities:                                                       |                           |         |                                   |          |    |          |    |         |    |          |
| Acquisition of property and equipment                                                       |                           |         |                                   | (11,970) |    | (24,695) |    |         |    | (36,665) |
| Proceeds from disposition of property and equipment                                         |                           |         |                                   | 6,907    |    | 10,203   |    |         |    | 17,110   |
| Other, net                                                                                  |                           |         |                                   |          |    | (2,094)  |    |         |    | (2,094)  |
| Net cash used in investing activities                                                       |                           |         |                                   | (5,063)  |    | (16,586) |    |         |    | (21,649) |
| Cash flows from financing activities:                                                       |                           |         |                                   |          |    |          |    |         |    |          |
| Change in borrowings, net                                                                   |                           |         |                                   |          |    | (28,757) |    |         |    | (28,757) |
| Net cash used in financing activities                                                       |                           |         |                                   |          |    | (28,757) |    |         |    | (28,757) |
| 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   |

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

**Note 15. Subsequent Events**

On July 1, 2008, we agreed to lease ten assisted living communities located in Pennsylvania and New Jersey that were previously operated by NewSeasons Assisted Living Communities, Inc., or NewSeasons, under leases from Senior Housing. In consideration of our lease assumption, NewSeasons paid us \$10,000 and transferred title to certain personal property located at the communities. We have recorded this lease concession as a liability, on our balance sheet, which will be amortized to rent expense over the remaining lease term. Simultaneously with these negotiations with NewSeasons, we negotiated to purchase three of these communities from Senior Housing and to lease the remaining seven. Effective July 1, 2008, we acquired these three assisted living communities with 259 units located in Pennsylvania and New Jersey for \$21,400 from Senior Housing. We allocated the purchase price of these communities to land, building and equipment. The purchase price of these properties was equal to the seller's net book value which Senior Housing and we believe reflects the fair market value of these properties. We and Senior Housing are obtaining appraisals of the properties, which appraisals have not yet been completed. If such appraisals indicate that the aggregate fair market value of the properties is materially different from the purchase price, then we and Senior Housing shall make the appropriate adjustments to cash consideration and rent. The remaining seven communities with 614 units will be leased from Senior Housing for annual rent of approximately \$7,600 per year. We acquired these ten communities because they complement our business strategy of focusing our operations in high quality senior living assets where residents pay for our services with private resources. All of the revenues of these communities come from residents' private resources.

On August 1, 2008, we leased from Senior Housing two assisted living communities with a total of 112 units which Senior Housing purchased from an unrelated party. Our rent payable to Senior Housing for these two communities is \$1,100 per year, plus future increases calculated as a percentage of the revenue increase at these communities after 2010. We added these communities to our existing lease with Senior Housing which has a term ending in 2024, with renewal options thereafter. In addition, we purchased land adjacent to one of these communities for \$890 for future development.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Conditions and Results of Operations****RESULTS OF OPERATIONS**

Our reportable segments consist of our senior living community business and our rehabilitation hospital business. In the senior living community segment, we operate independent living and congregate care communities, assisted living communities and skilled nursing facilities. Our rehabilitation hospital segment provides inpatient medical rehabilitation services at our two hospital locations and three satellite locations and outpatient medical rehabilitation services at 18 affiliated outpatient clinics. We do not consider our pharmacy operations to be a significant, separately reportable segment of our business but we report our pharmacy revenues and expense as separate items within our corporate and other activities. All of our operations and assets are located in the United States.

We use segment operating profit as an important measure to evaluate our performance and for internal business 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, 2008 and 2007):**

The following tables present a summary of our operations for the three months ended June 30, 2008 and 2007:

**Senior living communities:**

| (in thousands, except per day amounts)          | Three months ended June 30, |            |           |          |
|-------------------------------------------------|-----------------------------|------------|-----------|----------|
|                                                 | 2008                        | 2007       | \$ Change | % Change |
| Senior living revenue                           | \$ 228,442                  | \$ 200,601 | \$ 27,841 | 13.9%    |
| Senior living wages and benefits                | (111,795)                   | (103,901)  | (7,894)   | 7.6%     |
| Other senior living operating expenses          | (58,668)                    | (48,501)   | (10,167)  | 21.0%    |
| Rent expense                                    | (36,594)                    | (29,394)   | (7,200)   | 24.5%    |
| Depreciation and amortization                   | (2,447)                     | (2,290)    | (157)     | 6.9%     |
| Interest expense                                | (327)                       | (319)      | (8)       | 2.5%     |
| Interest and other income                       | 485                         | 426        | 59        | 13.8%    |
| Gain on extinguishment of debt                  |                             | 934        | (934)     | (100.0)% |
| Senior living income from continuing operations | 19,096                      | 17,556     | 1,540     | 8.8%     |
| No. of communities (end of period)              | 182                         | 161        | 21        | 13.0%    |
| No. of living units (end of period)             | 19,814                      | 18,007     | 1,807     | 10.0%    |
| Occupancy                                       | 88.6%                       | 90.0%      | n/a       | (1.4)%   |
| Average daily rate                              | \$ 145.75                   | \$ 136.11  | \$ 9.64   | 7.1%     |
| Percent of senior living revenue from Medicare  | 15.2%                       | 15.6%      | n/a       | (0.4)%   |
| Percent of senior living revenue from Medicaid  | 16.9%                       | 18.0%      | n/a       | (1.1)%   |
|                                                 | 67.9%                       | 66.4%      | n/a       | 1.5%     |

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Percent of senior living revenue from private and other sources

Comparable communities (senior living communities that we have operated continuously since April 1, 2007):

| (in thousands, except per day amounts)                          | Three months ended June 30, |            |           |  | % Change |
|-----------------------------------------------------------------|-----------------------------|------------|-----------|--|----------|
|                                                                 | 2008                        | 2007       | \$ Change |  |          |
| Senior living revenue                                           | \$ 207,586                  | \$ 200,329 | \$ 7,257  |  | 3.6%     |
| Senior living community expenses                                | (155,451)                   | (152,207)  | (3,244)   |  | 2.1%     |
| No. of communities (end of period)                              | 162                         | 162        |           |  |          |
| No. of living units (end of period)                             | 18,016                      | 18,016     |           |  |          |
| Occupancy                                                       | 88.7%                       | 90.0%      |           |  | (1.3)%   |
| Average daily rate                                              | \$ 144.09                   | \$ 136.21  | \$ 7.88   |  | 5.8%     |
| Percent of senior living revenue from Medicare                  | 16.3%                       | 15.6%      | n/a       |  | 0.7%     |
| Percent of senior living revenue from Medicaid                  | 18.0%                       | 18.0%      | n/a       |  |          |
| Percent of senior living revenue from private and other sources | 65.8%                       | 66.4%      | n/a       |  | (0.6)%   |

