

FIVE STAR QUALITY CARE INC

Form 10-Q

October 28, 2011

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**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 September 30, 2011

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 of Incorporation)

**04-3516029**  
(IRS Employer Identification No.)

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**400 Centre Street, Newton, Massachusetts 02458**

(Address of Principal Executive Offices) (Zip Code)

(Registrant's Telephone Number, Including Area Code): **617-796-8387**

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

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

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Smaller reporting company ☐

(Do not check if a 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, \$.01 par value, outstanding as of October 27, 2011: 47,557,362.

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

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)

	September 30, 2011	December 31, 2010
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 41,946	\$ 20,770
Accounts receivable, net of allowance of \$5,761 and \$5,224 at September 30, 2011 and December 31, 2010, respectively	59,972	64,806
Investments in available for sale securities, of which \$6,012 and \$1,022 are restricted as of September 30, 2011 and December 31, 2010, respectively	17,283	13,854
Restricted cash	5,171	6,594
Prepaid expenses and other current assets	21,001	17,084
Assets of discontinued operations	8,812	12,857
Total current assets	154,185	135,965
Property and equipment, net	353,639	201,223
Equity investment in Affiliates Insurance Company	5,245	5,076
Restricted cash	4,306	14,535
Restricted investments in available for sale securities	12,987	3,259
Goodwill and other intangible assets	15,383	15,722
Other long term assets	3,334	4,014
	\$ 549,079	\$ 379,794
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 21,512	\$ 20,356
Accrued expenses	27,433	21,449
Accrued compensation and benefits	44,091	37,783
Due to related persons	16,306	17,841
Mortgage notes payable	1,012	
Bridge loan from Senior Housing Properties Trust	48,000	
Accrued real estate taxes	14,833	9,258
Security deposit liability	10,677	10,783
Other current liabilities	15,477	11,563
Liabilities of discontinued operations	8,854	8,878
Total current liabilities	208,195	137,911

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Long term liabilities:

Mortgage notes payable	38,977	
Convertible senior notes	37,282	37,905
Continuing care contracts	2,068	2,247
Accrued self insurance obligations	27,074	27,928
Other long term liabilities	7,715	9,036
Total long term liabilities	113,116	77,116

Commitments and contingencies

Shareholders' equity:

Common stock, par value \$.01; 47,557,362 and 36,019,864 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively	476	360
Additional paid in capital	352,501	297,715
Accumulated deficit	(129,983)	(138,783)
Cumulative other comprehensive income	4,774	5,475
Total shareholders' equity	227,768	164,767
	\$ 549,079	\$ 379,794

See accompanying notes.

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## FIVE STAR QUALITY CARE, INC.

## CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
<b>Revenues:</b>				
Senior living revenue	\$ 275,605	\$ 259,767	\$ 803,647	\$ 770,729
Rehabilitation hospital revenue	26,273	24,756	78,235	73,917
Institutional pharmacy revenue	18,914	20,280	57,824	59,770
Management fee revenue	359		383	
Reimbursed costs incurred on behalf of managed communities	8,324		8,887	
Total revenues	329,475	304,803	948,976	904,416
<b>Operating expenses:</b>				
Senior living wages and benefits	136,135	129,071	398,975	382,095
Other senior living operating expenses	68,669	62,487	193,123	182,791
Costs incurred on behalf of managed communities	8,324		8,887	
Rehabilitation hospital expenses	23,300	22,579	70,798	68,196
Institutional pharmacy expenses	18,472	19,717	56,003	58,223
Rent expense	50,140	47,176	145,480	140,809
General and administrative	14,418	13,751	42,242	40,975
Depreciation and amortization	5,858	4,047	14,779	11,872
Total operating expenses	325,316	298,828	930,287	884,961
Operating income	4,159	5,975	18,689	19,455
Interest, dividend and other income	368	321	1,017	1,621
Interest and other expense	(1,034)	(578)	(2,405)	(2,050)
Acquisition related costs	(226)		(1,530)	
Gain on investments in trading securities				4,856
Loss on UBS put right related to auction rate securities				(4,714)
Equity in income (losses) of Affiliates Insurance Company	28	35	111	(17)
Gain on early extinguishment of debt		66	1	484
Gain on sale of available for sale securities	529		656	
Income from continuing operations before income taxes	3,824	5,819	16,539	19,635
(Provision) benefit for income taxes	(186)	123	(1,006)	(930)
Income from continuing operations	3,638	5,942	15,533	18,705
Loss from discontinued operations	(4,166)	(784)	(6,733)	(1,309)
Net income (loss)	\$ (528)	\$ 5,158	\$ 8,800	\$ 17,396
Weighted average shares outstanding - basic	47,557	35,724	40,294	35,698

