

FIVE STAR QUALITY CARE INC
Form S-1/A
November 29, 2004

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As filed with the Securities and Exchange Commission on November 29, 2004

Registration No. 333-119955

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

PRE-EFFECTIVE AMENDMENT NO. 2
TO

FORM S-1

REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

FIVE STAR QUALITY CARE, INC.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

8051
(Primary Standard Industrial
Classification Code Number)

04-3516029
(I.R.S. Employer
Identification Number)

400 Centre Street
Newton, Massachusetts 02458
(617) 796-8387

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Evrett W. Benton, President
Five Star Quality Care, Inc.
400 Centre Street
Newton, Massachusetts 02458
(617) 796-8387

(Name, address, including zip code, and telephone number, including area code, of agent for service)

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Approximate date of commencement of proposed sale to the public: As soon as practicable after this Registration Statement becomes effective.

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If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box.

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission acting pursuant to said Section 8(a), may determine.

Information contained herein is subject to completion or amendment. A registration statement relating to these securities has been filed with the Securities and Exchange Commission. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. This prospectus shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any state in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of such state.

PRELIMINARY PROSPECTUS

Subject to Completion

November 29, 2004

3,000,000 Shares

Common Stock

We are selling all of the 3,000,000 shares of common stock offered in this prospectus.

Our common shares are traded on the American Stock Exchange under the symbol "FVE". On November 26, 2004, the last reported sale price of our common shares on the American Stock Exchange was \$7.04 per share.

Investing in our common shares involves a high degree of risk. You should read carefully this entire prospectus, including the section entitled "Risk factors" that begins on page 7 of this prospectus, which describes the material risks.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public offering price	\$	\$
Underwriting discounts and commissions	\$	\$
Proceeds, before expenses, to us	\$	\$

The underwriters may also purchase from us up to an additional 450,000 shares, at the public offering price less the underwriting discounts and commissions payable by us to cover over-allotments, if any, within 30 days from the date of this prospectus. If the underwriters exercise the option in full, the total underwriting discounts and commissions payable by us will be \$, and the total proceeds, before expenses, to us will be \$.

The underwriters are offering our shares as described in "Underwriting". Delivery of the shares will be made on or about , 2004.

Sole Book-Running Manager

UBS Investment Bank

Ferris, Baker Watts
Incorporated

RBC Capital Markets

Stifel, Nicolaus & Company
Incorporated

You should rely only on the information contained in this prospectus. We have not, and the underwriters have not, authorized anyone to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information contained in this prospectus is accurate as of the date on the cover. Changes may occur after that date and we may not update this information except as required by applicable law.

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References in this prospectus to "we", "us", "our", the "Company" or "Five Star" mean Five Star Quality Care, Inc. and its subsidiaries.

Prospectus summary

The following summary highlights information contained in other parts of this prospectus. Because it is a summary, it does not contain all of the information you should consider before investing in our common shares. You should read the entire prospectus carefully, including "Risk factors" and the financial statements and related notes, before making an investment decision.

OUR COMPANY

We operate senior living communities, including independent and assisted living communities and nursing homes. We operate 160 senior living communities containing 17,560 living units located in 27 states. Since we became a public company, we have selectively divested nursing homes and acquired independent and assisted living communities where residents' private resources account for a large majority of revenues. The following charts illustrate the changes in our business since we became a public company on December 31, 2001 to September 30, 2004, adjusted for our recent acquisition of LTA Holdings, Inc., or LTA, described below in "Recent Developments":

At December 31, 2001

54 nursing homes
(5,074 living units)
2 assisted living
communities
(137 living units)

\$229.6 million revenues⁽¹⁾

At September 30, 2004

52 nursing homes
(4,847 living units)
34 independent living
communities
(7,790 living units)
74 assisted living
communities⁽²⁾
(4,923 living units)

\$694.9 million revenues⁽³⁾

-
- (1) Revenues at these communities for the year ended December 31, 2001.
- (2) Includes 12 assisted living communities with 957 living units that are operated by Five Star for third party owners under management agreements.
- (3) Revenues and management fees relating to these communities for the nine months ended September 30, 2004, annualized.

RECENT DEVELOPMENTS

Since January 1, 2004, we have experienced the following developments:

> *Improved profits.* We earned \$0.06/share, \$0.11/share and \$0.10/share in the three month periods ended March 31, June 30 and September 30, 2004, respectively. Since we became a public company, and until 2004, we were not consistently profitable. We believe that our recently

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improved financial performance is the result of changes in our business which we have implemented, including both improvements in operations and acquisitions; but our future profitability is not guaranteed. See "Risk factors" beginning on page 7.

> *LTA acquisition.* In November 2004, we acquired LTA for approximately \$211 million, excluding closing costs. LTA owned and operated 47 senior living communities with 2,636 living units, which primarily offer assisted living services. We also assumed operations of an additional 12 senior living communities with 957 living units that are managed by us for third party owners. LTA's revenues for the nine months ended September 30, 2004 annualized were \$80.9 million, and 100% of these revenues were paid by residents from their private resources. We financed the LTA acquisition with cash on hand, assumption of certain mortgage debt and leasehold obligations and a sale leaseback of 31 LTA communities for \$148.2 million. Our business plan for the LTA communities is to increase revenues by increasing occupancies at the communities. We also expect to realize cost savings by combining the LTA operations with our existing operations. By doing so, we expect this acquisition to be accretive to our earnings in the second half of 2005. Nevertheless, we can provide no assurance that the expected financial benefits from the LTA acquisition will be achieved.

> *Pharmacy expansion.* In September 2004, we purchased an institutional pharmacy business located in Nebraska for \$3 million. This business currently provides pharmacy services to 24 nursing homes. We used cash on hand to complete this acquisition. Our business plan is to expand this business by offering pharmacy services at some or all of the 14 communities which we operate in Nebraska. We expect that operations from these pharmacy businesses will generate approximately \$20 million of our revenues in 2005.

OUR GROWTH STRATEGY

We believe that the aging of the U.S. population will increase demand for existing independent living properties, assisted living communities and nursing homes. Our principal growth strategy is to profit from this demand by operating and acquiring properties that provide high quality services to residents who pay with private resources.

We continue to work toward improving the profitability of our existing operations by increasing revenues and improving margins. We attempt to increase revenues by increasing rates and occupancies. We attempt to improve margins by limiting increases in expenses and improving operating efficiencies.

In addition to managing our existing operations, we intend to continue to grow our business through acquisitions of independent and assisted living communities where residents' private resources account for a large majority of revenues. Since we became a public company in late 2001, we added 108 primarily independent and assisted living communities to our business which generate approximately 90% of their revenue from residents' private resources, rather than from Medicare or Medicaid. We prefer to purchase communities which have achieved or are close to stabilized operations. For example, the LTA communities which we acquired (excluding the 12 managed communities) have current occupancy of approximately 87%. We also try to make acquisitions where we can realize cost savings by combining operations with our existing operations.

Starting in the mid 1990s, a large number of independent and assisted living communities were developed with financing from private equity and real estate opportunity funds. We believe that many of these communities are now at or approaching stabilized operations and many of these financial investors are now anxious to sell. For example: in 2002, we acquired 15 independent and assisted living communities which were assembled and developed by Constellation Health Services, Inc., a division of Constellation Energy Group, Inc., f/k/a Baltimore Gas and Electric Company; and the controlling shareholder of LTA prior to our acquisition of LTA was a private equity fund. We expect to pursue similar acquisitions for the next several years.

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We also intend to expand our institutional pharmacy business. We acquired our first pharmacy in Wisconsin in 2003. As described above in "Recent Developments", during 2004 we acquired a second pharmacy located in Nebraska. Whenever we buy an institutional pharmacy, we seek to grow its business by providing pharmacy services at our senior living communities within the same service area. We estimate that the average resident of one of our independent living or assisted living communities spends approximately \$2,800 per year on pharmacy services and the average resident of one of our nursing homes spends approximately \$3,200 per year. We are currently interested in acquiring pharmacies in other areas where we own senior living communities. We can provide no assurances that we will be able to continue these pharmacy expansion activities, but we intend to do so.

Although expansion of our nursing home business is not our primary growth strategy, we have in the past considered acquiring more nursing homes. Most nursing homes are financially dependent upon the Medicare and Medicaid programs. Accordingly, we believe the potential for profitable operations of nursing homes is limited by government funding. In these circumstances, we are only interested in expanding our nursing home operations at prices which we believe take account of the risks inherent in government rate setting. In the past few years, we have been unable to buy nursing homes at prices we consider appropriate, but we may continue to investigate such opportunities in the future.

HISTORICAL AND CURRENT RELATIONS WITH SENIOR HOUSING PROPERTIES TRUST AND SUNRISE SENIOR LIVING, INC.

We were formed in 2000 as a subsidiary of Senior Housing Properties Trust, or Senior Housing, a publicly owned real estate investment trust, or REIT. We were created to operate nursing homes owned by Senior Housing which were repossessed from Senior Housing's former tenants. During 2000 and 2001, we closed certain unprofitable nursing homes and we stabilized operations at others. On December 31, 2001, we began to lease the nursing homes from Senior Housing which we formerly operated for it, and substantially all of our shares were distributed to Senior Housing shareholders. Although we are now a separate public company, we maintain close relations with Senior Housing. Two of our directors are also trustees of Senior Housing. We and Senior Housing sometimes consider joint acquisition opportunities. Of the 160 senior living communities which we currently operate (including 12 communities that we manage for the benefit of third parties), 133 are leased from, or mortgaged to, Senior Housing. Senior Housing also provided the majority of our funding for the LTA acquisition. We believe our close relationship with Senior Housing benefits us because it affords us an ability to consider larger investments than our independent resources might permit.

At the time of our spin off from Senior Housing, we agreed to lease 31 senior living communities with 7,418 living units which Senior Housing had agreed to purchase. These communities were operated under long term contracts by a subsidiary of Marriott International, Inc., or Marriott. In 2003, Marriott sold its senior living subsidiary to a subsidiary of Sunrise Senior Living, Inc., or Sunrise. At about that time, Marriott and we had litigation concerning whether we could terminate Sunrise's management as a result of this sale, among other matters. This litigation was settled in early 2004, and Sunrise now operates these communities for our account. By mutual agreement between us and Sunrise, one of these communities was closed in May 2004. Our annualized revenues from the remaining 30 Sunrise managed communities are approximately \$300 million, and these revenues, as well as rent to Senior Housing and management fees to Sunrise related to these communities, are recorded in our income statement.