Table of ContentsRehabilitation hospitals:

| (in thousands)                           | 2008      | Three months ended June 30, |           |          |
|------------------------------------------|-----------|-----------------------------|-----------|----------|
|                                          |           | 2007                        | \$ Change | % Change |
| Hospital revenues                        | \$ 24,421 | \$ 25,219                   | \$ (798)  | (3.2)%   |
| Hospital expenses                        | (22,615)  | (23,373)                    | 758       | (3.2)%   |
| Rent expense                             | (2,681)   | (2,569)                     | (112)     | 4.4%     |
| Depreciation and amortization            | (309)     | (277)                       | (32)      | 11.6%    |
| Hospital loss from continuing operations | (1,184)   | (1,000)                     | (184)     | 18.4%    |

Corporate and Other (1):

| (in thousands)                                       | 2008      | Three months ended June 30, |           |          |
|------------------------------------------------------|-----------|-----------------------------|-----------|----------|
|                                                      |           | 2007                        | \$ Change | % Change |
| Pharmacy revenue                                     | \$ 18,281 | \$ 14,318                   | \$ 3,963  | 27.7%    |
| Pharmacy expenses                                    | (17,347)  | (13,524)                    | (3,823)   | 28.3%    |
| Depreciation and amortization                        | (891)     | (671)                       | (220)     | 32.8%    |
| General and administrative (2)                       | (11,722)  | (10,887)                    | (835)     | 7.7%     |
| Unrealized loss on investments in trading securities | (1,096)   |                             | (1,096)   | n/a      |
| Interest and other income                            | 817       | 984                         | (167)     | (17.0)%  |
| Interest expense                                     | (1,273)   | (1,358)                     | 85        | (6.3)%   |
| Provision for income taxes                           | (444)     | (275)                       | (169)     | 61.5%    |
| Corporate and Other loss from continuing operations  | (13,675)  | (11,413)                    | (2,262)   | 19.8%    |

(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:

| (in thousands)                                | 2008       | Three months ended June 30, |           |          |
|-----------------------------------------------|------------|-----------------------------|-----------|----------|
|                                               |            | 2007                        | \$ Change | % Change |
| Summary of revenue:                           |            |                             |           |          |
| Senior living revenue                         | \$ 228,442 | \$ 200,601                  | \$ 27,841 | 13.9%    |
| Hospital revenue                              | 24,421     | 25,219                      | (798)     | (3.2)%   |
| Corporate and Other                           | 18,281     | 14,318                      | 3,963     | 27.7%    |
| Total revenue                                 | 271,144    | 240,138                     | 31,006    | 12.9%    |
| Summary of income from continuing operations: |            |                             |           |          |
| Senior living communities                     | 19,096     | 17,556                      | 1,540     | 8.8%     |

## RESULTS OF OPERATIONS

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|                                   |          |          |         |         |
|-----------------------------------|----------|----------|---------|---------|
| Rehabilitation hospitals          | (1,184)  | (1,000)  | (184)   | 18.4%   |
| Corporate and Other               | (13,675) | (11,413) | (2,262) | 19.8%   |
| Income from continuing operations | 4,237    | 5,143    | (906)   | (17.6)% |

### Three Months Ended June 30, 2008, Compared to Three Months Ended June 30, 2007

#### Senior living communities:

The 13.9% increase in senior living revenue for the three months ended June 30, 2008 is due primarily to revenues from the 19 communities we began to operate in the first quarter of 2008 and increased per diem charges, partially offset by a decrease in occupancy. The 3.6% increase in senior living revenue at the communities that we have operated continuously since April 1, 2007 is due primarily to increased per diem charges, partially offset by a decrease in occupancy.

Table of Contents

The 7.6% increase in senior living wages and benefits costs for the three months ended June 30, 2008 is primarily due to wages and benefits from the 19 communities we began to operate in the first quarter of 2008 and wage increases. The 21.0% 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 19 communities we began to operate in the first quarter of 2008. The senior living community expenses for the senior living communities that we have operated continuously since April 1, 2007 have increased by 2.1%, principally due to wage and benefit increases. The 24.5% rent expense increase is due to the communities that we began to operate in the first quarter of 2008 and our payment of additional rent for senior living community capital improvements purchased by Senior Housing since April 1, 2007.

The 6.9% increase in depreciation and amortization expense for the three months ended June 30, 2008 is primarily attributable to our purchase of furniture and fixtures for our communities.

Rehabilitation hospitals:

The 3.2% decrease in hospital revenues for the three months ended June 30, 2008 was primarily due to a decrease in census and the closing of several unprofitable outpatient clinics. The 3.2% decrease in hospital expenses was primarily due to reductions in labor and benefit expenses and the closing of several unprofitable outpatient clinics.

The 4.4% rent expense increase for the three months ended June 30, 2008 over the same period in 2007 is due to our payment of additional rent for hospital capital improvements purchased by Senior Housing since April 1, 2007.

The 11.6% increase in depreciation and amortization expense for the three months ended June 30, 2008 is primarily attributable to our purchase of furniture and fixtures for our rehabilitation hospitals.

Corporate and other:

The 27.7% increase in pharmacy revenues and the 28.3% increase in pharmacy expenses for the three months ended June 30, 2008, is primarily the result of adding new customers from both our existing senior living and third party operated communities.

The 7.7% increase in general and administrative expenses for the three months ended June 30, 2008 over the same period in 2007 results from the 19 communities we began to operate in the first quarter of 2008.

The 32.8% increase in depreciation and amortization expense for the three months ended June 30, 2008 is primarily attributable to our purchase of furniture and fixtures for our pharmacies and corporate and regional offices.