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Weighted average shares outstanding - diluted	47,557	38,937	43,169	39,302
Basic income (loss) per share from:				
Continuing operations	\$ 0.08	\$ 0.17	\$ 0.39	\$ 0.52
Discontinued operations	(0.09)	(0.02)	(0.17)	(0.03)
Net income (loss) per share - basic	\$ (0.01)	\$ 0.15	\$ 0.22	\$ 0.49
Diluted income (loss) per share from:				
Continuing operations	\$ 0.08	\$ 0.16	\$ 0.38	\$ 0.51
Discontinued operations	(0.09)	(0.02)	(0.16)	(0.03)
Net income (loss) per share - diluted	\$ (0.01)	\$ 0.14	\$ 0.22	\$ 0.48

See accompanying notes.

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## FIVE STAR QUALITY CARE, INC.

## CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

(unaudited)

	Nine months ended September 30,	
	2011	2010
Cash flows from operating activities:		
Net income	\$ 8,800	\$ 17,396
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	14,779	11,872
Gain on early extinguishment of debt	(1)	(484)
Loss from discontinued operations	6,733	1,309
Gain on investments in trading securities		(4,856)
Loss on UBS put right related to auction rate securities		4,714
Gain on sale of available for sale securities	(656)	
Equity in (income) losses of Affiliates Insurance Company	(111)	17
Stock-based compensation	949	514
Provision for losses on receivables	5,536	(6)
Changes in assets and liabilities:		
Accounts receivable	(662)	(1,068)
Prepaid expenses and other assets	(2,760)	1,243
Investment securities		74,425
Accounts payable and accrued expenses	6,975	(11,248)
Accrued compensation and benefits	6,308	10,205
Due to related persons	(1,535)	105
Other current and long term liabilities	5,400	5,838
Net cash provided by operating activities	49,755	109,976
Net cash used in discontinued operations	(2,703)	(597)
Cash flows from investing activities:		
Acquisition of property and equipment	(45,005)	(37,127)
Acquisition of senior living communities, net of working capital assumed	(107,165)	(13,232)
Payments from restricted cash and investment accounts, net	(3,117)	(32)
Investment in Affiliates Insurance Company		(75)
Proceeds from disposition of property and equipment held for sale	25,877	23,768
Proceeds from sale of available for sale securities	2,504	514
Net cash used in investing activities	(126,906)	(26,184)
Cash flows from financing activities:		
Net proceeds from the issuance of common stock	53,953	
Proceeds from borrowings on credit facilities	12,000	10,649
Repayments of borrowings on credit facilities	(12,000)	(49,790)
Proceeds from borrowing on the Bridge loan from Senior Housing Properties Trust	80,000	
Repayments of borrowing on the Bridge loan from Senior Housing Properties Trust	(32,000)	
Purchase and retirement of convertible senior notes	(623)	(7,778)
Repayments of mortgage notes payable	(300)	(4,584)
Net cash provided by (used in) financing activities	101,030	(51,503)



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Change in cash and cash equivalents during the period		21,176		31,692
Cash and cash equivalents at beginning of period		20,770		5,017
Cash and cash equivalents at end of period	\$	41,946	\$	36,709
Supplemental cash flow information:				
Cash paid for interest	\$	1,454	\$	1,527
Cash paid for income taxes	\$	1,257	\$	987
Non-cash activities:				
Issuance of common stock	\$	298	\$	174
Real estate acquisition	\$	(40,289)	\$	
Assumption of mortgage notes payable	\$	40,289	\$	

See accompanying notes.