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The offering

Common stock being offered	3,000,000 shares
Common stock to be outstanding after the offering	11,596,634 shares
Use of proceeds	The net proceeds to us from this offering will be \$19.7 million, assuming a public offering price of \$7.04 per share. We intend to use a portion of the net proceeds to repay a \$16.8 million loan provided to us by Senior Housing in connection with our recent acquisition of LTA. We intend to use the remainder of the net proceeds for general business purposes, including possible acquisitions which have not yet been identified.
American Stock Exchange symbol	FVE
Risk factors	An investment in our common shares involves significant risks. Before making an investment in our common shares, you should carefully review the information under the caption

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"Risk factors".

The number of shares to be outstanding after the offering is based on 8,596,634 shares outstanding on November 26, 2004. If the underwriters exercise their over-allotment option in full, we will issue an additional 450,000 shares. Unless otherwise stated, all information contained in this prospectus assumes no exercise of the over-allotment option we granted to the underwriters.

We are a Maryland corporation. Our principal place of business is 400 Centre Street, Newton, Massachusetts 02458, and our telephone number is (617) 796-8387.

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Summary historical and pro forma financial data

The following summary financial data has been derived from the financial statements included elsewhere in this prospectus, and shows, for the period or date presented, our summary historical and pro forma income statement and balance sheet data, giving effect to this offering, assuming a public offering price of \$7.04 per share, and our acquisition of LTA, including the sale and leaseback and mortgage financing provided by Senior Housing. As discussed under "Risk factors" and "Management's discussion and analysis of financial condition and results of operations", our historical financial information is not necessarily reflective of our current operations. Accordingly, you should not place undue reliance on our historical financial information. In addition, pro forma financial information may not be reflective of what our financial results or financial position would have been had the LTA acquisition, including the financing transactions with Senior Housing, been completed as of the dates indicated in our pro forma financial statements.

For the nine months ended September 30, 2004

	Historical	After giving pro forma effect to the LTA acquisition	As adjusted for this offering after giving pro forma effect to the LTA acquisition
(dollars in thousands, except per share data)			
Statement of Operations Data			
Revenues	\$ 460,553	\$ 521,197	\$ 521,197
Community expenses	364,303	406,327	406,327
Management fee to Sunrise	14,164	14,164	14,164
Rent expense	61,170	72,059	72,059
General and administrative	14,789	19,785	19,785
Depreciation and amortization	2,786	3,844	3,844
Interest expense	336	3,210	2,073
Total expenses	457,548	519,389	518,252
Income from continuing operations before gain on sale of assets, equity in income of affiliates and income taxes	3,005	1,808	2,945
Gain on sale of assets		6	6
Minority interest in income of consolidated entity		18	18
Equity in income of affiliates		98	98
		122	122
Income from continuing operations before income taxes	3,005	1,930	3,067

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For the nine months ended September 30, 2004

	112	112	112
Provision for income taxes			
Income from continuing operations	\$ 2,893	\$ 1,818	\$ 2,955
Income per share from continuing operations	\$ 0.34	\$ 0.21	\$ 0.26
Weighted average shares outstanding	8,523	8,523	11,523
Other data:			
Occupancy	89%	89%	89%
Total units	13,967	17,560	17,560
Private pay % of revenue	57%	63%	63%
Income from continuing operations before income taxes	\$ 3,005	\$ 1,930	\$ 3,067
add depreciation and amortization	2,786	3,844	3,844
add interest expense	336	3,210	2,073
EBITDA ⁽¹⁾	\$ 6,127	\$ 8,984	\$ 8,984

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Balance Sheet Data

Cash and cash equivalents	\$ 18,612	\$ 19,089	\$ 21,776
Total current assets	64,039	68,477	71,164
Total assets	147,217	202,363	205,050
Total current liabilities	50,243	78,534	61,685
Long term liabilities	30,104	56,959	56,959
Total shareholders' equity	\$ 66,870	\$ 66,870	\$ 86,406

(1)

We consider earnings before interest, taxes, depreciation and amortization, or EBITDA, to be an indicative measure of our operating performance. EBITDA is also useful in measuring our ability to service debt, fund capital expenditures and expand our business. Furthermore, we believe that EBITDA is a meaningful disclosure that will help shareholders and the investment community to understand better our financial performance, including comparing our performance to other companies. However, EBITDA as presented may not be comparable to amounts calculated by other companies. This information should not be considered as an alternative to net income, income from continuing operations, operating profit, cash flow from operations, or any other operating or liquidity performance measure prescribed by accounting principles generally accepted in the United States.

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Risk factors

Investing in shares of our common stock, or common shares, entails significant risk. The following is a description of the material risks which we can identify. There may be additional risks and uncertainties not presently known to us or that we currently deem immaterial that may also impair our business operations. You should carefully consider the risks and uncertainties described below and elsewhere in this prospectus before making an investment decision.

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A small percentage decline in our revenues or increase in our expenses could have a material negative impact upon our operating results.

For the nine months ended September 30, 2004, our revenues were \$461 million and our expenses were \$458 million. A small percentage decline in our revenues or increase in our expenses could have a material negative impact upon our income.

Our growth strategy may not succeed.

Our business plan includes acquiring additional senior living communities and institutional pharmacies. This growth strategy involves risks including the following:

- > we may be unable to locate senior living communities or pharmacies available for purchase at acceptable prices;
- > we may be unable to access capital to make acquisitions or operate acquired businesses;
- > acquired operations may bring with them contingent liabilities which mature;
- > to the extent we incur acquisition debt or leases, our operating leverage may increase; and
- > combining our present operations with newly acquired operations may disrupt operations or cost more than anticipated when acquisition prices are determined.

For these reasons and others:

- > our business plan to grow may not succeed;
- > the benefits which we hope to achieve by growing may not be achieved;
- > we may suffer declines in profitability or suffer recurring losses; and
- > our existing operations may suffer from a lack of management attention or financial resources if such attention and resources are devoted to a failed growth strategy.

We may not achieve the anticipated benefits of our recently completed acquisition of LTA.

The financial benefits we expect to realize from our acquisition of LTA are largely dependent upon our ability to increase the occupancy of the LTA communities and to realize cost savings by combining the LTA operations and our existing operations. If our management of the LTA communities does not increase revenues and lower costs, we will not realize the presently anticipated benefits and we may experience losses.

Our insurance costs have increased and may continue to increase.

In several well publicized instances, private litigation by residents of senior living communities for alleged abuses has resulted in large damage awards against other operating companies. Today, some

lawyers and law firms specialize in bringing litigation against senior living companies. As a result of this litigation and potential litigation, our cost of liability insurance has increased dramatically during the past few years. Workers compensation and employee health insurance costs have

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also increased in recent years. To partially offset these increases we have increased the amounts of our self insurance by use of higher deductibles and captive insurance companies. Medical liability insurance reform has become a topic of political debate and some states have enacted legislation to limit future liability awards. However, if such reforms are not generally adopted, we expect our insurance costs may continue to increase. Although our reserves for self insurance have been determined with guidance from third party professionals, our reserves may prove inadequate. Increasing insurance costs and increasing reserves may materially negatively affect our results of operations.

Our business is subject to extensive regulation which increases our costs and may result in losses.

Licensing and Medicare and Medicaid laws require operators of senior living communities to comply with extensive standards governing operations. There are also various laws prohibiting fraud by senior living operators, including criminal laws that prohibit false claims for Medicare and Medicaid and that regulate patient referrals. In recent years, the federal and state governments have devoted increased resources to monitoring quality of care at senior living communities and to anti-fraud investigations. When quality of care deficiencies are identified or improper billing is uncovered, various sanctions may be imposed, including denial of new admissions, exclusion from Medicare or Medicaid program participation, monetary penalties, governmental oversight or loss of licensure. Our communities receive notices of sanctions from time to time. A result of this extensive regulatory system and increasing enforcement initiatives has been to increase our costs of monitoring quality of care compliance and billing procedures, and we expect these costs may continue to increase. Also, if we become subject to regulatory sanctions, our business may be adversely affected and we might experience financial losses.

The failure of Medicare and Medicaid rates to match our costs will reduce our income.

Some of our operations, especially our nursing homes, receive significant revenues from the Medicare and Medicaid programs. During the nine months ended September 30, 2004, approximately 43% of our total revenues was received from these programs. The federal government and some states are now experiencing fiscal deficits. Historically when governmental deficits have increased, cut backs in Medicare and Medicaid funding have often followed. These cut backs sometimes include rate reductions, but more often result in a failure of Medicare and Medicaid rates to increase by sufficient amounts to offset increasing costs. We cannot now predict whether future Medicare and Medicaid rates will be sufficient to cover our future cost increases. Future Medicare and Medicaid rate declines or a failure of these rates to cover increasing costs would result in our experiencing lower earnings or losses.

Sunrise's management of 30 of our communities may have adverse consequences to us.

In March 2003, Marriott sold its subsidiary which manages 30 communities for us to Sunrise. We believe Sunrise's financial condition and reputation as an operator of senior living communities is weaker than the financial condition and reputation of Marriott. The operations and the financial results which we realize from the communities managed for us by Sunrise have declined and become more volatile since this sale and this decline and volatility may continue in the future.

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We are subject to possible conflicts of interest and we have engaged in, and will continue to engage in for the foreseeable future, transactions with related parties.

Our business is subject to possible conflicts of interest as follows:

- > our Chief Executive Officer, Everett W. Benton, and our Chief Financial Officer, Bruce J. Mackey Jr., are also part-time employees of Reit Management and Research LLC, or RMR. RMR is the investment manager for Senior Housing and we purchase various services from RMR pursuant to a shared services agreement;
- > our managing directors, Barry M. Portnoy and Gerard M. Martin, are also managing trustees of Senior Housing. Messrs. Portnoy and Martin also own RMR and another entity that leases office space to us; and
- > under our shared services agreement with RMR, in the event of a conflict between Senior Housing and us, RMR may act on behalf of Senior Housing rather than on our behalf.

