

CAPITAL SENIOR LIVING CORP

Form 10-Q

November 05, 2008

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Form 10-Q**

**(Mark One)**

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

**For the quarterly period ended September 30, 2008**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 1-13445**

**Capital Senior Living Corporation**

*(Exact Name of Registrant as Specified in its Charter)*

**Delaware**

*(State or Other Jurisdiction of  
Incorporation or Organization)*

**75-2678809**

*(I.R.S. Employer  
Identification No.)*

**14160 Dallas Parkway, Suite 300, Dallas, Texas**

*(Address of Principal Executive Offices)*

**75254**

*(Zip Code)*

**(972) 770-5600**

*(Registrant's Telephone Number, Including Area Code)*

**NONE**

*(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)*

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

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

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

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

As of November 3, 2008, the Registrant had 26,681,319, outstanding shares of its Common Stock, \$0.01 par value.

**CAPITAL SENIOR LIVING CORPORATION  
INDEX**

	<b>Page Number</b>
<b><u>Part I. Financial Information</u></b>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated Balance Sheets – September 30, 2008 and December 31, 2007</u>	3
<u>Consolidated Statements of Operations – Three and Nine Months Ended September 30, 2008 and 2007</u>	4
<u>Consolidated Statements of Cash Flows – Nine Months Ended September 30, 2008 and 2007</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	12
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	21
<u>Item 4. Controls and Procedures</u>	21
<b><u>Part II. Other Information</u></b>	
<u>Item 1. Legal Proceedings</u>	21
<u>Item 1A. Risk Factors</u>	22
<u>Item 6. Exhibits</u>	27
<u>Signature</u>	
Certifications	
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	

**Table of Contents****Part I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS**

**CAPITAL SENIOR LIVING CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands)

	<b>September 30, 2008 (unaudited)</b>	<b>December 31, 2007</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 28,047	\$ 23,359
Accounts receivable, net	5,018	3,232
Accounts receivable from affiliates	1,426	846
Federal and state income taxes receivable	878	2,084
Deferred taxes	960	996
Assets held for sale	354	1,011
Property tax and insurance deposits	8,771	7,860
Prepaid expenses and other	2,396	4,526
Total current assets	47,850	43,914
Property and equipment, net	306,672	310,442
Deferred taxes	12,143	12,824
Investments in limited partnerships	7,243	6,199
Other assets, net	15,822	16,674
Total assets	\$ 389,730	\$ 390,053
 <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,836	\$ 1,201
Accrued expenses	13,236	13,561
Current portion of notes payable	12,803	9,035
Current portion of deferred income	5,715	5,174
Customer deposits	1,720	2,024
Total current liabilities	35,310	30,995
Deferred income	20,834	23,168
Notes payable, net of current portion	178,444	185,733
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$.01 par value:		
Authorized shares 15,000; no shares issued or outstanding		
Common stock, \$.01 par value:		
Authorized shares 65,000; issued and outstanding shares 26,681 and 26,596 in 2008 and 2007, respectively	267	266
Additional paid-in capital	130,205	129,159

Edgar Filing: CAPITAL SENIOR LIVING CORP - Form 10-Q

Retained earnings	24,670	20,732
Total shareholders' equity	155,142	150,157
Total liabilities and shareholders' equity	\$ 389,730	\$ 390,053

See accompanying notes to consolidated financial statements.

3

---

**Table of Contents**

**CAPITAL SENIOR LIVING CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(unaudited, in thousands, except per share data)

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Revenues:				
Resident and health care revenue	\$ 43,224	\$ 41,910	\$ 128,795	\$ 124,842
Unaffiliated management services revenue	52	778	140	939
Affiliated management services revenue	1,011	864	4,180	2,035
Community reimbursement revenue	3,430	4,206	12,151	13,049
<b>Total revenues</b>	<b>47,717</b>	<b>47,758</b>	<b>145,266</b>	<b>140,865</b>
Expenses:				
Operating expenses (exclusive of facility lease expense and depreciation and amortization expense shown below)	27,320	26,344	80,191	77,263
General and administrative expenses	2,405	2,880	9,733	9,180
Facility lease expense	6,319	6,037	18,774	17,754
Stock-based compensation expense	293	283	786	763
Depreciation and amortization	3,143	2,835	9,258	8,361
Community reimbursement expense	3,430	4,206	12,151	13,049
<b>Total expenses</b>	<b>42,910</b>	<b>42,585</b>	<b>130,893</b>	<b>126,370</b>
Income from operations	4,807	5,173	14,373	14,495
Other income (expense):				
Interest income	140	154	363	509
Interest expense	(3,066)	(3,160)	(9,172)	(9,615)
(Loss) gain on sale of assets		(8)	596	74
Write-off of deferred loan costs				(538)
Other income (expense)	75	(8)	227	(61)
Income before provision for income taxes	1,956	2,151	6,387	4,864
Provision for income taxes	(754)	(784)	(2,449)	(1,807)
<b>Net income</b>	<b>\$ 1,202</b>	<b>\$ 1,367</b>	<b>\$ 3,938</b>	<b>\$ 3,057</b>
Per share data:				
Basic net income per share	\$ 0.05	\$ 0.05	\$ 0.15	\$ 0.12
Diluted net income per share	\$ 0.05	\$ 0.05	\$ 0.15	\$ 0.11
Weighted average shares outstanding basic	26,396	26,201	26,362	26,177
Weighted average shares outstanding diluted	26,705	26,593	26,667	26,641

See accompanying notes to consolidated financial statements.



**Table of Contents**

**CAPITAL SENIOR LIVING CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(unaudited, in thousands)

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating Activities</b>		
Net income	\$ 3,938	\$ 3,057
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	9,239	8,325
Amortization	19	36
Amortization of deferred financing charges	253	300
Amortization of deferred lease costs	275	258
Amortization of imputed interest	145	136
Deferred income	(1,743)	(2,376)
Deferred income taxes	717	1,629
Equity in the earnings of unconsolidated affiliates	(227)	61
Gain on sale of assets	(730)	(74)
Provision for bad debts	337	106
Write-off of deferred loan costs		538
Write-down of assets held for sale	134	
Reduction of contingent note payable		(340)
Stock based compensation expense	786	763
Changes in operating assets and liabilities:		
Accounts receivable	(2,123)	302
Accounts receivable from affiliates	(580)	311
Property tax and insurance deposits	(911)	(827)
Prepaid expenses and other	2,130	(1,780)
Other assets	305	927
Accounts payable	635	(410)
Accrued expenses	(325)	106
Federal and state income taxes receivable/payable	1,206	(2,003)
Customer deposits	(304)	(349)
Net cash provided by operating activities	13,176	8,696
<b>Investing Activities</b>		
Capital expenditures	(5,663)	(5,228)
Proceeds from the sale of assets	1,397	1,423
Net investment in limited partnerships	(817)	(421)
Net cash used in investing activities	(5,083)	(4,226)
<b>Financing Activities</b>		
Proceeds from notes payable	1,474	44,025
Repayments of notes payable	(5,140)	(49,675)
Cash proceeds from the issuance of common stock	231	278
Excess tax benefits on stock options exercised	30	127
Cash received to settle interest rate lock agreement		60
Deferred financing charges paid		(860)



Net cash used in financing activities	(3,405)	(6,045)
Increase (decrease) in cash and cash equivalents	4,688	(1,575)
Cash and cash equivalents at beginning of period	23,359	25,569
Cash and cash equivalents at end of period	\$ 28,047	\$ 23,994
<b>Supplemental Disclosures</b>		
Cash paid during the period for:		
Interest	\$ 8,790	\$ 9,322
Income taxes	\$ 1,599	\$ 2,283

See accompanying notes to consolidated financial statements.