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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, which we refer to as the Company, we, us or our, are unaudited. Certain information and disclosures required by U.S. generally accepted accounting principles, or GAAP, 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, 2010, or our Annual Report. 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. For discussion of our liquidity and capital resources see Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q.

We operate and manage senior living communities, including independent living communities, assisted living communities and skilled nursing facilities, or SNFs. As of September 30, 2011, we operated and managed 236 senior living communities containing 25,181 living units, including 198 primarily independent and assisted living communities with 21,758 living units and 38 SNFs with 3,423 living units. We own and operate 31 communities (2,954 living units), we lease and operate 191 communities (20,811 living units) and we manage 14 communities (1,416 living units). Our 236 senior living communities included 7,263 independent living apartments, 12,535 assisted living suites and 5,383 skilled nursing units. Two SNFs owned and operated by us containing 271 living units and one assisted living community leased from Senior Housing Properties Trust, or SNH, and operated by us containing 103 living units that we have classified as discontinued operations are excluded from all the preceding data in this paragraph.

We also lease and operate two rehabilitation hospitals with 321 beds that provide inpatient rehabilitation services to patients at the two hospitals and at three satellite locations. In addition, we lease and operate 13 outpatient clinics affiliated with these rehabilitation hospitals. We also own and operate five institutional pharmacies.

**Note 2. Recent Accounting Pronouncements**

In July 2011, the Financial Accounting Standards Board issued an accounting standards update requiring healthcare entities to change the presentation of their statements of operations by reclassifying any provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue. The update also requires enhanced disclosure about policies for recognizing revenue and assessing bad debts. The update is effective for interim and annual reporting periods beginning after December 15, 2011. The adoption of this update is not expected to cause any material changes to our condensed consolidated financial statements.

**Note 3. Property and Equipment**

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

	September 30, 2011	December 31, 2010
Land	\$ 21,849	\$ 14,254
Buildings and improvements	284,609	155,552
Furniture, fixtures and equipment	100,212	71,225
	406,670	241,031
Accumulated depreciation	(53,031)	(39,808)
	\$ 353,639	\$ 201,223

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As of September 30, 2011 and December 31, 2010, we had assets of \$4,722 and \$7,752, respectively, included in our property and equipment that we intend to sell to SNH for increased rent pursuant to the terms of our leases with SNH; however, we are not obligated to make these sales and SNH is not obligated to purchase the property and equipment.

**Note 4. Other Comprehensive Income**

Other comprehensive income for the three and nine months ended September 30, 2011 and 2010 is summarized below:

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Net income (loss)	\$ (528)	\$ 5,158	\$ 8,800	\$ 17,396
Net change in unrealized appreciation of investments	(1,435)	1,593	(759)	2,114
Our share of Affiliates Insurance Company's other comprehensive income	15		58	
Comprehensive income (loss)	\$ (1,948)	\$ 6,751	\$ 8,099	\$ 19,510

Cumulative other comprehensive income represents the net unrealized appreciation of investments and our share of Affiliates Insurance Company's, or AIC's, (see Note 14), other comprehensive income.

**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 for our own account, manage for the account of SNH and manage for the account of an unaffiliated third party, independent living communities, assisted living communities and SNFs that are subject to centralized oversight and provide housing and services generally to elderly residents. Our rehabilitation hospital segment provides inpatient rehabilitation services to patients at two hospital locations and at three satellite locations and outpatient rehabilitation services at 13 affiliated outpatient clinics. We do not consider our institutional pharmacy operations to be a material, separately reportable segment of our business. Consequently, we report our institutional pharmacy revenues and expenses as separate items within our corporate and other activities. All of our operations and assets are located in the United States, except for the operations of our captive insurance company, which participates in our workers' compensation, liability and automobile insurance programs and which operates in the Cayman Islands.