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During the three months ended June 30, 2008, we recognized an unrealized loss of \$1.1 million on investments in trading securities related to our holdings of auction rate securities.

Our interest and other income decreased by \$167,000, or 17.0%, for the three months ended June 30, 2008, compared to the three months ended June 30, 2007, primarily as a result of lower interest rates earned on our cash investments.

For the three months ended June 30, 2008, we incurred taxes of \$444,000, which includes \$383,000 of alternative minimum taxes and certain state taxes that are payable without regard to our tax loss carry forwards and \$61,000 related to a non cash deferred tax liability arising from the amortization of goodwill for tax purposes but not for book purposes.

Table of Contents**Key Statistical Data (for the six months ended June 30, 2008 and 2007):**

The following tables present a summary of our operations for the six months ended June 30, 2008 and 2007:

**Senior living communities:**

| (in thousands, except per day amounts)                                | Six months ended June 30, |            |           |          |
|-----------------------------------------------------------------------|---------------------------|------------|-----------|----------|
|                                                                       | 2008                      | 2007       | \$ Change | % Change |
| Senior living revenue                                                 | \$ 445,369                | \$ 397,664 | \$ 47,705 | 12.0%    |
| Senior living wages and benefits                                      | (220,889)                 | (205,836)  | (15,053)  | 7.3%     |
| Other senior living operating expenses                                | (112,089)                 | (98,412)   | (13,677)  | 13.9%    |
| Rent expense                                                          | (69,388)                  | (59,097)   | (10,291)  | 17.4%    |
| Depreciation and amortization                                         | (4,887)                   | (4,521)    | (366)     | 8.1%     |
| Interest expense                                                      | (633)                     | (773)      | 140       | (18.1)%  |
| Interest and other income                                             | 1,768                     | 781        | (987)     | 126.4%   |
| Gain on extinguishment of debt                                        |                           | 4,491      | (4,491)   | (100.0)% |
| Senior living income from continuing operations                       | 39,251                    | 34,297     | 4,954     | 14.4%    |
| No. of communities (end of period)                                    | 182                       | 161        | 21        | 13.0%    |
| No. of living units (end of period)                                   | 19,814                    | 18,007     | 1,807     | 10.0%    |
| Occupancy                                                             | 89.2%                     | 90.1%      | n/a       | (0.9)%   |
| Average daily rate                                                    | \$ 143.23                 | \$ 135.80  | \$ 7.43   | 5.5%     |
| Percent of net revenues from residents from Medicare                  | 15.6%                     | 15.6%      | n/a       |          |
| Percent of net revenues from residents from Medicaid                  | 17.4%                     | 18.0%      | n/a       | (0.6)%   |
| Percent of net revenues from residents from private and other sources | 67.0%                     | 66.4%      | n/a       | 0.6%     |

**Comparable communities** (communities that we operated continuously since January 1, 2007):

| (in thousands, except per day amounts)                                | Six months ended June 30, |            |           |          |
|-----------------------------------------------------------------------|---------------------------|------------|-----------|----------|
|                                                                       | 2008                      | 2007       | \$ Change | % Change |
| Net revenues from residents                                           | \$ 416,690                | \$ 397,392 | \$ 19,298 | 4.9%     |
| Community expenses                                                    | (311,522)                 | (304,053)  | (7,469)   | 2.5%     |
| No. of communities (end of period)                                    | 162                       | 162        |           |          |
| No. of living units (end of period)                                   | 18,016                    | 18,016     |           |          |
| Occupancy                                                             | 89.2%                     | 90.1%      | n/a       | (0.9)%   |
| Average daily rate                                                    | \$ 143.83                 | \$ 135.85  | \$ 7.98   | 5.9%     |
| Percent of net revenues from residents from Medicare                  | 16.3%                     | 15.6%      | n/a       | 0.7%     |
| Percent of net revenues from residents from Medicaid                  | 17.9%                     | 18.0%      | n/a       | (0.1)%   |
| Percent of net revenues from residents from private and other sources | 65.7%                     | 66.4%      | n/a       | (0.7)%   |

**Rehabilitation hospitals:**

| (in thousands)                           | Six months ended June 30, |           |            |          |
|------------------------------------------|---------------------------|-----------|------------|----------|
|                                          | 2008                      | 2007      | \$ Change  | % Change |
| Hospital revenues                        | \$ 49,165                 | \$ 51,348 | \$ (2,183) | (4.3)%   |
| Hospital expenses                        | (45,207)                  | (46,997)  | 1,790      | (3.8)%   |
| Rent expense                             | (5,331)                   | (5,131)   | (200)      | 3.9%     |
| Depreciation and amortization            | (617)                     | (493)     | (124)      | 25.2%    |
| Hospital loss from continuing operations | (1,990)                   | (1,273)   | (717)      | 56.3%    |

Corporate and Other (1):

| (in thousands)                                       | Six months ended June 30, |           |           |          |
|------------------------------------------------------|---------------------------|-----------|-----------|----------|
|                                                      | 2008                      | 2007      | \$ Change | % Change |
| Pharmacy revenue                                     | \$ 35,487                 | \$ 28,153 | 7,334     | 26.1%    |
| Pharmacy expenses                                    | (33,550)                  | (27,115)  | (6,435)   | 23.7%    |
| Depreciation and amortization                        | (1,778)                   | (1,375)   | (403)     | 29.3%    |
| General and administrative (2)                       | (22,855)                  | (20,946)  | (1,909)   | 9.1%     |
| Unrealized loss on investments in trading securities | (4,366)                   |           | (4,366)   |          |
| Interest and other income                            | 2,028                     | 2,049     | (21)      | (1.0)%   |
| Interest expense                                     | (2,561)                   | (2,682)   | 121       | (4.5)%   |
| Provision for income taxes                           | (1,010)                   | (483)     | (527)     | 109.1%   |
| Corporate and Other loss from continuing operations  | (28,605)                  | (22,399)  | (6,206)   | 27.7%    |