**Table of Contents**

**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2008**

**1. BASIS OF PRESENTATION**

Capital Senior Living Corporation, a Delaware corporation (together with its subsidiaries, the Company), is one of the largest operators of senior living communities in the United States in terms of resident capacity. The Company owns, operates, develops and manages senior living communities throughout the United States. As of September 30, 2008, the Company operated 65 senior living communities in 23 states with an aggregate capacity of approximately 9,600 residents, including 38 senior living communities which the Company either owned or in which the Company had an ownership interest, 25 senior living communities that the Company leased and two senior living communities it managed for third parties. As of September 30, 2008, the Company also operated one home care agency. The accompanying consolidated financial statements include the financial statements of Capital Senior Living Corporation and its wholly owned subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation. The Company accounts for significant investments in unconsolidated companies, in which the Company has significant influence, using the equity method of accounting.

The accompanying consolidated balance sheet, as of December 31, 2007, has been derived from audited consolidated financial statements of the Company for the year ended December 31, 2007, and the accompanying unaudited consolidated financial statements, as of September 30, 2008 and 2007, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to those rules and regulations. For further information, refer to the financial statements and notes thereto for the year ended December 31, 2007 included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 12, 2008.

In the opinion of the Company, the accompanying consolidated financial statements contain all adjustments (all of which were normal recurring accruals) necessary to present fairly the Company's financial position as of September 30, 2008, results of operations for the three and nine months ended September 30, 2008 and 2007, respectively, and cash flows for the nine months ended September 30, 2008 and 2007. The results of operations for the three and nine months ended September 30, 2008 are not necessarily indicative of the results for the year ending December 31, 2008.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Investments in Joint Ventures*

The Company accounts for its investments in joint ventures under the equity method of accounting. The Company is the general partner in two partnerships and owns member interests in seven joint ventures. The Company has not consolidated these joint venture interests because the Company has concluded that the limited partners or the other members of each joint venture have substantive kick-out rights or substantive participating rights as defined in EITF Issue 04-05 *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights* (EITF 04-05). Under the equity method of accounting the Company records its investments in joint ventures at cost and adjusts such investment for its share of earnings and losses of the joint venture.

*Development Guarantees*

The Company, on three joint venture developments, has guarantees that the communities will be completed at budgeted costs approved by the joint venture members. These costs include the hard and soft construction costs and operating costs until each community reaches breakeven. The budgeted costs include contingency reserves for potential costs overruns and other unforeseen costs. In addition, each of these joint ventures has entered into a guaranteed fixed price construction contract with the general contractor on each of the developments. The Company would be required to fund these guarantees if the actual development costs incurred by the joint venture exceed the budgeted costs for the development. The terms of these guarantees generally do not provide for a limitation on the maximum potential future payments. The Company has not made any payments under these guarantees and currently does not expect to be required to make any payments under these guarantees.



**Table of Contents***Assets Held for Sale*

Assets are classified as held for sale when the Company has committed to selling the asset and believes that it will be disposed of within one year. The Company determines the fair value, net of costs of disposal, of an asset on the date the asset is categorized as held for sale, and the asset is recorded at the lower of its fair value, net of cost of disposal, or carrying value on that date. The Company periodically reevaluates assets held for sale to determine if the assets are still recorded at the lower of fair value, net of cost of disposal, or carrying value. The fair value of properties are generally determined based on market rates, industry trends and recent comparable sales transactions. The Company had one parcel of land, in Fort Wayne, Indiana, held for sale at September 30, 2008.

In March 2007, the Company sold one parcel of land located in Baton Rouge, Louisiana that had been classified as held for sale. The land parcel sold for \$0.5 million, net of closing costs, resulting in a gain on sale of approximately \$0.1 million.

In May 2007, the Company sold one parcel of land located in Miami Township, Ohio that had been classified as held for sale to a joint venture ( SHP III/CSL Miami ), which is owned 90% by Senior Housing Partners III LP ( SHP III ), a fund owned by Prudential Real Estate Investors ( Prudential ), and 10% by the Company, for \$0.6 million resulting in a loss on sale of approximately \$3,000. In addition, during the second quarter of fiscal 2007, management reclassified a parcel of land in Carmichael, California to held for sale. The Company estimated on the date of reclassification that the fair value of the land parcel exceeded its carrying value of \$0.5 million. In February 2008, the Company sold the parcel of land located in Carmichael, California for \$1.2 million, net of closing costs, resulting in a gain on sale of approximately \$0.6 million.

In November 2007, the Company sold one parcel of land located in Richmond Heights, Ohio that had been classified as held for sale to a joint venture ( SHP III/CSL Richmond Heights ) which is owned 90% by SHP III and 10% by the Company, for \$0.8 million resulting in a gain on sale of approximately \$0.3 million, which has been deferred and will be recognized into income over the period required to construct and stabilize the senior living community.

During the first quarter of fiscal 2008, the Company recorded a write-down of approximately \$0.1 million on the remaining parcel of land, in Fort Wayne, Indiana, held for sale.

The Company estimates that the parcel of land held for sale at September 30, 2008 had an aggregate fair value, net of costs of disposal, that exceeds its carrying value of \$0.4 million. The amount that the Company will ultimately realize on the parcel of land could differ materially from this estimate.

*Lease Accounting*

The Company determines whether to account for its leases as either operating, capital or financing leases depending on the underlying terms of the lease agreement. This determination of classification is complex and requires significant judgment relating to certain information including the estimated fair value and remaining economic life of the community, the Company's cost of funds, minimum lease payments and other lease terms. As of September 30, 2008, the Company leased 25 communities and classified each of the leases as an operating lease. The Company incurs lease acquisition costs and amortizes these costs over the term of the lease agreement. Certain leases entered into by the Company qualified as sale/leaseback transactions under the provisions of Financial Accounting Standard No. 98 Accounting for Leases ( FAS 98 ) and as such any related gains have been deferred and are being amortized over the lease term.

Facility lease expense in the Company's statement of operations includes rent expense plus amortization expense relating to leasehold acquisition costs offset by the amortization of deferred gains.