We do not believe that these conflicts adversely affect our business.

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On December 31, 2001, Senior Housing distributed substantially all of its ownership of our shares to its shareholders. As a condition to the spin off, we entered into agreements with Senior Housing concerning, among other things, an amendment to our charter which limits ownership of more than 9.8% of our voting shares, restrictions on our ability to take any action that could jeopardize the tax status of Senior Housing and other REITs managed by RMR, and rights regarding an acquisition of, or financing for, real estate we may be considering. See "Management's discussion and analysis of financial condition and results of operations Related party transactions".

In addition, 128 of the 160 senior living communities we currently operate are leased from Senior Housing for total annual minimum rent of \$95.3 million and we owe \$16.8 million to Senior Housing pursuant to a mortgage note. We intend to repay this note with a portion of the net proceeds from this offering.

As a result of the agreements entered into in connection with the spin off, our leases with Senior Housing and our shared services agreement with RMR, Senior Housing, RMR and their respective affiliates play a significant role in our business and we do not anticipate any changes to that role for the foreseeable future. Future business dealings between us, Senior Housing, RMR and their respective affiliates may be on terms less favorable to us than we could achieve on an arm's length basis.

Our business requires regular capital expenditures.

Physical characteristics of senior living communities are mandated by various governmental authorities. Changes in these regulations may require us to make significant expenditures. In the future, our communities may require significant expenditures to address ongoing required maintenance and to make them attractive to residents. Our available financial resources may be insufficient to fund these expenditures.

Our business is highly competitive and we may be unable to operate profitably.

We compete with numerous other companies that provide senior living services, including home healthcare companies and other real estate based service providers. Historically, nursing homes have been somewhat protected from competition by state laws requiring certificates of need to develop new communities; however, these barriers are being eliminated in many states. Also, there are few barriers to competition for home healthcare or for independent and assisted living services. Growth in the availability of nursing home alternatives, including assisted living communities, has had and may in the

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future have the effect of reducing the occupancy or profitability at nursing homes, including those we operate. Many of our existing competitors are larger and have greater financial resources than we do. Accordingly, we cannot provide any assurances that we will be able to attract a sufficient number of residents to our communities or that we will be able to attract employees and keep wages and other employee benefits, insurance costs and other operating expenses at levels which will allow us to compete successfully or to operate profitably.

Anti-takeover provisions in our governing documents and in our material agreements may prevent shareholders from receiving a takeover premium for their shares.

Our charter places restrictions on the ability of any person or group to acquire beneficial ownership of more than 9.8% (in number of shares or value, whichever is more restrictive) of any class of our equity shares. Additionally, the terms of our leases with Senior Housing and our shared services agreement with RMR provide that our rights under these agreements may be cancelled by Senior Housing and RMR, respectively, upon the acquisition by any person or group of more than 9.8% of our voting stock, and upon other change in control events, as defined in those documents. If the breach of these ownership limitations causes a lease default, shareholders causing the default may become liable to us or to other shareholders for damages. Additionally, on March 10, 2004, we entered into a rights agreement whereby in the event a person or group of persons acquires or attempts to acquire 10% or more of our outstanding common shares, our shareholders, other than such person or group, will be entitled to purchase additional shares or other securities or property at a discount. These agreements and other provisions in our charter and bylaws may increase the difficulty of acquiring control of us by means of a tender offer, open market purchases, a proxy fight or otherwise, if the acquisition is not approved by our board of directors. Other provisions in our governing documents which may deter takeover proposals include the following:

- > staggered terms for members of our board of directors;
- > the power of our board of directors, without a shareholders' vote, to authorize and issue additional shares and classes of shares on terms that it determines;

- > a 75% shareholder vote and cause requirement for removal of directors; and
- > advance notice procedures with respect to nominations of directors and shareholder proposals.

For all of these reasons, shareholders may be unable to cause a change of control of us or to realize a change of control premium for their common shares.

A significant increase in our labor costs could have a material adverse effect on us.

We compete with other operators of senior living communities with respect to attracting and retaining qualified personnel responsible for the day-to-day operations of each of our communities. A shortage of nurses or other trained personnel may require us to increase the wages and benefits offered to our employees in order to attract and retain these personnel or to hire more expensive temporary personnel. No assurance can be given that our labor costs will not increase or that any increase will be matched by corresponding increases in rates charged to residents. Any significant failure by us to control our labor costs or to pass on any increased labor costs to residents through rate increases could have a material adverse effect on our business, financial condition and results of operations.

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We largely rely on private pay residents. Circumstances that adversely affect the ability of the elderly to pay for our services could have a material adverse effect on us.

Approximately 57% of our total revenues from our communities for the nine months ended September 30, 2004, and approximately 61% of our total revenues from our communities for the year ended December 31, 2003, were attributable to private pay sources. We expect to continue to rely on the ability of residents to pay for our services from their own financial resources. Inflation or other circumstances that adversely affect the ability of the elderly to pay for our services could have a material adverse effect on our business, financial condition and results of operations.

The price of our common stock has fluctuated, and a number of factors may cause our common stock price to decline.

The market price of our common stock has fluctuated and could fluctuate significantly in the future in response to various factors and events, including, but not limited to, the risks set out in this prospectus, as well as:

- > the liquidity of the market for our common stock;
- > variations in our operating results;
- > variations from analysts' expectations; and
- > general economic trends and conditions.

In addition, the stock market in recent years has experienced broad price and volume fluctuations that often have been unrelated to the operating performance of particular companies. These market fluctuations may also cause the market price of our common stock to decline. Investors may be unable to resell their shares of our common stock at or above the offering price.

The sale of our shares in this offering will dilute the holdings of existing shareholders and could cause our stock price to fall, and could adversely affect our ability to offer our shares in the future.

As a result of this offering, the number of common shares outstanding will increase by approximately 35%. The market price of our common shares could decline because of this dilution. This dilution from the offering might also make it more difficult for us to sell additional equity securities at a time and price that we deem appropriate. In addition, each of our officers and managing directors have agreed with the underwriters not to sell their shares of our common stock from the date of this prospectus through the date 90 days after the date of this

prospectus. These persons may sell, or indicate an intention to sell, our common stock after the 90-day contractual lock-up lapses and, as a result, the trading price of our common shares could decline.

Warning concerning forward looking statements

THIS PROSPECTUS CONTAINS FORWARD LOOKING STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND FEDERAL SECURITIES LAWS. THESE STATEMENTS REFLECT OUR INTENT, BELIEF OR EXPECTATION, OR THE INTENT, BELIEFS OR EXPECTATIONS OF OUR DIRECTORS AND OFFICERS, BUT THEY ARE NOT GUARANTEED TO OCCUR. FOR EXAMPLE:

- > THE FINANCIAL BENEFITS FROM THE LTA ACQUISITION, INCLUDING OUR EXPECTATION OF THE ACCRETION TO OUR EARNINGS IN THE SECOND HALF OF 2005, MAY NOT BE REALIZED OR WE MAY EXPERIENCE FUTURE LOSSES BECAUSE WE ARE UNABLE TO INCREASE OCCUPANCIES AT THE LTA COMMUNITIES AND/OR REALIZE COST SAVINGS FROM THE COMBINATION OF THE LTA OPERATIONS WITH OUR EXISTING OPERATIONS;
- > WE MAY BE UNABLE TO GENERATE OUR EXPECTED REVENUES IN 2005 FROM OUR PHARMACY BUSINESSES BECAUSE WE MAY BE UNSUCCESSFUL AT GROWING THESE BUSINESSES FOR SEVERAL REASONS, INCLUDING, WE MAY NOT BE ABLE TO GROW REVENUES BY PROVIDING PHARMACY SERVICES AT ADDITIONAL SENIOR LIVING COMMUNITIES WHICH WE OPERATE;
- > OUR FUTURE INSURANCE COSTS AND INSURANCE RESERVE CALCULATIONS MAY BE GREATER THAN WE NOW ANTICIPATE;
- > WE MAY BE UNABLE TO CARRY OUT OUR BUSINESS PLAN TO EXPAND BECAUSE WE ARE UNABLE TO LOCATE EXPANSION OPPORTUNITIES AT PRICES WE ARE WILLING OR ABLE TO PAY;
- > OUR RECEIVABLES RESERVES MAY BE INADEQUATE, ESPECIALLY THE RESERVES WHICH RELATE TO MEDICARE AND MEDICAID PAYMENTS BECAUSE SUCH PAYMENTS ARE SUBJECT TO GOVERNMENTAL AUDITS AND TO GOVERNMENT FISCAL POLICIES;
- > WE MAY BE UNABLE TO MAINTAIN OR IMPROVE OUR FUTURE OCCUPANCY RATES AND AS A RESULT OUR REVENUES MAY DECLINE;
- > THE IMPROVING ECONOMY MAY RESULT IN WAGE PRESSURES WHICH INCREASE OUR FUTURE COSTS;
- > FUTURE MEDICARE AND MEDICAID RATES MAY BE LOWER THAN WE NOW ANTICIPATE;
- > SUNRISE'S OPERATIONS OF THE COMMUNITIES WHICH IT MANAGES FOR US MAY RESULT IN LOSSES TO US; AND
- > WE MAY BECOME SUBJECT TO FINES OR REGULATORY SANCTIONS WHICH MATERIALLY ADVERSELY AFFECT OUR FINANCIAL CONDITION OR PERFORMANCE.

IN ANY SUCH EVENT, OUR FUTURE FINANCIAL PERFORMANCE MAY CAUSE THE IMPROVEMENTS IMPLIED BY OUR RECENT PERFORMANCE TO REVERSE AND WE MAY EXPERIENCE LOSSES. IF OUR FINANCIAL RESULTS DO NOT CONTINUE TO IMPROVE, OUR STOCK PRICE LIKELY WILL DECLINE. AN INVESTMENT IN OUR SECURITIES INVOLVES A HIGH DEGREE OF RISK OF LOSS, AND INVESTORS SHOULD NOT PLACE UNDUE RELIANCE UPON FORWARD LOOKING STATEMENTS WHICH IMPLY OTHERWISE. ANY FORWARD LOOKING STATEMENTS SHOULD BE CONSIDERED IN LIGHT OF

THE FACTORS DISCUSSED UNDER "RISK FACTORS" AND "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS".