Table of Contents

(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:

| (in thousands)                                | 2008       | Six months ended June 30, |           |          |
|-----------------------------------------------|------------|---------------------------|-----------|----------|
|                                               |            | 2007                      | \$ Change | % Change |
| Summary of revenue:                           |            |                           |           |          |
| Senior living revenue                         | \$ 445,369 | \$ 397,664                | \$ 47,705 | 12.0%    |
| Hospital revenue                              | 49,165     | 51,348                    | (2,183)   | (4.3)%   |
| Corporate and Other                           | 35,487     | 28,153                    | 7,334     | 26.1%    |
| Total revenue                                 | 530,021    | 477,165                   | 52,856    | 11.1%    |
| Summary of income from continuing operations: |            |                           |           |          |
| Senior living communities                     | 39,251     | 34,297                    | 4,954     | 14.4%    |
| Rehabilitation hospitals                      | (1,990)    | (1,273)                   | (717)     | 56.3%    |
| Corporate and Other                           | (28,605)   | (22,399)                  | (6,206)   | 27.7%    |
| Income from continuing operations             | 8,656      | \$ 10,625                 | (1,969)   | (18.5)%  |

Six Months Ended June 30, 2008, Compared to Six Months Ended June 30, 2007Senior living communities:

The 12.0% increase in senior living revenue for the six months ended June 30, 2008 is due primarily to revenues from the 19 communities we began to operate in the first quarter of 2008 and increased per diem charges, partially offset by a decrease in occupancy. The 4.9% increase in senior living revenue at the communities that we have operated continuously since January 1, 2007 is due primarily to increased per diem charges, partially offset by a decrease in occupancy.

Our 7.3% increase in senior living wages and benefits costs for the six months ended June 30, 2008 is primarily due to wages and benefits at the 19 communities we began to operate in the first quarter of 2008, and wage increases. The 13.9% 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 19 communities we began to operate in the first quarter of 2008, and increased charges from various service providers. The senior living community expenses for the senior living communities that we have operated continuously since January 1, 2007 have increased by 2.5%, principally due to wage and benefit increases. The 17.4% rent expense increase is due to the addition of 19 communities that we began to operate in the first quarter of 2008, our payment of percentage rent and our payment of additional rent for senior living community capital improvements purchased by Senior Housing since July 1, 2007.

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The 8.1% increase in depreciation and amortization expense for the six months ended June 30, 2008 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 and other income increased by \$987,000, or 126.4%, for the six months ended June 30, 2008, compared to the six months ended June 30, 2007, primarily as a result of recognizing an \$840,000 gain related to a 2003 sale of a property that was previously deferred until the buyer paid in full our note receivable during the first quarter of 2008.

Our interest expense for the six months ended June 30, 2008 decreased in 2008 by 18.1% because in 2007, we prepaid seven United States Department of Housing and Urban Development, or HUD, insured mortgages that were secured by six of our communities. We recognized a net gain of \$4.5 million during 2007 on extinguishments of these seven mortgages that consisted of the elimination of \$5.4 million of debt premium offset by \$841,000 in prepayment penalties which we paid.

Table of Contents

Rehabilitation hospitals:

The 4.3% decrease in hospital revenues for the six months ended June 30, 2008 was primarily due to a decrease in census and the closing of several unprofitable outpatient clinics. The 3.8% decrease in hospital expenses was primarily due to reductions in labor and benefit expenses and the closing of several unprofitable outpatient clinics.

The 3.9% rent expense increase in the six months ended June 30, 2008 over the same period in 2007 is due to our payment of additional rent for hospital capital improvements purchased by Senior Housing since July 1, 2007.

The 25.2% increase in depreciation and amortization expense for the six months ended June 30, 2008 is primarily attributable to our purchase of furniture and fixtures for our rehabilitation hospitals.

Corporate and other:

The 26.1% and 23.7% increase in 2008 revenues and expenses, respectively, from our pharmacies for the six months ended June 20, 2008 is primarily the result of adding new customers from both our existing senior living and third party communities.

The 9.1% increase in general and administrative expenses for the six months ended June 30, 2008 over the same period in 2007 results from the 19 communities we began to operate in the first quarter of 2008.

The 29.3% increase in depreciation and amortization expense for the six months ended June 30, 2008 is primarily attributable to our purchase of furniture and fixtures for our pharmacies and corporate and regional offices.

During the six months ended June 30, 2008, we recognized an unrealized loss of \$4.4 million on investments in trading securities related to our holdings of auction rate securities.

For the six months ended June 30, 2008, we incurred taxes of \$1.0 million, which includes \$889,000 of alternative minimum taxes and certain state taxes that are payable without regard to our tax loss carry forwards and \$121,000 of a non cash deferred tax liability arising from the amortization of goodwill for tax purposes but not for book purposes.

**LIQUIDITY AND CAPITAL RESOURCES**

**Investments**

At June 30, 2008, we had \$70.5 million invested in auction rate securities which we classified as long term investments in trading securities. Starting in February 2008, as a result of changes in the capital markets, auctions affecting our auction rate securities failed to close on their settlement dates. We do not know if future auctions for our auction rate securities will successfully close on future auction settlement dates. On March 31, 2008, we moved our auction rate securities from current assets to non-current assets due to our belief that the market for student loan collateralized instruments may take in excess of twelve months to fully recover.

Our auction rate securities consist primarily of bonds issued by various entities to fund student loans pursuant to the Federal Family Education Loan Program. The maturities of our auction rate securities range from 2032 to 2047. However, historically we have had the option to liquidate our investments in our auction rate securities whenever the interest rates are reset at auctions, usually every 35 days. All of our auction rate securities were rated AAA by at least one nationally recognized debt rating agency when we made these investments, and, to our knowledge, none of these ratings have been reduced. We and the broker dealer, who marketed the auction rate securities which we own, are presently monitoring developments in the auction rate securities markets. Based upon our analysis of impairment factors through June 30, 2008, we have recognized an unrealized loss of \$4.4 million on our investments in these securities.

The funds which we invested in auction rate securities were funds we were holding to invest in potential acquisitions which we have not yet identified or to satisfy longer term self insurance obligations. Accordingly, these funds are not needed to fund our current operations and we do not expect the failure of auctions affecting our auction rate securities holdings to have a material adverse impact upon us unless the auction rate securities market remains illiquid for an extended period, our auction rate securities ratings are reduced or the value of these securities

Table of Contents

declines. Nonetheless, the current illiquidity of these investments may mean we are unable to take advantage of acquisitions or other investment opportunities.