*Income Taxes*

The Company accounts for income taxes under the provision of SFAS No. 109, Accounting for Income Taxes ( FAS 109 ). Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. At September 30, 2008, the Company had recorded on its consolidated balance sheet deferred tax assets of \$13.1 million. Management regularly evaluates the future realization of deferred tax assets and provides a valuation allowance, if considered necessary, based on such evaluation. As part of that evaluation, management has evaluated future expectations of net income. However, the benefits of the net deferred tax asset might not be realized if actual results differ from expectations. The Company believes that based upon this analysis that the realization of the net deferred tax asset is

reasonably assured and therefore has not provided for a valuation allowance.

7

---

**Table of Contents**

The Company accounts for uncertain tax positions under the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 ( FIN 48 ). This standard clarifies the accounting for income tax benefits that are uncertain in nature. Under FIN 48, the Company is required to recognize a tax benefit in its financial statements for an uncertain tax position only if management's assessment is that its position is more likely than not (i.e., a greater than 50 percent likelihood) to be upheld on audit based only on the technical merits of the tax position. FIN 48 also provides guidance on thresholds, measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition that is intended to provide better financial-statement comparability among different companies. The Company's policy is to recognize interest related to unrecognized tax benefits as interest expense and penalties as income tax expense. The Company is not subject to income tax examinations for tax years prior to 2004.

*Net Income Per Share*

Basic net income per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share considers the dilutive effect of outstanding options and non-vested stock calculated using the treasury stock method.

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Net income	\$ 1,202	\$ 1,367	\$ 3,938	\$ 3,057
Weighted average shares outstanding basic	26,396	26,201	26,362	26,177
Effects of dilutive securities:				
Employee equity compensation plans	309	392	305	464
Weighted average shares outstanding diluted	26,705	26,593	26,667	26,641
Basic income per share	\$ 0.05	\$ 0.05	\$ 0.15	\$ 0.12
Diluted income per share	\$ 0.05	\$ 0.05	\$ 0.15	\$ 0.11

*Reclassifications*

Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications include reclassifying the amortization of deferred gains on sale leaseback transactions from gain on sale of assets to facility lease expense to better conform with industry practice.

**3. TRANSACTIONS WITH AFFILIATES***SHPII/CSL*

The Company accounts for its investment in a series of four joint ventures (collectively SHPII/CSL ) under the equity method of accounting and the Company recognized earnings in the equity of SHPII/CSL of \$0.2 million in each of the nine months ended September 30, 2008 and 2007. In addition, the Company earned \$0.9 million in management fees on the four senior living communities owned by SHPII/CSL (the Spring Meadows Communities ) in each of the nine months ended September 30, 2008 and 2007.

*SHPIII/CSL Miami*

In May 2007, the Company and SHPIII entered into SHPIII/CSL Miami to develop a senior housing community in Miamisburg, Ohio. Under the joint venture and related agreements, the Company earns development and management fees and may receive incentive distributions. The senior housing community consists of 101 independent living units and 45 assisted living units and opened in August 2008. As of September 30, 2008, the Company had made capital contributions of \$0.8 million to the joint venture. The Company accounts for its investment in SHPIII/CSL Miami

under the equity method of accounting and the Company recognized a loss in the equity of SHPIII/CSL Miami of \$26,000 in the nine months ended September 30, 2008. During the first nine months of fiscal 2008 and 2007, the Company earned \$0.3 million and \$0.4 million, respectively, in development fees from SHPIII/CSL Miami. In addition, during the first nine months of fiscal 2008, the Company earned \$0.1 million in pre-marketing fees and \$25,000 in management fees on the community.

**Table of Contents***SHPIII/CSL Richmond Heights*

In November 2007, the Company and SHPIII entered into SHPIII/CSL Richmond Heights to develop a senior housing community in Richmond Heights, Ohio. Under the joint venture and related agreements, the Company will earn development and management fees and may receive incentive distributions. The senior housing community will consist of 97 independent living units and 45 assisted living units and is expected to open in the first quarter of 2009. As of September 30, 2008, the Company had made capital contributions of \$0.8 million to the joint venture. During the first nine months of fiscal 2008, the Company earned \$1.0 million in development fees from SHPIII/CSL Richmond Heights. In addition, during the first nine months of fiscal 2008, the Company earned \$25,000 in pre-marketing fees on the community.

*SHPIII/CSL Levis Commons*

In December 2007, the Company and SHPIII entered into SHPIII/CSL Levis Commons, LLC ( SHPIII/CSL Levis Commons ) to develop a senior housing community near Toledo, Ohio. Under the joint venture and related agreements, the Company will earn development and management fees and may receive incentive distributions. The senior housing community will consist of 101 independent living units and 45 assisted living units and is expected to open in the first quarter of 2009. As of September 30, 2008, the Company had made capital contributions of \$0.8 million to the joint venture. During the first nine months of fiscal 2008, the Company earned \$1.1 million in development fees from SHPIII/CSL Levis Commons. In addition, during the first nine months of fiscal 2008, the Company earned \$25,000 in pre-marketing fees on the community.

*Midwest I*

The Company accounts for its investment in Midwest Portfolio Holdings, LP ( Midwest I ) under the equity method of accounting and the Company recognized earnings in the equity of Midwest I of \$0.1 million in the first nine months of fiscal 2008 compared to a loss of \$23,000 in the first nine months of fiscal 2007. The Company earned \$0.4 million in management fees on the five communities owned by Midwest I in each of the nine months ended September 30, 2008 and 2007.

*Midwest II*

The Company accounts for its investment in Midwest Portfolio Holdings II, LP ( Midwest II ) under the equity method of accounting and the Company recognized a loss in the equity of Midwest II of \$0.1 million and \$0.2 million in the nine months ended September 30, 2008 and 2007, respectively. The Company earned \$0.4 million in management fees on the three communities owned by Midwest II in each of the nine months ended September 30, 2008 and 2007.

*BRE/CSL*

In March 2007, the Company received a final distribution from three joint ventures (collectively BRE/CSL ) of \$0.4 million relating to the sale of the six communities owned by BRE/CSL to Ventas Healthcare Properties, Inc. ( Ventas ). This distribution resulted in the recognition of an additional gain of \$0.4 million, which has been deferred and is being amortized in the Company's statement of operations as a reduction in facility rent expense over the remaining initial lease term.

**4. DEBT TRANSACTIONS / REFINANCINGS**

In May 2008, the Company financed \$1.5 million in insurance premiums at a fixed interest rate of 3.75%. The insurance loan will be repaid in 12 equal payments of principal and interest payments of approximately \$0.1 million. On May 3, 2007, the Company refinanced \$30.0 million of mortgage debt on four senior living communities with Federal National Mortgage Association ( Fannie Mae ). As part of the refinancing, the Company repaid approximately \$2.7 million of mortgage debt on the four communities. The new mortgage loans have a ten-year term with interest fixed at 5.91% and principal amortized over a 30-year term. The Company incurred \$0.5 million in deferred financing costs related to this loan, which is being amortized over ten years. In addition, as part of this refinancing, the Company wrote-off \$0.4 million in deferred loan costs. The new loans replaced \$32.7 million of variable rate debt with an effective interest rate of 7.6%.