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Use of proceeds

Our net proceeds from this offering, assuming a public offering price of \$7.04, the closing price of our common shares on the American Stock Exchange on November 26, 2004, and after deduction of the underwriting discount and estimated offering expenses payable by us, are estimated to be \$19.6 million (\$22.6 million if the underwriters' over-allotment option is exercised in full). We intend to use a portion of the net proceeds to repay a \$16.8 million mortgage note provided to us by Senior Housing in connection with our recent acquisition of LTA. This loan has an interest rate of 9.0% per annum and matures on May 2, 2005. We intend to use the remainder of the net proceeds for general business purposes, including possible acquisitions which have not been identified. Until we utilize the net proceeds, we may deposit all or a portion of the net proceeds in interest bearing accounts or invest them in short term securities, including securities that may not be investment grade rated.

Market price of common shares

Our common shares are traded on the American Stock Exchange under the symbol "FVE". The following table sets forth for the periods indicated the high and low sales price for our common shares as reported by the American Stock Exchange:

2002

	Low	High
First Quarter	\$ 6.75	\$ 9.00
Second Quarter	5.09	7.48
Third Quarter	1.06	5.53
Fourth Quarter	0.96	2.25

2003

First Quarter	\$ 1.11	\$ 1.80
Second Quarter	1.06	1.87
Third Quarter	1.43	2.88
Fourth Quarter	2.06	4.50

2004

First Quarter	\$ 3.50	\$ 6.39
Second Quarter	3.55	5.25
Third Quarter	4.10	7.69
Fourth Quarter through November 26, 2004	6.55	7.93

The closing price of our common shares on the American Stock Exchange on November 26, 2004 was \$7.04 per share.

As of November 26, 2004, there were approximately 3,900 shareholders of record of our common shares, and we estimate that as of such date there were approximately 60,500 beneficial owners of our common shares.

Dividend policy

We have never paid dividends on our common stock. We do not expect to pay dividends in the foreseeable future.

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Capitalization

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The following table describes our capitalization, as of September 30, 2004, on a historical and pro forma basis, giving effect to our recent acquisition of LTA, including the sale and leaseback and mortgage financing provided by Senior Housing, and as adjusted for this offering and the application of the net proceeds as described in this prospectus, assuming a public offering price of \$7.04 per share.

	Historical	After giving pro forma effect to the LTA acquisition	As adjusted for this offering and after giving pro forma effect to the LTA acquisition
(dollars in thousands)			
Cash	\$ 18,612	\$ 19,089	\$ 21,776
Debt	\$ 4,995	\$ 53,133	\$ 36,284
Shareholders' equity:			
Common stock, par value \$0.01 per share; 20,000,000 shares authorized; shares outstanding: 8,538,634 historical; 11,538,634 as adjusted	85	85	115
Additional paid-in capital	86,347	86,347	105,853
Accumulated deficit	(19,562)	(19,562)	(19,562)
Total shareholders' equity	66,870	66,870	86,406
Total capitalization	\$ 71,865	\$ 120,003	\$ 122,690

Dilution

The recent trading price of our common shares is less than their book value per share determined according to accounting principles generally accepted in the United States, or GAAP. Accordingly, assuming that you purchase our shares at the price set forth on the cover of this prospectus, you will not suffer dilution in book value. Book value per share at September 30, 2004 was \$7.83; as adjusted for this offering, assuming a public offering price of \$7.04 per share, book value per share will be \$7.49.

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Selected financial data

The following table presents selected financial data which has been derived from our historical financial statements for the period from April 27, 2000 (the date we commenced operations) through December 31, 2003 and for the nine months ended September 30, 2003 and 2004. The following data should be read in conjunction with, and is qualified in its entirety by reference to, our consolidated financial statements and the notes thereto included elsewhere in this prospectus. Prior to December 31, 2001, we were owned by Senior Housing and, as discussed under "Management's discussion and analysis of financial condition and results of operations", our historical financial information before January 1, 2002 is not fully reflective of our current operations. Accordingly, you should not place undue reliance on our historical financial information before January 1, 2002.

Nine months ended September 30,		Year ended December 31,			Period from April 27, 2000 through December 31,
2004	2003	2003	2002	2001	2000
(unaudited)					

(dollars in thousands, except per share amounts)

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Operating data:	Nine months ended September 30,					Period from April 27, 2000 through December 31, 2000
	Total revenues	\$ 460,553	\$ 428,261	\$ 576,215	\$ 519,403	\$ 219,834
Net income (loss) from continuing operations	2,893	(4,246)	(7,567)	(10,259)	1,473	\$(1,614)
Net income (loss) from discontinued operations	(553)	(1,431)	(372)	(2,915)	(946)	298
Net income (loss)	\$ 2,340	\$ (5,677)	\$ (7,939)	\$ (13,174)	\$ 527	\$ (1,316)

Per common share data:

Income (loss) from continuing operations	\$ 0.34	\$ (0.50)	\$ (0.89)	\$ (1.36)	\$ 0.34	\$ (0.37)
Income (loss) from discontinued operations	(0.07)	(0.17)	(0.05)	(0.38)	(0.22)	0.07
Net income (loss)	\$ 0.27	\$ (0.67)	\$ (0.94)	\$ (1.74)	\$ 0.12	\$ (0.30)

Balance sheet data (as of December 31):

Total assets	\$ 147,217	\$ 143,810	\$ 147,370	\$ 133,197	\$ 68,043	\$ 54,788
Total indebtedness	4,995	15,833	10,435	16,123		100
Other long term obligations	25,157	14,971	18,417	17,723		
Total shareholders' equity	\$ 66,870	\$ 65,067	\$ 64,427	\$ 65,047	\$ 50,233	\$ 54,688

The following table presents selected financial data from 1999 and 2000 derived from historical financial statements of our two predecessors, Integrated Health Services, Inc. and Mariner Post-Acute Network, Inc., prior to their acquisition by Senior Housing.

	Year ended December 31,	
	2000	1999
(dollars in thousands)		
Integrated Health Services, Inc.		
Operating data:		
Operating revenues	\$ 135,378	\$ 130,333
Net loss	(25,252)	(126,939)
Balance sheet data (as of December 31):		
Total assets	\$ 34,942	\$ 61,274
Long term liabilities		17,500
Mariner Post-Acute Network, Inc.		
Operating data:		
Operating revenues	\$ 85,325	\$ 86,945
Net loss	(7,421)	(43,804)
Balance sheet data (as of December 31):		
Total assets	\$ 23,052	\$ 17,433
Long term liabilities	32,090	28,603

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Management's discussion and analysis of financial condition and results of operations

You should read the following discussion in conjunction with our financial statements included elsewhere in this prospectus.

OVERVIEW

We were formed as a 100% owned subsidiary of Senior Housing. Effective July 1, 2000, we assumed the operations of healthcare communities from two bankrupt former tenants of Senior Housing. Pursuant to tax laws applicable to REITs, Senior Housing engaged FSQ, Inc., an

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independent operating company formed by our managing directors, to manage these communities. At the time we assumed operations of these communities, we had not received substantially all of the required licenses for these communities. As a result, for the period from July 1, 2000 through December 31, 2000, we accounted for the operations of these communities using the equity method of accounting and we only recorded the net income from these operations. Thereafter, we obtained all necessary licenses to operate these communities, and on January 1, 2001, we began to consolidate the results of operations of these communities. On December 31, 2001, Senior Housing distributed substantially all of our shares to its shareholders in a spin off transaction and we became a separately traded public company. On January 2, 2002, in order to acquire the personnel, systems and assets necessary to operate these communities, we acquired FSQ, Inc. by merger.

Since we succeeded to substantially all of the business formerly conducted by subsidiaries or units of two former tenants of Senior Housing, these subsidiaries and units are considered to be our predecessors. See "Selected financial data" for a discussion of financial data of our predecessors.

Our revenues consist primarily of payments for services provided to residents at our communities. The payments are either made by the residents, their families or insurers, referred to as private pay revenues, or by the Medicare and Medicaid programs. For the year ended December 31, 2003 and the nine months ended September 30, 2004, private pay revenues represented 61% and 57% of our total revenues, respectively. Our expenses consist primarily of rent, wages and benefits of personnel, food, supplies, insurance and other resident care costs, as well as taxes, and other property related costs.

OUR HISTORICAL RESULTS OF OPERATIONS

As described above, until completion of the spin off, we operated as a subsidiary of Senior Housing. Our past operations as Senior Housing's subsidiary prior to 2002 differ from our 2002, 2003 and current operations as an independent public company. Specifically, in 2000 and 2001, we operated only 56 communities for Senior Housing, which owned the real estate as well as the operations. Effective December 31, 2001, we began to lease these 56 communities (now 52 communities) from Senior Housing which continued to own the real estate. In January 2002, we leased from Senior Housing an additional 31 communities (now 30 communities) that are currently managed by Sunrise. Since Sunrise assumed the management of these communities from Marriott, the financial results of these communities have declined and this decline has had a material and adverse impact on our financial results. We are having discussions with Sunrise concerning possible improvements in the financial results of these operations. In April 2002, October 2002 and May 2003, we acquired and began to operate five, 15 and three, respectively, additional senior living communities. During 2002 and 2003, we disposed of six senior living communities. Our principal source of financing as a subsidiary of Senior Housing prior to 2002 was intercompany advances from Senior Housing, an

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entity with financial resources substantially in excess of ours. Because of these differences, we believe that our historical results of operations for periods prior to 2002 described below are not comparable to our operations since then or our expected future operations.