**Assets and Liabilities**

Our total current assets at June 30, 2008 were \$137.5 million, compared to \$186.0 million at December 31, 2007. At June 30, 2008, we had cash and cash equivalents of \$45.9 million compared to \$31.0 at December 31, 2007. Our current liabilities were \$116.3 million at June 30, 2008, compared to \$104.1 million at December 31, 2007. The decrease in current assets is primarily the result of our reclassifying our investments in auction rate securities from current to long term assets.

**Our Cash Flows**

Cash provided from continuing operations was \$22.2 million for the first half of 2008 as compared with \$48.4 million for the same period of 2007. Excluding cash flows associated with our investments in trading securities, cash provided from continuing operations was \$34.7 and \$36.7 for the six months ended June 30, 2008 and 2007, respectively. Acquisitions of property plant and equipment, on a net basis after considering the proceeds from sales of fixed assets to Senior Housing, were \$9.4 million and \$19.6 million for the six month periods ended June 30, 2008 and 2007, respectively. During the first six months of 2007, as a result of an early repayment of debt, we repaid long term debt of \$28.8 million.

**Our Leases with Senior Housing**

As of June 30, 2008, we leased 163 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 \$153.2 million annually and percentage rent for most senior living communities but not for our rehabilitation hospitals. We paid approximately \$877,000 and \$616,000 in percentage rent to Senior Housing for the three months ended June 30, 2008 and 2007, respectively, and \$1.9 million and \$1.2 million for the six months ended June 30, 2008 and 2007, respectively.

Upon our request, Senior Housing may purchase our capital expenditures made at the properties we lease from Senior Housing and increase our rent pursuant to contractual formulas. During the six months ended June 30, 2008, Senior Housing reimbursed us \$27.3 million for capital expenditures made at the properties leased from Senior Housing and these purchases resulted in our annual rent being increased by \$2.4 million.

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

On July 1, 2008, we agreed to lease ten assisted living communities located in Pennsylvania and New Jersey that were previously operated by NewSeasons Assisted Living Communities, Inc., or NewSeasons, under leases from Senior Housing. In consideration of our lease assumption, NewSeasons paid us \$10.0 million and transferred title to certain personal property located at the communities. We have recorded this lease

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concession as a liability, on our balance sheet, which will be amortized to rent expense over the remaining lease term. Simultaneously with these negotiations with NewSeasons, we negotiated to purchase three of these communities from Senior Housing and to lease the remaining seven. Effective July 1, 2008, we acquired these three assisted living communities with 259 units located in Pennsylvania and New Jersey for \$21.4 million from Senior Housing. We allocated the purchase price of these communities to land, building and equipment. The purchase price of these properties was equal to the seller's net book value which Senior Housing and we believe reflects the fair market value of these properties. We and Senior Housing are obtaining appraisals of the properties, which appraisals have not yet been completed. If such appraisals indicate that the aggregate fair market value of the properties is materially different from the purchase price, then we and Senior Housing shall make the appropriate adjustments to cash consideration and rent. The remaining seven communities with 614 units will be leased from Senior Housing for annual rent of approximately \$7.6 million per year. We acquired these ten communities because they complement our business strategy of focusing our operations in high quality senior living assets where residents pay for our services with private resources. All of the revenues of these communities come from residents' private resources.

On August 1, 2008, we leased from Senior Housing two assisted living communities with a total of 112 units which Senior Housing purchased from an unrelated party. Our rent payable to Senior Housing for these two communities is \$1.1 million per year, plus future increases calculated as a percentage of the revenue increase at these communities after 2010. We added these communities to our existing lease with Senior Housing which has a term

Table of Contents

ending in 2024, with renewal options thereafter. In addition, we purchased land adjacent to one of these communities for \$890,000 for future development.

**Our Revenues**

Our revenues from services to residents at our senior living communities and patients of our rehabilitation hospitals and clinics are our primary source of cash to fund our operating expenses, including rent, principal and interest payments on our debt and our capital expenditures.

During the past several months, our census has been negatively affected by worsening economic conditions in many of the markets that we serve. These conditions appear to be impacting many companies both within and outside of our industry and there can be no certainty as to when conditions will substantially improve.

At some of our senior living communities, we receive operating revenues for skilled nursing services from the Medicare and Medicaid programs. Medicare and Medicaid revenues from senior living communities were earned primarily at our 49 skilled nursing facilities. We derived 32% and 34% of our senior living revenue from these programs during the three months ended June 30, 2008 and 2007, respectively, and 33% and 34% during the six months ended June 30, 2008 and 2007, respectively.

Our net Medicare revenues from services to senior living community residents totaled \$67.5 million and \$61.6 million for the six months ended June 30, 2008 and 2007, respectively. In October 2007, our senior living community Medicare rates increased by approximately 3.6% over the prior period. Our net Medicaid revenues from services to senior living community residents totaled \$74.0 million and \$71.2 million for the six months ended June 30, 2008 and 2007, 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 rates. 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 impact on us 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. On July 31, 2008, the Federal Centers for Medicare and Medicaid Services, or CMS, announced that it will increase Medicare rates for skilled nursing facilities by approximately 3.4% for the federal fiscal year ending September 30, 2009, under a rule adding an annual update to account for inflation in the cost of goods and services included in a skilled nursing facility stay. CMS had proposed a recalibration of the payment categories for skilled nursing facilities, which would have resulted in a net reduction of rates by approximately 0.3% in federal fiscal year 2009, but delayed the recalibration in order to continue to evaluate the data. On July 15, 2008, as part of the Medicare Improvements for Patients and Providers Act of 2008, Congress enacted an 18-month extension of the Medicare outpatient therapy exception process through the end of 2009, under which Medicare may approve payments for medically necessary outpatient therapies which exceed the Medicare payment caps. This July 15, 2008 law may forestall a reduction in certain therapy revenues we have historically realized.