On March 21, 2007, the Company refinanced \$9.5 million of mortgage debt on one of its senior living communities ( Gramercy Hill ) with Federal Home Loan Mortgage Corporation ( Freddie Mac ). As part of the refinancing, the Company received approximately \$2.1 million in cash proceeds, net of closing costs. The new mortgage loan has a ten-year term with a one-year extension available at the Company's option, interest fixed at 5.75% and requires interest



only payments in the first two years with principal amortized

9

---

**Table of Contents**

thereafter over a 25-year term. The Company incurred \$0.2 million in deferred financing costs related to this loan, which is being amortized over ten years. In addition, as part of this refinancing, the Company wrote-off \$13,000 in deferred loan costs and paid \$0.2 million in loan exit fees to the prior lender. The loan exit fees are a component of write-off of deferred loan costs in the accompanying statement of operations.

**5. NEW ACCOUNTING STANDARDS**

FASB Statement No. 157, Fair Value Measurements ( FAS 157 ) defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 does not require any new fair value measurements but would apply to assets and liabilities that are required to be recorded at fair value under other accounting standards. The Company adopted FAS 157 on January 1, 2008 and elected to defer the provisions of FAS 157 for its nonfinancial assets and liabilities. Under the provisions of FAS 157 nonfinancial assets and liabilities will be subject to the provisions of FAS 157 on January 1, 2009. The Company's adoption of FAS 157 did not have a material effect on the Company's financial statements.

FASB Statement No. 159, Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement 115 ( FAS 159 ) permits, but does not require, entities to measure many financial instruments, including liabilities and certain other items, at fair value with resulting changes in fair value reported in earnings. The Company has elected not to apply the fair value option to any of its financial instruments not already carried at fair value in accordance with other accounting standards, and therefore the adoption of FAS 159 did not impact the Company's consolidated financial statements.

FASB Statement No. 141(R) Business Combinations ( FAS 141(R) ) requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to disclose to investors and other users all of the information needed to evaluate and understand the nature and financial effect of the business combination. FAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The impact of FAS 141(R) on the Company's consolidated financial statements will depend upon the nature, terms and size of the acquisitions we consummate after the effective date.

FASB Staff Position ( FSP ) Emerging Issues Task Force ( EITF ) 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities ( FSP 03-6-1 ). FSP 03-6-1 clarifies that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of earnings per share under the two-class method described in SFAS No. 128, Earnings Per Share. This FSP is effective for us on January 1, 2009 and requires all presented prior-period earnings per share data to be adjusted retrospectively. The Company is still in the process of evaluating the impact FSP 03-6-1 will have on our Consolidated Financial Statements.

**6. STOCK-BASED COMPENSATION**

The Company accounts for share-based payments under the provisions of Statement of Financial Accounting Standards No. 123 (revised), Share-based Payment ( FAS 123R ), which requires all share-based payments to employees, including grants of employee stock options and awards of restricted stock to be recognized in the statement of operations based on their fair values. Under FAS 123R the Company recognizes compensation expense for share-based awards.

On May 8, 2007, the Company's shareholders approved the 2007 Omnibus Stock and Incentive Plan for Capital Senior Living Corporation (the 2007 Plan ) which provides for, among other things, the grant of restricted stock awards and stock options to purchase shares of the Company's common stock. The 2007 Plan authorizes the Company to issue up to 2.6 million shares of common stock and the Company has reserved 2.4 million shares of common stock for future issuance pursuant to awards under the 2007 Plan. Effective May 8, 2007, the 1997 Omnibus Stock and Incentive Plan (as amended, the 1997 Plan ) was terminated and no additional shares will be granted under the 1997 Plan. The Company has reserved 0.9 million shares of common stock for future issuance upon the exercise of outstanding stock options pursuant to the 1997 Plan.

**Table of Contents***Stock Options*

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

A summary of the Company's stock option activity and related information for the nine months ended September 30, 2008, is presented below:

	Outstanding at Beginning of	Granted	Exercised	Forfeited	Outstanding End of Period	Options Exercisable
Shares	937,334		38,000	4,000	895,334	893,834
Weighted average price	\$ 4.87	\$	\$ 6.06	\$ 3.69	\$ 4.83	\$ 4.83

The options outstanding and the options exercisable at September 30, 2008 each had an intrinsic value of \$2.6 million.

*Restricted Stock*

The Company grants restricted stock awards to employees and officers. Restricted stock granted generally vests over a period of three and one half to four years but such awards are considered outstanding at the time of grant, since the holders thereof are entitled to dividends and voting rights.

A summary of the Company's restricted stock awards activity and related information for the nine months ended September 30, 2008, is presented below:

	Outstanding at Beginning of	Issued	Vested	Forfeited	Outstanding End of Period
Shares	256,858	58,000	37,086	10,990	266,782

The restricted stock outstanding at September 30, 2008 had an intrinsic value of \$2.0 million.

During the nine months ended September 30, 2008, the Company awarded 58,000 shares of restricted common stock to certain employees and directors of the Company. The average market value of the common stock on the date of grant was \$7.94. These awards of restricted shares vest over a three to four-year period and had an intrinsic value of \$0.5 million on the date of issue.

*Stock Based Compensation*

The Company accounts for share-based compensation under the principles of FAS 123R. The Company uses the Black-Scholes option pricing model to estimate the grant date fair value of its stock. The Black-Scholes model requires the input of certain assumptions including expected volatility, expected dividend yield, expected life of the option and the risk free interest rate. The expected volatility used by the Company is based primarily on an analysis of historical prices of the Company's common stock. The expected term of options granted is based primarily on historical exercise patterns on the Company's outstanding stock options. The risk free rate is based on zero-coupon U.S. Treasury yields in effect at the date of grant with the same period as the expected option life. The Company does not currently plan to pay dividends on its common stock and therefore has used a dividend yield of zero in determining the fair value of its awards. The option forfeiture rate assumption used by the Company, which affects the expense recognized as opposed to the fair value of the award, is based primarily on the Company's historical option forfeiture patterns. The Company issued no stock options during the first nine months of fiscal 2008 and 2007.

The Company has total stock-based compensation expense of \$1.4 million not recognized as of September 30, 2008, and expects this expense to be recognized over approximately a four-year period.

**7. CONTINGENCIES**

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

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

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

**Overview**

The following discussion and analysis addresses (i) the Company's results of operations for the three and nine months ended September 30, 2008 and 2007, respectively, and (ii) liquidity and capital resources of the Company and should be read in conjunction with the Company's consolidated financial statements contained elsewhere in this report. The Company is one of the largest operators of senior living communities in the United States. The Company's operating strategy is to provide quality senior living services to its residents, while achieving and sustaining a strong, competitive position within its chosen markets, as well as to continue to enhance the performance of its operations. The Company provides senior living services to the elderly, including independent living, assisted living, skilled nursing and home care services.