RESULTS OF OPERATIONS

Key statistical data (for the three and nine months ended September 30, 2004 and 2003)

The following tables present an overview of our operations for the quarters ended September 30, 2004 and 2003:

	Three months ended September 30			Nine months ended September 30		
	2004	2003	Change	2004	2003	Change
Revenues from residents (in 000s)	\$ 151,685	\$ 145,867	4%	\$ 450,047	\$ 427,871	5%
Community expenses (in 000s)	\$ 123,073	\$ 117,483	5%	\$ 364,303	\$ 346,013	5%
Total expenses (in 000s)	\$ 154,527	\$ 146,762	5%	\$ 457,548	\$ 432,507	6%
No. of communities (end of period)	101	100	1	101	100	1
No. of living units (end of period)	13,967	13,862	105	13,967	13,862	105
Occupancy	90%	89%	1%	89%	89%	
Average daily rate	\$ 131	\$ 129	2%	\$ 132	\$ 127	4%
Revenue per day per available unit	\$ 118	\$ 114	4%	\$ 118	\$ 113	4%

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	Three months ended September 30			Nine months ended September 30		
	2004	2003	Change	2004	2003	Change
Percent of revenues from Medicare / Medicaid	43%	41%	2%	43%	40%	3%
Percent of revenues from private / other	57%	59%	-2%	57%	60%	-3%
"Same Store" Communities (communities that we operated continuously since July 1, 2003 and January 1, 2003, respectively):						
	Three months ended September 30			Nine months ended September 30		
	2004	2003	Change	2004	2003	Change
Revenues from residents (in 000s)	\$ 150,679	\$ 145,867	3%	\$ 445,132	\$ 426,610	4%
Community expenses (in 000s)	\$ 121,387	\$ 117,421	3%	\$ 358,430	\$ 344,895	4%
No. of communities (end of period)	100	100		97	97	
No. of living units (end of period)	13,862	13,862		13,719	13,719	
Occupancy	89%	89%		89%	90%	-1%
Average daily rate	\$ 132	\$ 129	2%	\$ 133	\$ 127	5%
Revenue per day per available unit	\$ 118	\$ 114	4%	\$ 119	\$ 114	4%
Percent of revenues from Medicare / Medicaid	43%	44%	-1%	43%	41%	2%
Percent of revenues from private / other	57%	56%	1%	57%	59%	-2%

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Three months ended September 30, 2004, compared to three months ended September 30, 2003

Total revenues from residents for the three months ended September 30, 2004 were \$151.7 million, a 4% increase over revenues from residents of \$145.9 million for the three months ended September 30, 2003. This increase is due primarily to higher per diem charges as well as an increase in occupancy. Revenues from residents at the communities that we have operated continuously since July 1, 2003, were \$150.7 million and \$145.9 million for the three months ended September 30, 2004 and 2003, respectively, an increase of 3%. This increase is due primarily to higher per diem charges to residents. Approximately 43% and 41% of our revenues from residents in the three months ended September 30, 2004 and 2003, respectively, were received from Medicare and Medicaid. Revenues from our two pharmacies were \$3.6 million and \$76,000 for the three months ended September 30, 2004 and 2003, respectively. The increase is a result of our acquiring these pharmacies during and after the third quarter of 2003.

Interest and other income increased by \$174,000 in the three months ended September 30, 2004 to \$260,000, compared to \$86,000 in the three months ended September 30, 2003, primarily due to interest earned on mortgage notes receivable. The notes were received in the second half of 2003 as a result of asset sales.

Expenses for the three months ended September 30, 2004 were \$154.5 million, an increase of 5% over expenses of \$146.8 million for the three months ended September 30, 2003. Our wages and benefits costs increased from \$77.8 million to \$80.1 million, or 3%, primarily due to wage increases. Other operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, increased from \$39.7 million to \$42.9 million, or 8%, primarily as a result of our pharmacy acquisition in September 2003, as well as increased charges from third parties. Management fees related to the 30 communities that Sunrise manages for us were \$5.0 million and \$4.4 million for the three months ended September 30, 2004 and 2003, respectively. The increase in fees at these 30 communities is the result of increased revenues at these communities and a contractual increase in the effective management fee calculation. Rent expense to Senior Housing increased from \$19.4 million to \$20.6 million, or 6%, primarily due to the addition of one community to our leases with Senior Housing in May 2004 and additional rent for capital improvements that were funded by Senior Housing in 2003 and 2004. Community level operating expenses related to the communities that we operated throughout the three months ended September 30, 2004 and September 30, 2003 were \$121.4 million and \$117.4 million, respectively, an increase of 3%. This increase is primarily due to wage increases as well as increased charges from third parties.

Our general and administrative expenses for the three months ended September 30, 2004 were \$4.9 million, an increase of 8% over expenses of \$4.5 million for the three months ended September 30, 2003, primarily due to costs resulting from our increased operations and wage increases for our corporate personnel.

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Depreciation expense for the three months ended September 30, 2004 was \$947,000, an increase of 17% over depreciation expense of \$810,000 for the three months ended September 30, 2003. This change is the net effect of decreases attributable to our sale of three communities in the second half of 2003, offset by increases attributable to our purchase of furniture and fixtures related to the communities that Sunrise manages, as well as the purchase of one community from Senior Housing in 2004.

We provided \$112,000 for alternative minimum income taxes during the three months ended September 30, 2004. This provision was not required for the three months ended September 30, 2003.

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Income from discontinued operations for the three months ended September 30, 2004 was \$22,000, compared to a loss of \$433,000 for the three months ended September 30, 2003. This increase is primarily the result of our ceasing operations at seven properties in the 2003 period compared with one property in the 2004 period. In addition, during the third quarter of 2004, an insurance reserve was deemed not necessary.

As a result of the factors described above, our net income for the three months ended September 30, 2004 was \$891,000 compared to a loss of \$1.2 million for the three months ended September 30, 2003. Our net income per share for the three months ended September 30, 2004 was \$0.10 compared to a loss per share of \$0.14 for the three months ended September 30, 2003.

Nine months ended September 30, 2004, compared to nine months ended September 30, 2003

Total revenues from residents for the nine months ended September 30, 2004 were \$450.0 million, an increase of 5% over revenues from residents of \$427.9 million for the nine months ended September 30, 2003. This increase is due primarily to higher per diem charges to residents and our beginning operations at three additional communities in May 2003 and one community in May 2004. Revenues from residents at the communities that we have operated continuously since January 1, 2003 were \$445.1 million and \$426.6 million for the nine months ended September 30, 2004 and September 30, 2003, respectively, an increase of 4%. This increase is due primarily to higher per diem charges to residents somewhat offset by a decrease in occupancy. Approximately 43% and 40% of our revenues from residents in the nine months ended September 30, 2004 and 2003, respectively, were received from Medicare and Medicaid. Revenues from our two pharmacies were \$8.6 million and \$76,000 for the nine months ended September 30, 2004 and 2003, respectively. The increase is a result of our acquiring these pharmacies during and after the third quarter 2003.

Interest and other income increased by \$1.6 million in the nine months ended September 30, 2004 to \$1.9 million compared to \$314,000 in the nine months ended September 30, 2003. The increase is primarily due to our settlement with Marriott and its senior living subsidiary. On January 7, 2004, we and Senior Housing settled then pending litigation with Marriott and its senior living subsidiary. Under the terms of the settlement, we and Senior Housing, and Marriott and its senior living subsidiary, agreed to dismiss all claims and counterclaims asserted in the litigation. Also under the terms of the settlement, Marriott paid to us and Senior Housing \$1.3 million each.

Expenses for the nine months ended September 30, 2004 were \$457.5 million, an increase of 6% over expenses of \$432.5 million for the nine months ended September 30, 2003. Our wages and benefits costs increased from \$232.0 million to \$241.3 million, or 4%, primarily due to wage increases as well as wages related to three communities we began to operate in May 2003, one community we began to operate in May 2004 and the pharmacy we acquired in September 2003. Other operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, increased from \$114.0 million to \$123.0 million, or 8%, primarily as a result of increased charges from third parties, our operation of three additional properties in May 2003, one community we began to operate in May 2004 and our pharmacy acquisition in September 2003. Management fees related to the 30 communities that Sunrise manages for us were \$14.2 million and \$12.9 million for the nine months ended September 30, 2004 and 2003, respectively. The increase in fees at these 30 communities is the result of increased revenues at these communities and a contractual increase in the effective management fee calculation. Rent expense to Senior Housing increased from \$57.3 million to \$61.2 million, or 6%, primarily due to the addition of communities that we began to lease in 2003 and 2004 and additional rent for capital improvements that were funded by Senior Housing since January 1, 2003. Community level operating expenses related to the communities that

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we have operated throughout the nine months ended September 30, 2004 and 2003 were \$358.4 million and \$344.9 million, respectively, an increase of 4%. This increase is primarily due to wage increases as well as increased charges from third parties.

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Our general and administrative expenses for the nine months ended September 30, 2004 were \$14.8 million, an increase of 15% over expenses of \$12.9 million for the nine months ended September 30, 2003, primarily due to costs resulting from our increased operations.

Depreciation expense for the nine months ended September 30, 2004 was \$2.8 million, an increase of 9% over depreciation expense of \$2.5 million for the nine months ended September 30, 2003. This increase is primarily attributable to our purchase of furniture and fixtures related to the communities managed by Sunrise, offset by our sale of seven communities in the second half of 2003.

We provided \$112,000 for alternative minimum income taxes during the nine months ended September 30, 2004. This provision was not required for the nine months ended September 30, 2003.

Loss from discontinued operations for the nine months ended September 30, 2004 was \$553,000, a decrease of \$878,000 over a loss of \$1.4 million for the nine months ended September 30, 2003. This decrease is primarily the result of our ceasing operations at seven properties in the 2003 period compared with one property in the 2004 period.

As a result of the factors described above, our net income for the nine months ended September 30, 2004 was \$2.3 million compared to a loss of \$5.7 million for the nine months ended September 30, 2003. Our net income per share for the nine months ended September 30, 2004 was \$0.27 compared to a loss per share of \$0.67 for the nine months ended September 30, 2003.