We began operating our two rehabilitation hospitals in October 2006. Approximately 65% and 70% of our revenues from these hospitals came from the Medicare and Medicaid programs for the six months ended June 30, 2008 and 2007, respectively. In October 2007, our rehabilitation hospital Medicare rates increased by approximately 3.5% over the prior period. However, for payments on and after April 1, 2008, as required by the Medicare, Medicaid and SCHIP Extension Act of 2007, Medicare inflation rate increases for these hospitals are set at zero per cent for the federal fiscal years ending September 30, 2008 and 2009, eliminating substantially all of the October 2007 rate increase. On July 31, 2008, CMS issued a rule updating the Medicare rates for inpatient rehabilitation facilities, or IRFs, for the federal fiscal year ending September 30, 2009. The rule recalculates the weights assigned to patient case-mix groups that are used to calculate Medicare rates for IRFs under the

prospective payment system. The rule also re-sets the outlier threshold to maintain estimated outlier payments at 3% of total estimated IRF payments for fiscal year 2009. CMS estimates that the changes contained in the rule will result in a decrease of 0.7% to total Medicare payments to IRFs for federal fiscal year 2009. In May 2004, CMS issued a rule establishing revised Medicare criteria that rehabilitation hospitals are required to meet in order to participate as inpatient rehabilitation facilities, or IRFs, in the Medicare program. As recently amended, the rule requires that 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's designated medical conditions. An IRF that fails to meet the requirements of this 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, 2008 and August 6, 2008, we believe we are in compliance with the CMS requirements to remain an IRF. However, the actual percentage of patients at these hospitals who meet these Medicare requirements may not remain as high as we anticipate, or may decline. A CMS finding of non-compliance, if it occurs, would result in our receiving lower Medicare rates than we currently receive at our hospitals.

#### **Debt Instruments and Covenants**

We have a \$40.0 million revolving bank line of credit facility available for general business purposes, including acquisitions and working capital, which is currently scheduled to expire in May 2009. The amount we are able to

Table of Contents

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; and this facility also places limits on our ability to incur or assume debt or create liens with respect to certain of our assets and has other customary provisions. In certain circumstances and subject to available collateral and lender approvals, the maximum amounts which we may borrow under this credit facility may be increased to \$80.0 million. The termination date may be extended twice, in each case by twelve months upon our payment of extension fees and other conditions, including lender's approvals. As of June 30, 2008 and August 6, 2008, no amounts were outstanding under this credit facility. As of June 30, 2008 and August 6, 2008 we believe we are in compliance with all applicable covenants under this credit facility.

At June 30, 2008, four of our senior living communities were encumbered by five HUD insured mortgages totaling \$15.9 million. 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 maturities of the mortgages. The mortgage premium balance included in mortgage notes payable as of June 30, 2008 was \$749,000.

In October 2006, we issued \$126.5 million principal amount of Convertible Senior Notes due in 2026, or the Notes. Our net proceeds from this issuance 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 the Notes at any time after October 20, 2011 and the Note holders may require that we purchase all or a portion of these Notes on each October 15 of 2013, 2016 and 2021. We issued these Notes pursuant to an indenture which contains various customary covenants. As of June 30, 2008 and August 6, 2008, we believe we are in compliance with all applicable covenants of this indenture.

**Seasonality**

Our business is subject to modest effects of seasonality. During the fourth calendar 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 Person Transactions**

As of June 30, 2008, we leased 163 of the 182 senior living communities and our two rehabilitation hospitals that we operate from Senior Housing for total annual minimum rent of \$153.2 million. In addition to the minimum rent, we paid \$877,000 and \$616,000 in percentage rent to Senior Housing for the three months ended June 30, 2008 and 2007, respectively, and \$1.9 million and \$1.2 million for the six months ended June 30, 2008 and 2007, respectively.

Included in the 163 communities we lease from Senior Housing are 19 senior living communities with 1,743 units which Senior Housing acquired and we began to operate during the first quarter of 2008. Twenty-one of these communities are assisted living communities (one of which offers some skilled nursing services and one of which offers some independent living services) and one is a continuing care retirement community which offers independent living, assisted living and skilled nursing services. Our rent payable to Senior Housing for these 19 communities is \$21.8 million per year, plus future increases calculated as a percentage of the revenue increases for all of these communities after 2009. We added nine of these communities to one of our existing leases with Senior Housing which has a term ending in 2022, with renewal options thereafter. We added the remaining 10 of these communities to another existing lease with Senior Housing which has a term ending in 2024, with renewal options thereafter.

Table of Contents

During the six months ended June 30, 2008, as permitted by our leases with Senior Housing, we sold to Senior Housing, at cost, \$27.3 million of improvements made to properties leased from Senior Housing, and the annual rent payable to Senior Housing increased by approximately \$2.4 million.

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

On July 1, 2008, we agreed to lease ten assisted living communities located in Pennsylvania and New Jersey that were previously operated by NewSeasons Assisted Living Communities, Inc., or NewSeasons, under leases from Senior Housing. In consideration of our lease assumption, NewSeasons paid us \$10.0 million and transferred title to certain personal property located at the communities. We have recorded this lease concession as a liability, on our balance sheet, which will be amortized to rent expense over the remaining lease term. Simultaneously with these negotiations with NewSeasons, we negotiated to purchase three of these communities from Senior Housing and to lease the remaining seven. Effective July 1, 2008, we acquired these three assisted living communities with 259 units located in Pennsylvania and New Jersey for \$21.4 million from Senior Housing. We allocated the purchase price of these communities to land, building and equipment. The purchase price of these properties was equal to the seller's net book value which Senior Housing and Five Star believe reflects the fair market value of these properties. We and Senior Housing are obtaining appraisals of the properties, which appraisals have not yet been completed. If such appraisals indicate that the aggregate fair market value of the properties is materially different from the purchase price, then we and Senior Housing shall make the appropriate adjustments to cash consideration and rent. The remaining seven communities with 614 units will be leased from Senior Housing for annual rent of approximately \$7.6 million per year. We acquired these ten communities because they complement our business strategy of focusing our operations in high quality senior living assets where residents pay for our services with private resources. All of the revenues of these communities come from residents' private resources.

On August 1, 2008, we leased from Senior Housing two assisted living communities with a total of 112 units which Senior Housing purchased from an unrelated party. Our rent payable to Senior Housing for these two communities is \$1.1 million per year, plus future increases calculated as a percentage of the revenue increase at these communities after 2010. We added these communities to our existing lease with Senior Housing which has a term ending in 2024, with renewal options thereafter. In addition, we purchased land adjacent to one of these communities for \$890,000 for future development.