As of September 30, 2008, the Company operated 65 senior living communities in 23 states with an aggregate capacity of approximately 9,600 residents, including 25 senior living communities which the Company owned, 13 senior living communities in which the Company had an ownership interest, 25 senior living communities that the Company leased and two senior living communities it managed for third parties. As of September 30, 2008, the Company also operated one home care agency.

**Joint Venture Transactions and Management Contracts**

As of September 30, 2008, the Company managed 13 communities owned by joint ventures in which the Company has a minority interest and two communities owned by third parties. For communities owned by joint ventures and third parties, the Company typically receives a management fee of 5% of gross revenues. In addition, certain of the contracts provide for supplemental incentive fees that vary by contract based upon the financial performance of the managed community.

The Company believes that the factors affecting the financial performance of communities managed under contracts with third parties do not vary substantially from the factors affecting the performance of owned and leased communities, although there are different business risks associated with these activities.

The Company's third-party management fees are primarily based on a percentage of gross revenues. As a result, the cash flow and profitability of such contracts to the Company are more dependent on the revenues generated by such communities and less dependent on net cash flow than for owned or leased communities. Further, the Company is not responsible for capital investments in managed communities. The management contracts are generally terminable only for cause and upon the sale of a community, subject to the Company's rights to offer to purchase such community.

**Midwest I Transactions**

Midwest I is owned approximately 89% by GE Healthcare Financial Services (GE Healthcare) and 11% by the Company. Midwest I owns five communities and the Company manages the five communities under long-term management agreements. The Company accounts for its investment in Midwest I under the equity method of accounting and the Company recognized earnings in the equity of Midwest I of \$0.1 million in the nine months ended

September 30, 2008 compared to a loss in the equity of Midwest I of \$23,000 in the nine months ended September 30, 2007. The Company earned \$0.4 million in management fees on the Midwest I communities in each of the nine months ended September 30, 2008 and 2007. During the second quarter of fiscal 2007, Midwest I finalized its

**Table of Contents**

purchase price allocation on the five communities it acquired in fiscal 2006, resulting in a noncash charge of \$0.1 million being recognized by the Company. The final purchase price allocation resulted in more of the purchase price being allocated to assets with shorter economic lives, which resulted in additional depreciation and amortization expense.

*Midwest II Transactions*

Midwest II is owned approximately 85% by GE Healthcare and 15% by the Company. Midwest II owns three communities and the Company manages the three communities under long-term management agreements. The Company accounts for its investment in Midwest II under the equity method of accounting and the Company recognized a loss in the equity of Midwest II of \$0.1 million and \$0.2 million in the nine months ended September 30, 2008 and 2007, respectively. The Company earned \$0.4 million in management fees on the Midwest II communities in each of the nine months ended September 30, 2008 and 2007. During the second quarter of fiscal 2007, Midwest II finalized its purchase price allocation on the three communities it acquired in fiscal 2006, resulting in a noncash charge of \$0.2 million being recognized by the Company. The final purchase price allocation resulted in more of the purchase price being allocated to assets with shorter economic lives, which resulted in additional depreciation and amortization expense.

*SHPII/CSL Transactions*

SHPII/CSL is owned 95% by Senior Housing Partners II, LP ( SHP II ), a fund managed by Prudential, and 5% by the Company. Effective as of November 30, 2004, SHPII/CSL acquired the four Spring Meadows Communities. The Company accounts for its investment in SHPII/CSL under the equity method of accounting and the Company recognized earnings in the equity of SHPII/CSL of \$0.2 million in each of the nine months ended September 30, 2008 and 2007. In addition, the Company earned \$0.9 million in management fees on the Spring Meadows Communities in each of the nine months ended September 30, 2008 and 2007.

*BRE/CSL*

The Company and Blackstone Real Estate Advisors ( Blackstone ) own three joint ventures, collectively BRE/CSL, and the joint ventures are owned 90% by Blackstone and 10% by the Company. BRE/CSL previously owned six senior living communities. The Company managed the six communities owned by BRE/CSL under long-term management contracts. In September 2005, Ventas acquired the six communities owned by BRE/CSL and the Company entered into a series of lease agreements whereby the Company leases the six communities from Ventas. In March 2007, the Company received a final distribution from BRE/CSL of \$0.4 million relating to the sale of six communities owned by BRE/CSL to Ventas. This distribution resulted in the recognition of an additional gain of \$0.4 million, which has been deferred and is being amortized in the Company's statement of operations as a reduction in facility rent expense over the remaining initial lease term.

***Development Agreements****SHPIII/CSL Miami*

In May 2007, the Company and SHPIII entered into SHPIII/CSL Miami to develop a senior housing community in Miamisburg, Ohio. Under the joint venture and related agreements, the Company earns development and management fees and may receive incentive distributions. The senior housing community consists of 101 independent living units and 45 assisted living units and opened in August 2008. As of September 30, 2008, the Company had made capital contributions of \$0.8 million to the joint venture. The Company accounts for its investment in SHPIII/CSL Miami under the equity method of accounting and the Company recognized a loss in the equity of SHPIII/CSL Miami of \$26,000 in the nine months ended September 30, 2008. During the first nine months of fiscal 2008 and 2007, the Company earned \$0.3 million and \$0.4 million, respectively, in development fees from SHPIII/CSL Miami. In addition during the first nine months of fiscal 2008, the Company earned \$0.1 million in pre-marketing fees and \$25,000 in management fees from SHPIII/CSL Miami.

*SHPIII/CSL Richmond Heights*

In November 2007, the Company and SHPIII entered into SHPIII/CSL Richmond Heights to develop a senior housing community in Richmond Heights, Ohio. Under the joint venture and related agreements, the Company will earn development and management fees and may receive incentive distributions. The senior housing community will consist of 97 independent living units and 45 assisted living units and is expected to open in the first quarter of 2009.

As of September 30, 2008, the Company had made capital contributions of \$0.8 million to the joint venture. During the first nine months of fiscal 2008, the Company earned \$1.0 million in development fees from SHPIII/CSL Richmond Heights. In addition during the first nine months of fiscal 2008, the Company earned \$25,000 in pre-marketing fees.



**Table of Contents****SHPIII/CSL Levis Commons**

In December 2007, the Company and SHPIII entered into SHPIII/CSL Levis Commons to develop a senior housing community near Toledo, Ohio. Under the joint venture and related agreements, the Company will earn development and management fees and may receive incentive distributions. The senior housing community will consist of 101 independent living units and 45 assisted living units and is expected to open in the first quarter of 2009. As of September 30, 2008, the Company had made capital contributions of \$0.8 million to the joint venture. During the first nine months of fiscal 2008, the Company earned \$1.1 million in development fees from SHPIII/CSL Levis Commons. In addition during the first nine months of fiscal 2008, the Company earned \$25,000 in pre-marketing fees.