Year ended December 31, 2003, compared to year ended December 31, 2002

The following tables present an overview of our portfolio for the years ended December 31, 2003 and 2002:

	2003	2002	Change
Revenues from residents (in 000s)	\$ 575,986	\$ 519,106	11%
Community expenses (in 000s)	\$ 466,628	\$ 417,301	12%
Total expenses (in 000s)	\$ 583,782	\$ 529,662	10%
No. of communities (end of period)	101	105	-4
No. of living units (end of period)	14,035	13,962	73
Occupancy	88%	89%	-1%
Average daily rate	\$ 126	\$ 114	11%
Revenue per day per available unit	\$ 112	\$ 102	10%
Percent of revenues from Medicare and Medicaid	39%	39%	
Percent of revenues from private / other	61%	61%	

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"Same Store" Communities (communities that we operated continuously since January 1, 2002):

	2003	2002	Change
Revenues from residents (in 000s)	\$ 236,667	\$ 227,446	4%
Community expenses (in 000s)	\$ 215,793	\$ 210,645	2%
No. of communities (end of period)	53	53	
No. of living units (end of period)	4,868	4,868	
Occupancy	90%	89%	1%
Average daily rate	\$ 148	\$ 144	3%
Revenue per day per available unit	\$ 133	\$ 128	4%
Percent of revenues from Medicare and Medicaid	79%	78%	1%
Percent of revenues from private / other	21%	22%	-1%

Revenues from residents for 2003 were \$576.0 million, an increase of 11% over revenues from residents of \$519.1 million for 2002. This increase is attributable primarily to our beginning operations at 15 communities on October 26, 2002, and at three communities on May 30, 2003. Revenues from residents at the communities we operated throughout 2003 and 2002 were \$236.7 million and \$227.4 million, respectively, an increase of 4%. This increase is due primarily to higher per diem charges to residents and higher occupancy. About 39% of our revenues from residents in 2003 and 2002 were received from Medicare and Medicaid.

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Interest and other income decreased by \$68,000 in 2003 to \$229,000 compared to \$297,000 in 2002 due to lower cash balances and lower interest rates in 2003 partially offset by interest earned on mortgage notes receivable.

Expenses for 2003 were \$583.8 million, an increase of 10% over expenses of \$529.7 million for 2002. Our wages and benefits costs increased from \$274.2 million to \$315.6 million, or 15%, primarily due to expenses at the 18 communities we began to operate since October 2002 as well as increases in workers compensation and employee health insurance costs. Other operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, increased from \$143.1 million to \$151.0 million, or 6%, again primarily due to expenses at the 18 communities we began to operate since October 2002, as well as higher professional and general liability insurance costs. Management fees related to the 31 communities managed for us by Sunrise for 2003 and 2002, were \$17.4 million and \$16.6 million, respectively. This increase is primarily because these arrangements commenced on January 11, 2002, and, therefore, the 2003 period includes 11 more days than the 2002 period. Rent expense to Senior Housing increased from \$75.2 million to \$77.3 million, or 3%, primarily due to rents for communities we began to lease since October 2002, and rent increases which accompanied Senior Housing's purchase of improvements at leased communities, partially offset by a lease modification entered into on October 1, 2002 which changed the ownership of certain reserve accounts for future capital expenditures at the communities managed by Sunrise. Community level operating expenses related to the communities we operated throughout 2003 and 2002, were \$215.8 million and \$210.6 million, respectively, an increase of 2%. This increase is primarily due to increases in employee health, workers compensation and professional and general liability insurance costs.

Our general and administrative expenses for 2003 were \$17.7 million, an increase of 15% over 2002 of \$15.4 million, primarily due to costs resulting from our increased operations and to legal costs incurred in connection with our litigation with Marriott, which was settled in January 2004.

Depreciation expense in 2003 was \$3.6 million, an increase of 95% over depreciation expense of \$1.8 million in 2002. The increase is attributable to our purchase of seven communities in the second

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half of 2002 as well as capitalized improvements to some of our communities which increased our depreciable assets.

Loss from discontinued operations for 2003 was \$372,000, a decrease of \$2.5 million over the loss in 2002. This decrease is attributable to our dispositions of these operations as well as the recovery of some accounts receivable that were previously written off.

As a result of the factors described above, our net loss for 2003 was \$7.9 million, compared to a loss of \$13.2 million in 2002. Our net loss per share in 2003 was \$0.94 compared to a loss per share of \$1.74 in 2002.

Year ended December 31, 2002, compared to year ended December 31, 2001

The following tables present an overview of our portfolio for the years ended December 31, 2002 and 2001:

	2002	2001	Change
Revenues from residents (in 000s)	\$ 519,106	\$ 219,742	136%
Community expenses (in 000s)	\$ 417,301	\$ 201,447	107%
Total expenses (in 000s)	\$ 529,662	\$ 218,361	142%
No. of communities (end of period)	105	56	49
No. of living units (end of period)	13,962	5,211	8,751
Occupancy	89%	90%	-1%
Average daily rate	\$ 114	\$ 130	-12%
Revenue per day per available unit	\$ 102	\$ 116	-12%
Percent of revenues from Medicare and Medicaid	39%	78%	-39%
Percent of revenues from private / other	61%	22%	39%

"Same Store" Communities (communities that we operated continuously since January 1, 2001):

	2002	2001	Change
Revenues from residents (in 000s)	\$ 227,446	\$ 219,742	4%
Community expenses (in 000s)	\$ 210,645	\$ 201,447	5%

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	2002	2001	Change
No. of communities (end of period)	53	53	
No. of living units (end of period)	4,868	4,868	
Occupancy	89%	89%	
Average daily rate	\$ 144	\$ 139	4%
Revenue per day per available unit	\$ 128	\$ 124	3%
Percent of revenues from Medicare and Medicaid	78%	78%	
Percent of revenues from private / other	22%	22%	

Revenues from residents for 2002 were \$519.1 million, an increase of 136% over revenues from residents of \$219.7 million for 2001. This increase is attributable primarily to our lease of 31 communities on January 11, 2002, our acquisition of five communities on April 1, 2002, and the 15 communities we began to operate in October 2002. Revenues from residents at the communities we operated throughout 2002 and 2001 were \$227.4 million and \$219.7 million, respectively, an increase of 4%. This increase is due primarily to higher per diem charges to residents. About 39% of our revenues from residents in 2002 were received from Medicare and Medicaid, compared to 78% in 2001. This decrease is due largely to the 31 communities and other communities we leased or acquired during 2002, all of which are focused on services to residents who pay with private resources.

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Interest income increased by \$205,000 in 2002 from \$297,000 compared to \$92,000 in 2001 due to earnings on higher cash balances in the 2002 period.

Expenses for 2002 were \$529.6 million, an increase of 142% over expenses of \$218.4 million for 2001. Our wages and benefits costs increased from \$153.4 million to \$274.2 million, or 78%, primarily due to expenses at the 51 communities we leased or acquired in 2002. Other operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, rose from \$48.0 million to \$143.1 million or 198%, again primarily due to expenses at the 51 communities we leased or acquired in 2002. During 2001, neither Marriott nor Sunrise managed any communities for us and we were a subsidiary of Senior Housing that did not lease any communities. As a result, we did not incur management fees or rent expense in 2001. Community level operating expenses related to the communities we operated throughout 2002 and 2001, were \$210.6 million and \$201.5 million, respectively, an increase of 5%. This increase is principally attributable to higher insurance premiums, an increase in reserves for the self funded portion of our insurance programs and higher wage and benefit costs, which were partially offset by a decrease in expenses from our reduced use of higher cost, third party staffing.

Our general and administrative expenses for 2002 were \$15.4 million, a decrease of 1% over 2001, primarily due to operational start up costs incurred during 2001 which we did not incur in 2002 and which were only partially offset by increased costs in 2002 associated with operating as a separate, publicly owned company and the legal and other costs incurred in connection with our litigation with Marriott.

Depreciation expense in 2002 was \$1.8 million, an increase of 38% over depreciation expense of \$1.3 million in 2001. The increase is attributable to our purchase of 11 communities in 2002.

Loss from discontinued operations for 2002 was \$2.9 million, an increase of \$2.0 million over the loss in 2001. This increase was the result of reserves recorded for Medicaid receivables due from the State of Connecticut related to community closure costs and an asset impairment charge related to a closed community.

As a result of the factors described above, our net loss for 2002 was \$13.2 million, compared to a profit of \$527,000 in 2001. Our net loss per share in 2002 was \$1.74. Assuming the shares outstanding as of December 31, 2001 were outstanding for all of 2001, our earnings per share would have been \$0.12 for 2001.

LIQUIDITY AND CAPITAL RESOURCES

Our total current assets at September 30, 2004 were \$64.0 million, compared to \$56.1 million at December 31, 2003 and \$48.3 million at December 31, 2002. At September 30, 2004 and December 31, 2003, we had cash and cash equivalents of \$18.6 million and \$17.6 million, respectively.

Our total current liabilities were \$50.2 million at September 30, 2004, compared to \$58.1 million at December 31, 2003 and \$34.4 million at December 31, 2002. The decrease from December 31, 2003 to September 30, 2004 was due primarily to our repayment of amounts outstanding under our revolving credit facility and the payment of amounts due to Sunrise during the nine months ended September 30, 2004. The increase from 2002 to 2003 was due to several factors. At December 31, 2003, we had \$4.0 million outstanding under our revolving credit facility and there were no such outstanding amounts at December 31, 2002. At December 31, 2003, we owed Senior Housing \$6.6 million primarily related

to our lease obligations, while at December 31, 2002 no amounts were owed. This amount was paid in January 2004. In addition, our accounts payable and accrued expenses

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and our accrued compensation and benefits increased between December 31, 2002 and December 31, 2003, primarily due to a change in the timing of payment of certain current liabilities at the Sunrise managed communities as well as increases in our insurance reserves. Finally, the increase in amounts between December 31, 2002 and December 31, 2003 due to Sunrise was primarily due to Sunrise's failure to transfer cash amounts due to them on a timely basis.

As described in Note 1 to our audited financial statements, in 2003, information became available to us which resulted in \$7.2 million of additional paid in capital. This amount was the result of our having received more working capital assets and having assumed fewer liabilities than we had previously recorded at the time of our spin off from Senior Housing.

We lease 128 communities from Senior Housing under four leases. Our leases with Senior Housing require us to pay a total of \$95.3 million of minimum rent annually. Percentage rent on the leases begins in 2006. We believe we are in compliance with the terms of these leases.