We currently intend to lease from Senior Housing eight additional assisted living communities with a total of 451 units which Senior Housing has agreed to purchase from an unrelated party. We expect our rent to Senior Housing for these eight communities to be approximately \$5.0 million per year, plus future increases calculated as a percentage of the revenue increase at these communities after 2010. Senior Housing's purchase and our lease of these properties are contingent upon further diligence, consent from mortgage lenders and other customary closing conditions. We can provide no assurance that we will lease these properties.

Other historical and continuing related party transactions are described in our Annual Report on Form 10K for the year ended December 31, 2007 and in our definitive proxy statement for our 2008 annual meeting, both of which are filed at the Securities and Exchange Commission, or S.E.C, and available at the S.E.C website [www.sec.gov](http://www.sec.gov).

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

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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, 2007.

At June 30, 2008, we owned certain auction rate securities. As a result of the current conditions in the capital markets, our auction rate securities have experienced multiple failed auctions and, as a result, there is currently no market for our sale of these securities. While we continue to earn and receive interest on these investments at the contractual rates, we believe that the fair values of these auction rate securities no longer approximate par value. Due to the declines in fair value for our auction rate securities through the six months ended June 30, 2008, we have recorded an unrealized loss of \$4.4 million. We determined this unrealized loss by reference to a statement provided by our securities broker which statement was calculated with the assistance of a valuation model. This model considered, among other items, the collateral underlying the investments, the creditworthiness of the counterparty and

Table of Contents

the timing of expected future cash flows including possible refinancing of the securities and a determination of the appropriate discount rate. This third party analysis also included a comparison, when possible, to other observable market data with characteristics similar to our auction rate securities. We reviewed the components of, and the calculations made under, our broker's model. The valuation of our auction rate securities is subject to uncertainties that are difficult to predict. Factors that may impact our valuation include changes to credit ratings of the securities as well as to the underlying assets supporting those securities, rates of default of the underlying assets, underlying collateral value, discount rates and the ongoing strength and quality of credit market conditions and liquidity.

We currently intend to hold these auction rate securities until the market recovers. We do not anticipate having to sell these auction rate securities in order to operate our business. We believe that, based on our current unrestricted cash and cash equivalents balances of \$45.9 million at June 30, 2008, the current lack of liquidity in the credit and capital markets will not have a material impact on our liquidity, our cash flow, or our ability to fund our operations. See Item 2 above, Management's Discussion and Analysis of Financial Conditions and Results of Operations Liquidity and Capital Resources Recent Developments: Investments .

**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, 2008, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.**

**Table of Contents**

**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. THESE FORWARD LOOKING STATEMENTS AND THEIR IMPLICATIONS ARE BASED UPON OUR PRESENT INTENT, BELIEFS OR EXPECTATIONS, BUT FORWARD LOOKING STATEMENTS ARE NOT GUARANTEED TO OCCUR AND MAY NOT OCCUR. OUR ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE CONTAINED IN OR IMPLIED BY OUR FORWARD LOOKING STATEMENTS AS A RESULT OF VARIOUS FACTORS SOME OF WHICH ARE BEYOND OUR CONTROL. FOR EXAMPLE:

- WE EXPECT TO OPERATE OUR REHABILITATION HOSPITALS PROFITABLY. HOWEVER, WE ARE CURRENTLY EXPERIENCING LOSSES FROM THESE OPERATIONS AND WE MAY BE UNABLE TO OPERATE THESE HOSPITALS PROFITABLY. IN ADDITION, THESE HOSPITALS MAY BE SUBJECT TO RETROACTIVE RATE ADJUSTMENTS. SIXTY PERCENT OF PATIENTS AT OUR HOSPITALS ARE REQUIRED TO MEET CERTAIN MEDICARE REQUIREMENTS. WHILE WE BELIEVE THAT WE ARE IN COMPLIANCE WITH THESE MEDICARE REQUIREMENTS, AND ALTHOUGH WE EXPECT TO CONTINUE TO BE IN COMPLIANCE WITH THESE REQUIREMENTS, THE PERCENTAGE OF PATIENTS AT THESE HOSPITALS WHO MEET THESE MEDICARE REQUIREMENTS MAY NOT BE OR MAY NOT REMAIN AS HIGH AS WE CURRENTLY BELIEVE OR ANTICIPATE. FAILURE TO COMPLY AND TO REMAIN IN COMPLIANCE WITH APPLICABLE MEDICARE REQUIREMENTS WOULD RESULT IN THE RECLASSIFICATION OF OUR HOSPITALS BY MEDICARE AUTHORITIES AND OUR RECEIVING LOWER MEDICARE PAYMENTS THAN WE CURRENTLY RECEIVE AT THESE HOSPITALS. THESE EVENTS WOULD MATERIALLY AND ADVERSELY AFFECT OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS.
- ALTHOUGH WE EXPECT TO LEASE FROM SENIOR HOUSING EIGHT ADDITIONAL SENIOR LIVING COMMUNITIES WHICH SENIOR HOUSING HAS AGREED TO PURCHASE FROM THIRD PARTIES, OUR DILIGENCE ON THESE COMMUNITIES HAS NOT YET BEEN COMPLETED AND WE OR SENIOR HOUSING MAY DECIDE NOT TO PROCEED WITH THIS TRANSACTION. ALSO, SENIOR HOUSING'S PURCHASE OF THESE COMMUNITIES AND OUR LEASE ARE CONTINGENT UPON APPROVALS FROM THIRD PARTY MORTGAGE LENDERS AND GOVERNMENT REGULATORY AGENCIES, WHICH APPROVALS MAY NOT BE OBTAINED. AS A RESULT, THE PROPOSED TRANSACTION MAY NOT CLOSE.
- SINCE WE BELIEVE THE DECLINE IN VALUE OF THE AUCTION RATE SECURITIES WE OWN IS TEMPORARY, WE INTEND TO HOLD THESE INVESTMENTS FOR THE FORESEEABLE FUTURE. HOWEVER, THIS DECLINE MAY NOT BE TEMPORARY AND THERE MAY BE FURTHER DECLINES. IN ADDITION, WE EVENTUALLY MAY LIQUIDATE SOME OR ALL OF THESE INVESTMENTS AT A LOSS MAY BE DIFFERENT OR MORE THAN THE LOSS WE HAVE RECORDED FOR THESE SECURITIES.