**Facility Lease Transactions**

The Company currently leases 25 communities with certain real estate investment trusts ( REITs ) and accounts for each of the leases as an operating lease. The lease terms are generally for ten years with renewal options for 10-20 years at the Company's option. Under these agreements the Company is responsible for all operating costs, maintenance and repairs, insurance and property taxes. The following table further describes each of the lease agreements (dollars in millions):

Landlord	Date of Lease	Number of Communities	Value of Transaction	Term	Initial Lease Rate (1)	Lease Acquisition Costs (2)	Deferred Gains/Lease Concession (3)
Ventas	September 30, 2005	6	\$84.6	10 years (Two five-year renewals)	8%	\$ 1.3	\$ 4.6
Ventas	October 18, 2005	1	19.5	10 years (Two five-year renewals)	8%	0.2	
Ventas	March 31, 2006	1	29.0	10 years (Two five-year renewals)	8%	0.1	14.3
Ventas	June 8, 2006	1	19.1	9.5 years (Two five-year renewals)	8%	0.4	
Ventas	January 31, 2008	1	5.0	10 years (Two five-year renewals)	7.75%	0.2	
HCP	May 1, 2006	3	54.0	10 years (Two ten-year renewals)	8%	0.2	12.8
HCP	May 31, 2006	6	43.0	10 years	8%	0.2	0.6

Edgar Filing: CAPITAL SENIOR LIVING CORP - Form 10-Q

HCP	December 1, 2006	4	51.0	(Two ten-year renewals) 10 years	8%	0.7	
HCP	December 14, 2006	1	18.0	(Two ten-year renewals) 10 years	7.75%	0.3	
HCP	April 11, 2007	1	8.0	(Two ten-year renewals) 10 years	7.25%	0.1	
				(Two ten-year renewals)			
Subtotal						3.7	32.3
Accumulated amortization						(0.9)	
Accumulated deferred gain recognized							(8.3)
Net lease acquisition costs / deferred gains as of September 30, 2008						\$	2.8 \$ 24.0

- (1) Initial lease rates are subject to conditional lease escalation provisions as set forth in each lease agreement.
- (2) Lease acquisition costs are being amortized over the leases' initial term.
- (3) Deferred gains of \$31.7 million and lease concessions of \$0.6 million are being recognized in the Company's statement of operations as a

reduction in  
facility rent  
expense over  
the leases' initial  
term. Lease  
concessions  
relate to the  
HCP transaction  
on May 31,  
2006.

The Company is currently in discussions with Ventas regarding its lease on the Towne Centre facility. The Company and Ventas have differing interpretations of the correct method of computing the lease coverage ratio. Based on these discussions with Ventas, the Company expects this issue to be resolved on terms acceptable to the Company, without a material impact on the Company's financial statements.

**Table of Contents**

**Recently Issued Accounting Standards**

FASB Statement No. 157, Fair Value Measurements. FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 does not require any new fair value measurements but would apply to assets and liabilities that are required to be recorded at fair value under other accounting standards. The Company adopted FAS 157 on January 1, 2008 and elected to defer the provisions of FAS 157 for its nonfinancial assets and liabilities. Under the provisions of FAS 157 nonfinancial assets and liabilities will be subject to the provisions of FAS 157 on January 1, 2009. The Company's adoption of FAS 157 did not have a material effect on the Company's financial statements.

FASB Statement No. 159, Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement 115 permits, but does not require, entities to measure many financial instruments, including liabilities and certain other items, at fair value with resulting changes in fair value reported in earnings. The Company has elected not to apply the fair value option to any of its financial instruments not already carried at fair value in accordance with other accounting standards, and therefore the adoption of FAS 159 did not impact the Company's consolidated financial statements.

FASB Statement No. 141(R) Business Combinations requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to disclose to investors and other users all of the information needed to evaluate and understand the nature and financial effect of the business combination. FAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The impact of FAS 141(R) on the Company's consolidated financial statements will depend upon the nature, terms and size of the acquisitions we consummate after the effective date.

EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities. FSP 03-6-1 clarifies that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of earnings per share under the two-class method described in SFAS No. 128, Earnings Per Share. This FSP is effective for us on January 1, 2009 and requires all presented prior-period earnings per share data to be adjusted retrospectively. The Company is still in the process of evaluating the impact FSP 03-6-1 will have on our Consolidated Financial Statements.

**Website**

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

**Table of Contents****Results of Operations**

The following table sets forth for the periods indicated selected statements of income data in thousands of dollars and expressed as a percentage of total revenues.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2008		2007		2008		2007	
	\$	%	\$	%	\$	%	\$	%
Revenues:								
Resident and healthcare revenue	\$ 43,224	90.6	\$ 41,910	87.8	\$ 128,795	88.7	\$ 124,842	88.6
Unaffiliated management service revenue	52	0.1	778	1.6	140	0.1	939	0.7
Affiliated management service revenue	1,011	2.1	864	1.8	4,180	2.9	2,035	1.4
Community reimbursement revenue	3,430	7.2	4,206	8.8	12,151	8.4	13,049	9.3
Total revenue	47,717	100.0	47,758	100.0	145,266	100.0	140,865	100.0
Expenses:								
Operating expenses (exclusive of depreciation and amortization shown below)	27,320	57.3	26,344	55.2	80,191	55.2	77,263	54.8
General and administrative expenses	2,405	5.0	2,880	6.0	9,733	6.7	9,180	6.5
Facility lease expense	6,319	13.2	6,037	12.6	18,774	12.9	17,754	12.6
Stock-based compensation	293	0.6	283	0.6	786	0.5	763	0.5
Depreciation and amortization	3,143	6.6	2,835	5.9	9,258	6.4	8,361	5.9
Community reimbursement expense	3,430	7.2	4,206	8.8	12,151	8.4	13,049	9.3
Total expenses	42,910	89.9	42,585	89.2	130,893	90.1	126,370	89.7
Income from operations	4,807	10.1	5,173	10.8	14,373	9.9	14,495	10.3
Other income (expense):								
Interest income	140	0.3	154	0.3	363	0.2	509	0.4
Interest expense	(3,066)	(6.4)	(3,160)	(6.6)	(9,172)	(6.3)	(9,615)	(6.8)
			(8)	0.0	596	0.4	74	0.1

(Loss) gain on sale of assets								
Write-off of deferred loan costs							(538)	(0.4)
Other income (expense)	75	0.2	(8)	(0.0)	227	0.2	(61)	(0.0)
Income before provision for income taxes	1,956	4.1	2,151	4.5	6,387	4.4	4,864	3.5
Provision for income taxes	(754)	(1.6)	(784)	(1.6)	(2,449)	(1.7)	(1,807)	(1.3)
Net income	\$ 1,202	2.5	\$ 1,367	2.9	\$ 3,938	2.7	\$ 3,057	2.2

**Three Months Ended September 30, 2008 Compared to the Three Months Ended September 30, 2007**  
*Revenues.*

Total revenues were \$47.7 million for the three months ended September 30, 2008 compared to \$47.8 million for the three months ended September 30, 2007, representing a decrease of approximately \$0.1 million or 0.1%. This decrease in revenue is primarily the result of a decrease in unaffiliated management services revenue of \$0.7 million and a decrease in community reimbursement revenue of \$0.8 million offset by an increase in resident and healthcare revenue of \$1.3 million and an increase in affiliated management services revenue of \$0.1 million.