Our revenues from services to residents at our communities is the primary source of cash to fund operating expenses, including rent, principal and interest payments on our mortgage debt and capital expenditures. At some of our communities, operating revenues for nursing home services are received from the Medicare and Medicaid programs. For the nine months ended September 30, 2004, 43% of our total revenues were derived from these programs. In 2003, 39% of our total revenues were derived from these programs. Medicare and Medicaid revenues were earned primarily from the 51 nursing home communities we lease from Senior Housing. Since 1998, a Medicare prospective payment system has generally lowered Medicare rates paid to senior living communities, including many of those that we operate. In October 2002, temporary increases in Medicare payment rates expired. In October 2003, Medicare rates increased by approximately 6%. Our Medicare revenues totaled \$68.3 million during the first nine months of 2004 and \$86.1 million and \$68.4 million during 2003 and 2002, respectively. Our Medicaid revenues totaled \$110.4 million during the first nine months of 2004 and \$148.6 million and \$142.6 million during 2003 and 2002, respectively. Some of the states in which we operate have not raised rates by amounts sufficient to offset increasing costs or are expected to reduce Medicaid funding. The magnitude of the potential Medicaid rate reductions cannot currently be estimated, but it may be material and may affect our future results of operations. Further Medicare and Medicaid rates declines may have a dramatic negative impact on our revenues and may produce greater losses.

Recent increases in the costs of insurance, especially tort liability insurance, workers compensation and employee health insurance, which are affecting the senior living industry, may continue to have an adverse impact upon our future results of operations. As discussed in Note 15 to our audited financial statements and note 7 to our unaudited financial statements, a failure by Integrated Health Services, Inc. or the United States Department of Health and Human Services to make payments that we believe are due to us would have a material adverse impact upon our future results. Also, we believe Marriott's sale of its senior living management business to Sunrise has had, and may continue to have, an adverse impact on our financial results and has increased, and may continued to increase, our working capital requirements.

Also, prior to June 2004, pursuant to existing contract terms, a portion of our management fees payable to Sunrise were conditional, based on exceeding a threshold of net operating income that was not achieved and therefore was not being paid. As of July 2004, this portion of the management fee is no longer conditional and we will now be required to pay the full fee. We expect the annual amount of this additional management fee to be approximately \$3.0 million per year. We expect improvements in our operations will offset this increased cost, but we can not be assured that our efforts in this regard will be successful.

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Our revolving credit facility limits our ability to incur debt as more fully described below in "Debt Instruments and Covenants". The terms of our leases with Senior Housing contain provisions whereby Senior Housing may cancel our rights under these agreements upon the acquisition by any person or group of more than 9.8% of our voting stock, and upon other change of control events. These leases also limit our ability to create, incur, assume or guarantee indebtedness.

In August 2003, we sold a community in Bloomfield, Connecticut for \$3.5 million, \$3.15 million of which was in the form of a promissory note from the purchaser. This note is payable in monthly installments of \$8,750 of principal, plus interest which accrues on the unpaid principal balance at a rate of 8% per year. This note matures on August 26, 2009, but we have the right to require prepayment as of August 31, 2008.

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In December 2003, we sold group homes in Maryland for \$3.55 million, \$3.11 million of which was in the form of a promissory note from the purchaser. This note is payable in monthly installments of \$1,700 of principal, plus interest which accrues on the unpaid principal balance at a rate of 9%. This note matures November 30, 2018, but we have the right to require prepayment earlier by giving notice after November 30, 2009.

During 2003, Senior Housing agreed to sell us two nursing homes in Michigan that we leased from Senior Housing. The purchase price is \$10.5 million, the appraised value of the properties. On April 19, 2004, we purchased one of these properties from Senior Housing for \$5.9 million. We financed this acquisition with proceeds we received from a new HUD insured mortgage and by using cash on hand. We expect the second purchase to occur in the fourth quarter of 2004 and we intend to finance the second sale with proceeds that we receive from a second HUD insured mortgage and with available cash. The remaining property is still leased from Senior Housing on a combined basis with 65 other properties. Under the terms of our lease with Senior Housing, upon completion of the sale, the annual rent payable under the combined lease is reduced by 10% of the sale prices we pay to Senior Housing.

On August 9, 2004, we entered into an agreement to acquire an institutional pharmacy located in Nebraska that services 24 senior living communities with approximately 1,450 beds for approximately \$3.0 million. This acquisition was completed on September 1, 2004.

Despite the commitments, contingencies and limitations described above, we believe that a combination of our efforts to increase revenues and contain costs, our ability to borrow on our revolving credit facility, our ability to sell to Senior Housing certain capital improvements made to communities leased from Senior Housing and the possibility of sales or financings of our owned communities will be sufficient to meet our working capital needs, operating expenses, rent payments to Senior Housing, debt service and capital expenditures for the next 12 months and the foreseeable future.

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As of September 30, 2004, our contractual obligations were as follows (dollars in thousands):

Contractual obligations	Payment due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt obligations ⁽¹⁾	\$ 4,947	\$ 48	\$ 103	\$ 124	\$ 4,672
Operating lease obligations ⁽²⁾	1,080,216	82,200	164,401	164,401	669,214
Purchase obligations ⁽³⁾	216,500	216,500			
Other long-term liabilities reflected on our balance sheet under GAAP ⁽⁴⁾	25,157	5,402	9,636	6,372	3,747
Total	\$ 1,326,820	\$ 304,150	\$ 174,140	\$ 170,897	\$ 677,633

- (1) This amount represents amounts due under a HUD insured mortgage.
- (2) These amounts represent minimum lease payments due to Senior Housing through 2017 and 2020.
- (3) This amount represents the estimated purchase price of LTA, including estimated changes in LTA's working capital and estimated closing costs, as of September 30, 2004, and our agreement to acquire a property from Senior Housing. The LTA acquisition closed on November 19, 2004.
- (4) These amounts include liabilities for continuing care contracts which require residents to make advance payments some of which are refundable and continuously carried as liabilities and some of which are not refundable and are carried as liabilities until they are recognized as revenues over the periods during which we expect to provide the service. These amounts also include insurance reserves related to workers compensation and professional liability insurance as well as deferred gains related to property sales.

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DEBT INSTRUMENTS AND COVENANTS

In October 2002, we entered into a revolving credit facility. The interest rate on borrowings on this facility is LIBOR plus a spread. The maximum amount available under this facility is \$12.5 million, and is subject to limitations based upon qualifying collateral. The borrower under this facility is a subsidiary that we organized with the intention that it be "bankruptcy-remote". Certain of our other subsidiaries sell or contribute their accounts receivable to the borrower on a true sale basis and make certain representations and other undertakings in favor of the borrower in connection with each sale. The seller subsidiaries have granted security interests in their assets to secure their obligations to the borrower. We guarantee the seller subsidiaries' obligations to the borrower subsidiary and have pledged the stock or membership interests in each of the seller subsidiaries to the borrower. The borrower has in turn collaterally assigned these undertakings, guarantees and collateral to the revolving credit facility lenders, and has granted a security interest in the purchased receivables and all of its other assets to secure its obligations under the facility. The facility is available for acquisitions, working capital and general business purposes. The facility contains covenants and events of default requiring the maintenance of collateral, minimum net worth and certain other financial ratios, and places limits on our ability to incur or assume debt or create liens with respect to certain of our properties, and other customary provisions. The accounts receivable collateralizing the facility totaled approximately \$20.0 million, net of allowances of \$1.5 million, as of September 30, 2004. In certain circumstances and subject to available collateral and lender approvals, the maximum amounts which we may draw under this credit agreement may be increased to \$25.0 million. The termination date of the facility is October 24, 2005. As of September 30, 2004, no amounts were, and currently no amounts are, outstanding under the facility. We believe we are in compliance with all applicable covenants under the credit agreement.

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As described above, on April 19, 2004, we purchased a property from Senior Housing for \$5.9 million. We financed this acquisition with \$5.0 million in proceeds we received from a new HUD insured mortgage and by using cash on hand. The interest cost on this debt is 5.6% per year. Principal and interest is due monthly through April 2039. This mortgage contains standard HUD mortgage covenants. We believe we are in compliance with all material covenants of this mortgage.

As part of the purchase price for our recent LTA acquisition, we assumed \$30.9 million of HUD insured mortgage debt. The interest cost on this debt is a weighted average rate of 7.4% per year. Principal and interest is due monthly through varying dates ranging from February 2032 to June 2039. These mortgages are secured by seven of our communities and contain standard HUD mortgage covenants. We believe we are in compliance with all material covenants of these mortgages.

As described above, in connection with our recent LTA acquisition, we borrowed \$16.8 million from Senior Housing. This loan is secured by mortgages on five of our communities, bears interest at a rate of 9.0% per year and matures on May 2, 2005. We intend to use a portion of the net proceeds from this offering to repay this loan. We believe we are in compliance with all material covenants of this mortgage.

OFF-BALANCE SHEET ARRANGEMENTS

We have no off-balance sheet arrangements as defined in Regulation S-K 303(a)(4)(ii).

RELATED PARTY TRANSACTIONS

On December 31, 2001, Senior Housing distributed substantially all of its ownership of our shares to its shareholders. In order to effect this spin off and to govern relations after the spin off, we entered into agreements with Senior Housing, pursuant to which it was agreed, among other things, that:

- > so long as Senior Housing remains a REIT, we may not waive the share ownership restrictions in our charter on the ability of any person or group to acquire more than 9.8% of any class of our equity shares without, among other requirements, the consent of Senior Housing and our determination that the exception to the ownership limitations would not cause a default under any of our leases;
- > so long as we are a tenant of Senior Housing, we will neither permit any person or group to acquire more than 9.8% of any class of our voting stock or permit the occurrence of other change in control events, as defined, nor will we take any action that, in the reasonable judgment of Senior Housing or HRPT Properties Trust (another REIT which owns shares of Senior Housing), or HRPT, might

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jeopardize the tax status of Senior Housing or HRPT as a REIT;

- > Senior Housing has the option, upon the acquisition by a person or group of more than 9.8% of our voting stock and upon other change in control events, as defined, to cancel all of our rights under the leases we have with Senior Housing; and
- > so long as we maintain our shared services agreement with RMR or are a tenant under a lease with Senior Housing then we will not acquire or finance any real estate without first giving Senior Housing, HRPT, Hospitality Properties Trust, or HPT, or any other publicly owned REIT or other entity managed by RMR the opportunity to acquire or finance real estate investments of the type in which Senior Housing, HRPT, HPT or any other publicly owned REIT or other entity managed by RMR, respectively, invest.