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We use segment operating profit as a means to evaluate our performance and for our business decision making purposes. Segment operating profit excludes interest, dividend and other income, interest and other expense, and corporate expenses.

Our revenues by segments and a reconciliation of segment operating profit (loss) to income from continuing operations for the three and nine months ended September 30, 2011 and 2010 are as follows:

	Senior Living Communities	Rehabilitation Hospitals	Corporate and Other(1)	Total
<b>Three months ended September 30, 2011</b>				
Revenues	\$ 275,605	\$ 26,273	\$ 18,914	\$ 320,792
Management fee revenue	359			359
Reimbursed costs incurred on behalf of managed communities	8,324			8,324
Total segment revenues	284,288	26,273	18,914	329,475
Segment expenses:				
Operating expenses	204,804	23,300	18,472	246,576
Costs incurred on behalf of managed communities	8,324			8,324
Rent expense	47,543	2,597		50,140
Depreciation and amortization	4,923	46	889	5,858
Total segment expenses	265,594	25,943	19,361	310,898
Segment operating profit	18,694	330	(447)	18,577
General and administrative expenses(2)			(14,418)	(14,418)
Operating income (loss)	18,694	330	(14,865)	4,159
Interest, dividend and other income	19		349	368
Interest and other expense	(294)		(740)	(1,034)
Acquisition related costs			(226)	(226)
Equity in income of Affiliates Insurance Company			28	28
Gain on sale of available for sale securities			529	529
Provision for income taxes			(186)	(186)
Income (loss) from continuing operations	\$ 18,419	\$ 330	\$ (15,111)	\$ 3,638
Total Assets as of September 30, 2011	\$ 454,938	\$ 14,104	\$ 80,037	\$ 549,079

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## FIVE STAR QUALITY CARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

	Senior Living Communities	Rehabilitation Hospitals	Corporate and Other(1)	Total
<b>Three months ended September 30, 2010</b>				
Revenues	\$ 259,767	\$ 24,756	\$ 20,280	\$ 304,803
Segment expenses:				
Operating expenses	191,558	22,579	19,717	233,854
Rent expense	44,635	2,541		47,176
Depreciation and amortization	3,156	35	856	4,047
Total segment expenses	239,349	25,155	20,573	285,077
Segment operating profit (loss)	20,418	(399)	(293)	19,726
General and administrative expenses(2)			(13,751)	(13,751)
Operating profit (loss)	20,418	(399)	(14,044)	5,975
Interest, dividend and other income	21		300	321
Interest and other expense	(29)		(549)	(578)
Equity in income of Affiliates Insurance Company			35	35
Gain on early extinguishment of debt			66	66
Benefit for income taxes			123	123
Income (loss) from continuing operations	\$ 20,410	\$ (399)	\$ (14,069)	\$ 5,942

	Senior Living Communities	Rehabilitation Hospitals	Corporate and Other(1)	Total
<b>Nine months ended September 30, 2011</b>				
Revenues	\$ 803,647	\$ 78,235	\$ 57,824	\$ 939,706
Management fee revenue	383			383
Reimbursed costs incurred on behalf of managed communities	8,887			8,887
Total segment revenues	812,917	78,235	57,824	948,976
Segment expenses:				
Operating expenses	592,098	70,798	56,003	718,899
Costs incurred on behalf of managed communities	8,887			8,887
Rent expense	137,722	7,758		145,480
Depreciation and amortization	12,159	132	2,488	14,779
Total segment expenses	750,866	78,688	58,491	888,045
Segment operating profit (loss)	62,051	(453)	(667)	60,931
General and administrative expenses(2)			(42,242)	(42,242)
Operating income (loss)	62,051	(453)	(42,909)	18,689
Interest, dividend and other income	100		917	1,017
Interest and other expense	(509)		(1,896)	(2,405)
Acquisition related costs			(1,530)	(1,530)