Resident and healthcare revenue increased \$1.3 million or 3.1% as a result of an increase of \$0.3 million from the addition of the Whitley Place community which was leased from HCP on January 31, 2008 along with an increase in the average monthly rent of 4.9% at the Company's consolidated communities offset by a decrease in occupancy at the Company's consolidated communities of 2.8%. The Company consolidated 50 communities in the third quarter of fiscal 2008 compared to 49 communities in the third quarter of fiscal 2007.

Affiliated management services revenue increased due primarily to an increase in development and pre-marketing fees of \$0.1 million. The Company earned \$0.4 million in development and pre-marketing fees on two communities under development in the three months ended September 30, 2008 compared to development fee revenue of \$0.3 million on one community under development in the three months ended September 30, 2007.

Unaffiliated management services revenue decreased by \$0.7 million to \$0.1 million in the third quarter of fiscal 2008 compared to unaffiliated management services revenue of \$0.8 million in the third quarter of fiscal 2007. The third quarter of fiscal 2007 included the recovery of management fees of \$0.4 million from Covenant Group of Texas, Inc. (Covenant) and the reduction of a contingent note payable to Covenant of \$0.3 million under the provisions of the CGI Management, Inc. (CGIM) purchase and sale agreement. The Company managed two communities owned by third parties in the three months ended September 30, 2008 compared to three communities in the three months ended September 30, 2007.

Community reimbursement revenue is comprised of reimbursable expenses from non-consolidated communities that the Company operates under long-term management agreements.

**Table of Contents**

*Expenses.*

Total expenses were \$42.9 million in the third quarter of fiscal 2008 compared to \$42.6 million in the third quarter of fiscal 2007, representing an increase of \$0.3 million or 0.8%. This increase is primarily the result of a \$1.0 million increase in operating expenses, a \$0.3 million increase in facility lease expense, a \$10,000 increase in stock-based compensation and a \$0.3 million increase in depreciation and amortization expense offset by a \$0.5 million decrease in general and administrative expenses and a decrease of \$0.8 million in community reimbursement expense.

Operating expenses increased \$1.0 million or 3.7% primarily due to an increase of \$0.3 million from the addition of the Whitley Place community, along with an increase in operating expenses at the Company's other communities of \$0.7 million. The primary increases in operating expense include an increase in labor and benefit costs of \$0.5 million, an increase in utility costs of \$0.2 million, an increase in provision for doubtful accounts of \$0.2 million along with a net increase of \$0.1 million in other community operating costs.

General and administrative expenses decreased \$0.5 million primarily due to a decrease in health insurance claims of \$0.4 million and a reduction in bonus expense of \$0.3 million in the current year offset by a net increase in other general and administrative costs of \$0.2 million.

Facility lease expenses increased \$0.3 million primarily due to the Company leasing 25 senior living communities in the third quarter of fiscal 2008 compared to 24 senior living communities in the third quarter of fiscal 2007 along with increases in contingent rent on certain leases.

Stock-based compensation increased \$10,000 in the third quarter of fiscal 2008 compared to the third quarter of fiscal 2007 primarily due to the award of additional restricted shares to certain employees and directors of the Company.

Depreciation and amortization expense increased \$0.3 million primarily as a result of an increase in depreciation expense at the Company's 50 consolidated communities of \$0.2 million along with depreciation expense of \$0.1 million primarily related to leasehold improvements at the Company's corporate offices and new information systems which were put into service on January 1, 2008.

Community reimbursement expense represents payroll and administrative costs paid by the Company for the benefit of non-consolidated communities and joint ventures.

*Other income and expense.*

Interest income reflects interest earned on investment of cash balances and interest earned on escrowed funds.

Interest expense decreased \$0.1 million to \$3.1 million in the third quarter of 2008 compared to \$3.2 million in the comparable period of 2007. This decrease in interest expense primarily results from lower debt outstanding during third quarter of fiscal 2008 compared to the third quarter of fiscal 2007.

Other expense/income in the third quarter of fiscal 2008 and 2007 relates to the Company's equity in the earnings/losses of unconsolidated affiliates, which represents the Company's share of the earnings/losses on its investments in SHPII/CSL, SHPIII/CSL, Midwest I and Midwest II.

*Provision for income taxes.*

Provision for income taxes for the third quarter of fiscal 2008 was \$0.8 million or 38.5% of income before taxes compared to a provision for income taxes of \$0.8 million, or 36.4% of income before taxes, for the third quarter of fiscal 2007. The effective tax rates for the third quarter of 2008 and 2007 differ from the statutory tax rates because of state income taxes and permanent tax differences. Management regularly evaluates the future realization of deferred tax assets and provides a valuation allowance, if considered necessary, based on such evaluation. At September 30, 2008, no valuation allowance was considered necessary based on this evaluation.

**Table of Contents**

*Net income/loss.*

As a result of the foregoing factors, the Company reported net income of \$1.2 million for the three months ended September 30, 2008 compared to a net income of \$1.4 million for the three months ended September 30, 2007.

**Nine Months Ended September 30, 2008 Compared to the Nine Months Ended September 30, 2007**

*Revenues.*

Total revenues were \$145.3 million for the nine months ended September 30, 2008 compared to \$140.9 million for the nine months ended September 30, 2007 representing an increase of approximately \$4.4 million or 3.1%. This increase in revenue is primarily the result of a \$4.0 million increase in resident and healthcare revenue, an increase in affiliated management services revenue of \$2.1 million offset by a decrease in unaffiliated management services revenue of \$0.8 million and a decrease in community reimbursement revenue of \$0.9 million.

Resident and healthcare revenue increased \$4.0 million or 3.2% as a result of an increase of \$0.9 million from the addition of the Whitley Place community along with an increase in the average monthly rent of 4.3% at the Company's consolidated communities offset by a decrease in occupancy at the Company's consolidated communities of 3.3%. The Company consolidated 50 communities in the first nine months of fiscal 2008 compared to 49 communities in the first nine months of fiscal 2007.

Affiliated management services revenue increased due primarily to an increase in development and pre-marketing fees of \$2.1 million. The Company earned \$2.5 million in development and pre-marketing fees on three communities under development in the nine months ended September 30, 2008 compared to development fee revenue of \$0.4 million on one community under development in the nine months ended September 30, 2007.

Unaffiliated management services revenue decreased by \$0.8 million to \$0.1 million in the first nine months of fiscal 2008 compared to unaffiliated management services revenue of \$0.9 million in the first nine months of fiscal 2007. The first nine months of fiscal 2007 included the recovery of management fees of \$0.4 million from Covenant and the reduction of a contingent note payable to Covenant of \$0.3 million under the provisions of the CGIM purchase and sale agreement. The Company managed two communities owned by third parties in the nine months ended September 30, 2008 compared to three communities in the nine months ended September 30, 2007.