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At the time of our spin off from Senior Housing, all of the persons serving as our directors were trustees of Senior Housing. Two of our current directors, Messrs. Martin and Portnoy, are current managing trustees of Senior Housing.

One hundred twenty eight of the 160 senior living communities we currently operate are leased from Senior Housing for total annual minimum rent of \$95.3 million.

During 2003, we and Senior Housing were jointly involved in litigation with Marriott, the operator of the senior living communities which we leased from Senior Housing. We and Senior Housing equally shared the costs of this litigation. This litigation was settled in January 2004.

Since we became a separate public company we have had and continue to have extensive business dealings with Senior Housing. Since January 1, 2002, we have entered into or agreed to enter into several transactions with Senior Housing, including the following:

- > During 2002, we acquired seven senior living communities from a third party for \$27 million. Prior to this acquisition Senior Housing waived its right to acquire these assets, subject to a continuing right to acquire or finance these assets in the event we determine to sell or finance them. To finance the cash portion of our purchase, we sold a senior living community to Senior Housing, which we purchased in April 2002, for \$12.7 million, its approximate carrying value. Simultaneous with our acquisition, Senior Housing acquired eight other senior living communities from the same third party. We acquired operating assets and liabilities related to these eight communities. We began to lease these eight communities and the community we sold to Senior Housing for minimum annual rent of \$6.3 million. The terms of this transaction with Senior Housing were negotiated on our behalf by our independent director who is not on the board of Senior Housing.
- > During 2002, we acquired FSQ, Inc., an entity owned by Messrs. Martin and Portnoy, in a merger transaction that was entered into as part of our spin off from Senior Housing. We acquired all of the stock of FSQ, Inc. and Messrs. Martin and Portnoy each received 125,000 of our common shares. The board of trustees of Senior Housing received an opinion from an internationally recognized investment banking firm, to the effect that the merger was fair, from a financial point of view, to us. The terms of this merger were approved by Senior Housing's trustees other than Messrs. Martin and Portnoy.
- > During 2003, pursuant to the terms of our leases with Senior Housing, Senior Housing purchased \$11.4 million of improvements to its properties leased by us, and the annual rent payable to Senior Housing was increased by 10% of the amounts invested, or \$1.1 million.
- > In May 2003, Senior Housing purchased from an unrelated third party three assisted living properties with 143 living units located in Virginia for \$6.5 million. In September 2003, we sold to Senior Housing one independent living property with 164 units in California for \$12.3 million, its appraised value. These four properties were added to an existing lease with Senior Housing for nine other independent and assisted living properties. The minimum rent for the properties included in this lease was increased by \$1.9 million per year. All other terms of the lease remained unchanged.
- > In July 2003, we agreed to buy two nursing homes in Michigan that we leased from Senior Housing. The purchase price is \$10.5 million, the appraised value of the properties. One of these purchases for \$5.9 million closed on April 19, 2004 and we expect the second sale to close in the fourth of quarter 2004, which is contingent on our obtaining HUD insured financing for the property. The remaining property is still leased from Senior Housing on a combined basis with other nursing home properties. Under the terms

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of our lease with Senior Housing, upon completion of the sale, the annual rent payable under the combined lease is reduced by 10% of the net proceeds that Senior Housing received from the sale.

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- > On March 1, 2004, Senior Housing purchased from us one independent and assisted living community with 229 units located in Maryland. The purchase price was \$24.1 million, the appraised value of the property. Simultaneous with this purchase, our existing leases with Senior Housing were modified as follows:
 - > the lease for 53 nursing homes and the lease for 13 independent and assisted living communities were combined into one lease and the property acquired on March 1, 2004 was added to this combined lease;
 - > the combined lease maturity date was changed to December 31, 2020 from December 31, 2018 and 2019 for the separate leases;
 - > our minimum rent for the combined lease of 53 nursing homes and 14 independent living communities was increased by \$2.4 million per year;
 - > for all of our leases with Senior Housing, the amount of additional rent to be paid to Senior Housing was changed to 4% of the increase in revenues at the leased properties beginning in 2006. Prior to the lease combination, the percentage and the beginning time period for the nursing home lease and the independent and assisted living community lease was 3% and 2004 and 4% and 2005, respectively; and
 - > all other lease terms remain substantially unchanged.
- > In 2003, Senior Housing evicted a nursing home tenant that had defaulted on its obligations to Senior Housing. Until May 2004, we managed this nursing home for Senior Housing's account. Effective on May 1, 2004, we agreed with Senior Housing to add this nursing home to a multi-property lease from Senior Housing and to increase the annual rent by \$180,000. All other lease terms remained unchanged.
- > One of the properties we lease from Senior Housing was subject to a ground lease with an unaffiliated third party. We are responsible for paying the ground rent of \$307,000 per year. On June 3, 2004, Senior Housing exercised an option to purchase this land for \$3.6 million and acquired the landlord's rights and obligations under the ground lease. We now pay the ground rent to Senior Housing.
- > On November 18, 2004, Senior Housing loaned us \$117.0 million in connection with our acquisition of LTA. Such loan was repaid on November 19, 2004 with the proceeds we received from a \$148.2 million sale leaseback with Senior Housing for 31 of the 47 acquired communities and a \$16.8 million mortgage loan from Senior Housing secured by five of our communities.
- > During 2004, pursuant to the terms of our leases with Senior Housing, we sold to Senior Housing \$6.5 million of improvements we had made to its properties, and our annual rent payable to Senior Housing was increased by 10% of Senior Housing's purchase price amounts invested, or \$646,000.

We obtained a workers compensation insurance policy for the year beginning June 15, 2003, from a third-party insurer. This third-party insurer ceded a portion of the premiums we paid to a Bermuda based company, Affiliates Insurers, Limited, or Affiliates, which was owned by RMR. Affiliates was organized by RMR to assist us in creating a partial self insurance program on an expedited basis. On December 8, 2003, we acquired Affiliates from RMR for an amount equal to RMR's cost of organizing and capitalizing that company, approximately \$1.3 million.

Our Chief Executive Officer and Chief Financial Officer are also officers and employees of RMR. These officers devote a substantial majority of their business time to our affairs and the remainder to RMR's business which is separate from our business. We believe the compensation we pay to these

officers reasonably reflects their division of business time; however, periodically, these individuals may divide their business time differently than they do currently and their compensation from us may become disproportionate to this division.

RMR provides investment, management and administrative services to us under a shared services agreement. RMR is compensated at an annual rate equal to 0.6% of our total revenues. Aggregate fees earned by RMR for services during 2002 and 2003 and in 2004 through September 30, were \$2.9 million, \$3.4 million and \$2.7 million, respectively. The fact that RMR has responsibilities to other entities, including one of our landlords, Senior Housing, could create conflicts; and in the event of such conflicts between Senior Housing and us, the shared services agreement allows RMR to act on behalf of Senior Housing rather than on our behalf. RMR is owned by Messrs. Martin and Portnoy who are our managing directors. Messrs. Martin and Portnoy each have material interests in the transactions between us and RMR described above. All transactions between us and RMR are approved by our independent directors. Our independent directors have approved the renewal of the shared services agreement for its current term which will end December 31, 2004.

Messrs. Martin and Portnoy own the building in which our headquarters is located. Our lease for space was originally executed by FSQ, Inc. This lease expires in 2011. We paid rent under this lease during 2002 and 2003 and for the nine month period ending September 30, 2004 of \$539,000, \$569,000 and \$423,000 respectively.

Until March 31, 1997, Mr. Portnoy was a partner of Sullivan & Worcester LLP, our counsel and counsel to Senior Housing, RMR and affiliates of each of the foregoing, and he received payments from that firm during 2002, 2003 and 2004 in respect of his retirement.

Wells Fargo & Company beneficially owns 9.8% of our common shares. Wells Fargo Bank, N.A., an affiliate of Wells Fargo & Company, will become the transfer agent and registrar for our common shares effective as of December 13, 2004.

CRITICAL ACCOUNTING POLICIES

Our critical accounting policies concern revenue recognition, our assessment of the net realizable value of our accounts receivable, the realizable value of long term assets, accounting for long term care contracts, accounting for business combinations and our assessment of reserves related to our self insurance programs.

Our revenue recognition policies involve judgments about Medicare and Medicaid rate calculation. These judgments are based principally upon our experience with these programs and our knowledge and familiarity with the current rules and regulations of these programs. We recognize revenues when services are provided and these amounts are reported at their estimated net realizable amounts. Some Medicare and Medicaid revenues are subject to audit and retroactive adjustment.

Our policies for valuing accounts receivable involve significant judgments based upon our experience, including consideration of the age of the receivable, the terms of the agreements with our residents or their third party payors, the residents, or payors, stated intent to pay, the residents, or payors, financial capacity and other factors which may include litigation or appeal proceedings.

We monitor our long-term assets to determine whether any impairment of these assets may have occurred. If the facts and circumstances indicate that an impairment may have occurred, we evaluate the asset's carrying value to determine whether an impairment charge is appropriate. This process includes a review of historical and projected future financial results realized or to be realized from the affected asset, market conditions affecting the sale of similar assets and the like. This process requires that estimates be made and errors in our judgments or estimates could have a material effect on our financial statements.

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At certain of our communities, we offer long-term care contracts under which residents pay a one time amount in exchange for reduced charges during their stay. The one time amount may be refundable or non-refundable, or partially refundable and partially non-refundable. We record such amounts as a long term obligation and amortize the non-refundable portion of such amounts into revenue over our estimate of the periods during which future services will be provided. We base these estimates on our experience and actuarial information.

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Since we became a separate public company, each of our acquisitions has been accounted for as a purchase business combination in accordance with Statement of Financial Accounting Standards No. 141. Purchase accounting requires that we make certain judgments and estimates based on our experience, including determining the fair value and useful lives of assets a