- OTHER RISKS THAT MAY ADVERSELY IMPACT OUR FORWARD LOOKING STATEMENTS AND THEIR IMPLICATIONS ARE DESCRIBED MORE FULLY UNDER ITEM 1A. RISK FACTORS IN OUR ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2007.

YOU SHOULD NOT PLACE UNDUE RELIANCE UPON OUR 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.

Table of Contents

**Part II. Other Information**

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

On May 15, 2008, we granted 5,250 shares of common stock, par value \$0.01 per share, valued at \$6.79 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, 2008, our shareholders re-elected Ms. Barbara D. Gilmore as an Independent Director (22,640,342 shares voted in favor and 2,522,380 shares withheld) and Mr. Barry M. Portnoy as a Managing Director (22,871,990 shares voted in favor and 2,290,731 shares withheld). The terms of office of Ms. Gilmore and Mr. Portnoy will extend until our annual meeting of shareholders in 2011. Messrs. Arthur G. Koumantzelis and Gerard Martin and Bruce M. Gans continue to serve as directors with terms of office expiring in 2009, 2009 and 2010, respectively.

**Item 6. Exhibits**

- 4.1 Form of Common Shares Certificate. (Filed herewith).
- 10.1 Summary of Director Compensation. (*Incorporated by reference to the Company's Current Report on Form 8-K dated May 20, 2008*).
- 10.2 Amended and Restated Master Lease Agreement (Lease No. 1), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (*Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008*).
- 10.3 Amended and Restated Guaranty Agreement (Lease No. 1), dated as of June 30, 2008, made by the Company, as Guarantor, for the benefit of certain affiliates of Senior Housing Properties Trust under the Amended and Restated Master Lease Agreement (Lease No. 1), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (*Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008*).
- 10.4 Amended and Restated Subtenant Guaranty Agreement (Lease No. 1), dated as of June 30, 2008, made by certain affiliates of the Company, each a Subtenant Guarantor, for the benefit of certain affiliates of Senior Housing Properties Trust under the Amended and Restated Master Lease Agreement (Lease No. 1), dated June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (*Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008*).
- 10.5 Amended and Restated Pledge of Shares of Beneficial Interest Agreement (Tenant Pledge Lease No.1 and Lease No. 3), dated as of June 30, 2008, made by FSQ, Inc. for the benefit of the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 1), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and

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Five Star Quality Care Trust, as Tenant, and for the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 3), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*

Table of Contents

- 10.6 Amended and Restated Security Agreement (Lease No. 1), dated as of June 30, 2008, by and among Five Star Quality Care Trust, as Tenant, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 1), dated June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.7 Amended and Restated Subtenant Security Agreement (Lease No. 1), dated as of June 30, 2008, made by certain affiliates of the Company, as Subtenants, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 1), dated June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.8 Amended and Restated Master Lease Agreement (Lease No. 2), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and certain affiliates of the Company, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.9 Amended and Restated Guaranty Agreement (Lease No. 2), dated as of June 30, 2008, made by the Company, as Guarantor, for the benefit of certain affiliates of Senior Housing Properties Trust under the Amended and Restated Master Lease Agreement (Lease No. 2), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and certain affiliates of the Company, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.10 Subtenant Guaranty Agreement (Lease No. 2), dated as of June 30, 2008, made by certain affiliates of the Company, each a Subtenant Guarantor, for the benefit of the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 2), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and certain affiliates of the Company, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.11 Amended and Restated Pledge of Shares of Beneficial Interest Agreement (Lease No. 2), dated as of June 30, 2008, made by FSQ, Inc. and FS Tenant Holding Company Trust for the benefit of the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 2), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and certain affiliates of the Company, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.12 Amended and Restated Security Agreement (Lease No. 2), dated as of June 30, 2008, made by certain affiliates of the Company, as Tenant, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 2), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and certain affiliates of the Company, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.13 Amended and Restated Subtenant Security Agreement (Lease No. 2), dated as of June 30, 2008, made by certain affiliates of the Company, as Subtenants, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 2), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and certain affiliates of the Company, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.14 Amended and Restated Master Lease Agreement (Lease No. 3), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*

Table of Contents

- 10.15 Amended and Restated Guaranty Agreement (Lease No. 3), dated as of June 30, 2008, made by the Company, as Guarantor, for the benefit of certain affiliates of Senior Housing Properties Trust under the Amended and Restated Master Lease Agreement (Lease No. 3), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.16 Amended and Restated Subtenant Guaranty Agreement (Lease No. 3), dated as of June 30, 2008, made by certain affiliates of the Company, each a Subtenant Guarantor, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 3), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.17 Amended and Restated Security Agreement (Lease No. 3), dated as of June 30, 2008, by and between Five Star Quality Care Trust and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 3), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.18 Amended and Restated Subtenant Security Agreement (Lease No. 3), dated as of June 30, 2008, by and among certain affiliates of the Company, as Subtenants, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 3), dated as of June 30, 2008, by and among certain affiliates of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. *(Incorporated by reference to the Company's Current Report on Form 8-K dated July 7, 2008).*
- 10.19 First Amendment to Amended and Restated Master Lease Agreement (Lease No. 3) dated as of August 1, 2008, by and among certain subsidiaries of the Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. *(Filed herewith).*
- 10.20 Amendment No. 3 to Shared Services Agreement, dated as of May 12, 2002, by and between the Company and Reit Management & Research LLC. *(Filed herewith).*
- 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.)*

Table of Contents

**SIGNATURES**

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

FIVE STAR QUALITY CARE, INC.

**/s/ Bruce J. Mackey Jr.**

Bruce J. Mackey Jr.

President and Chief Executive Officer

Dated: August 7, 2008

**/s/ Francis R. Murphy III**

Francis R. Murphy III

Treasurer and Chief Financial Officer

(Principal Financial Officer)

Dated: August 7, 2008