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Equity in income of Affiliates Insurance Company				111		111
Gain on early extinguishment of debt				1		1
Gain on sale of available for sale securities				656		656
Provision for income taxes				(1,006)		(1,006)
Income (loss) from continuing operations	\$	61,642	\$	(453)	\$	15,533

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## FIVE STAR QUALITY CARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

	Senior Living Communities	Rehabilitation Hospitals	Corporate and Other(1)	Total
<b>Nine months ended September 30, 2010</b>				
Revenues	\$ 770,729	\$ 73,917	\$ 59,770	\$ 904,416
Segment expenses:				
Operating expenses	564,886	68,196	58,223	691,305
Rent expense	133,373	7,436		140,809
Depreciation and amortization	9,028	97	2,747	11,872
Total segment expenses	707,287	75,729	60,970	843,986
Segment operating profit (loss)	63,442	(1,812)	(1,200)	60,430
General and administrative expenses(2)			(40,975)	(40,975)
Operating profit (loss)	63,442	(1,812)	(42,175)	19,455
Interest, dividend and other income	174		1,447	1,621
Interest and other expense	(199)		(1,851)	(2,050)
Gain on investments in trading securities			4,856	4,856
Loss on UBS put right related to auction rate securities			(4,714)	(4,714)
Equity in losses of Affiliates Insurance Company			(17)	(17)
Gain on early extinguishment of debt			484	484
Provision for income taxes			(930)	(930)
Income (loss) from continuing operations	\$ 63,417	\$ (1,812)	\$ (42,900)	\$ 18,705

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

(2) General and administrative expenses are not attributable to a reportable specific segment and include items such as corporate payroll and benefits and expenses of our home office activities.



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FIVE STAR QUALITY CARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except share data)

(unaudited)

**Note 6. Goodwill and Other Intangible Assets**

The changes in the carrying amount of goodwill and other intangible assets from January 1, 2011 to September 30, 2011 are as follows:

		Senior Living Communities(1)		Corporate and Other(2)		Total
Balance as of January 1, 2011	\$	11,695	\$	4,027	\$	15,722
Amortization of intangibles		(68)		(271)		(339)
Balance as of September 30, 2011	\$	11,627	\$	3,756	\$	15,383

(1) Goodwill and other intangible assets in our Senior Living Communities segment relate to management agreements and trademarks we acquired in connection with one of the leases we initiated with SNH in 2009 and goodwill we recorded in connection with our senior living community acquisitions in previous years.

(2) Intangible assets in our Corporate and Other segment relate to customer agreements we acquired in connection with our pharmacy acquisitions.

**Note 7. Income Taxes**

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 because we currently do not believe that it is more likely than not that we will realize such benefit. In measuring our deferred tax assets, we considered all available evidence, both positive and negative, to determine whether, based on the weight of that evidence, a valuation allowance is needed for all or a portion of the deferred tax assets. Judgment is required in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence is commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is unnecessary. In order to realize these deferred tax assets, we need future taxable income. We believe that our history of losses coupled with the uncertainties surrounding the current changes to the healthcare industry and our recently declining occupancy rates is sufficient evidence for these purposes that realization of the necessary future taxable income is not more likely than not. As a result, we believe a full valuation allowance against our deferred tax assets is required. When we believe that we will more likely than not realize the benefit of our deferred tax assets, we will record deferred tax assets as an income tax benefit in our consolidated statement of

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operations, which will affect our results of operations. As of December 31, 2010, our federal net operating loss carry forward, which begins to expire in 2025 if unused, was approximately \$107,507, and our tax credit carry forward, which begins to expire in 2022 if unused, was approximately \$5,315. Our net operating loss carry forwards and tax credit carry forwards are subject to audit and adjustments by the Internal Revenue Service.

For the nine months ended September 30, 2011, we recognized tax expenses of \$1,006, which includes tax expense of \$892