Community reimbursement revenue is comprised of reimbursable expenses from non-consolidated communities that the Company operates under long-term management agreements.

*Expenses.*

Total expenses were \$130.9 million in the first nine months of fiscal 2008 compared to \$126.4 million in the first nine months of fiscal 2007, representing an increase of \$4.5 million or 3.6%. This increase is primarily the result of a \$2.9 million increase in operating expenses, a \$0.6 million increase in general and administrative expenses, a \$1.0 million increase in facility lease expense, a \$23,000 increase in stock-based compensation and a \$0.9 million increase in depreciation and amortization expense offset by a \$0.9 million decrease in community reimbursement expense.

Operating expenses increased \$2.9 million or 3.8% primarily due to an increase of \$0.7 million from the addition of the Whitley Place community along with an increase in operating expenses at the Company's other communities of \$2.2 million. The primary increases in operating expense include an increase in labor and benefit costs of \$1.7 million, an increase in utility costs of \$0.4 million, an increase in provision for doubtful accounts of \$0.2 million, along with an increase of \$0.6 in other community operating costs.

General and administrative expenses increased \$0.6 million primarily relating to due diligence costs of \$0.4 million related to potential acquisitions and developments that the Company terminated, along with an increase in other general and administrative costs of \$0.2 million.



Facility lease expenses increased \$1.0 million primarily due to the Company leasing 25 senior living communities in the first nine months of fiscal 2008 compared to 24 senior living communities in the first nine months of fiscal 2007 along with increases in contingent rent on certain leases.

**Table of Contents**

Stock-based compensation increased \$23,000 in the first nine months of fiscal 2008 compared to the first nine months of fiscal 2007 primarily due to the award of additional restricted shares to certain employees and directors of the Company.

Depreciation and amortization expense increased \$0.9 million primarily as a result of an increase in depreciation expense at the Company's 50 consolidated communities of \$0.6 million along with depreciation expense of \$0.3 million primarily related to leasehold improvements at the Company's corporate offices and new information systems which were put into service on January 1, 2008.

Community reimbursement expense represents payroll and administrative costs paid by the Company for the benefit of non-consolidated communities and joint ventures.

*Other income and expense.*

Interest income reflects interest earned on investment of cash balances and interest earned on escrowed funds. Interest income decreased \$0.1 million primarily due to lower interest rates in the current fiscal year.

Interest expense decreased \$0.4 million to \$9.2 million in the first nine months of 2008 compared to \$9.6 million in the comparable period of 2007. This decrease in interest expense primarily results from slightly lower debt outstanding during fiscal 2008 compared to fiscal 2007 along with a lower average interest rate in the current fiscal year compared to the prior year.

Gain on sale of assets in the first nine months of fiscal 2008 represents gains associated with the sale of two parcels of land of \$0.7 million and the amortization of a deferred gain on the sale of the Richmond Heights land in fiscal 2007 to a joint venture in which the Company has an equity interest offset by a \$0.1 million impairment adjustment on a parcel of land, located in Fort Wayne, Indiana, which is classified as held for sale. Gain on sale of assets in the nine months of fiscal 2007 represents the recognition of a gain of \$0.1 million related to the sale of a parcel of land located in Baton Rouge, Louisiana and a gain on the sale of a treasury rate lock agreement.

Other expense/income in the first nine months of fiscal 2008 and 2007 relates to the Company's equity in the earnings/losses of unconsolidated affiliates, which represents the Company's share of the earnings/losses on its investments in SHPII/CSL, SHPIII/CSL, Midwest I and Midwest II. During the second quarter of fiscal 2007, Midwest I and Midwest II finalized their purchase price allocation on the eight communities they acquired, resulting in a noncash charge of \$0.3 million being recognized by the Company. The final purchase price allocation resulted in more of the purchase price being allocated to assets with shorter economic lives which resulted in additional depreciation and amortization expense.

*Provision for income taxes.*

Provision for income taxes for the first nine months of fiscal 2008 was \$2.4 million or 38.3% of income before taxes compared to a provision for income taxes of \$1.8 million, or 37.2% of income before taxes, for the first nine months of fiscal 2007. The effective tax rates for the first nine months of 2008 and 2007 differ from the statutory tax rates because of state income taxes and permanent tax differences. Management regularly evaluates the future realization of deferred tax assets and provides a valuation allowance, if considered necessary, based on such evaluation. At September 30, 2008, no valuation allowance was considered necessary based on this evaluation.

*Net income/loss.*

As a result of the foregoing factors, the Company reported net income of \$3.9 million for the nine months ended September 30, 2008 compared to a net income of \$3.1 million for the nine months ended September 30, 2007.

**Liquidity and Capital Resources**

The impact of the current economic environment could result in decreases in the fair value of assets, slowing of transactions, tightening liquidity and credit markets. These impacts could make securing debt for acquisitions or

refinancings for the Company or buyers of the Company's properties more difficult or on terms not acceptable to the Company.

In addition to approximately \$28.0 million of cash balances on hand as of September 30, 2008, the Company's principal sources of liquidity are expected to be cash flows from operations, proceeds from the sale of assets, cash flows from SHPII/CSL, Midwest I and

**Table of Contents**

Midwest II and/or additional debt refinancing. The Company expects its available cash and cash flows from operations, proceeds from the sale of assets, and cash flows from SHPII/CSL, Midwest I and Midwest II to be sufficient to fund its short-term working capital requirements. The Company's long-term capital requirements, primarily for acquisitions and other corporate initiatives, could be dependent on its ability to access additional funds through joint ventures and the debt and/or equity markets. The Company from time to time considers and evaluates transactions related to its portfolio including refinancings, purchases and sales, reorganizations and other transactions. There can be no assurance that the Company will continue to generate cash flows at or above current levels or that the Company will be able to obtain the capital necessary to meet the Company's short and long-term capital requirements. In summary, the Company's cash flows were as follows (in thousands):

	<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Net cash provided by operating activities	\$ 13,176	\$ 8,696
Net cash used in investing activities	(5,083)	(4,226)
Net cash used in financing activities	(3,405)	(6,045)
Net increase (decrease) in cash and cash equivalents	\$ 4,688	\$ (1,575)

*Operating Activities*

The net cash provided by operating activities for the first nine months of fiscal 2008 primarily results from net income of \$3.9 million, net non-cash charges of \$9.2 million, a decrease in prepaid and other assets of \$2.1 million, a decrease on other assets of \$0.3 million, an increase in accounts payable and accrued expenses of \$0.3 million and a decrease in federal and state income taxes receivable of \$1.2 million offset by an increase in accounts receivable of \$2.7 million, an increase in property tax and insurance deposits of \$0.9 million and a decrease in customer deposits of \$0.3 million. The net cash provided by operating activities for the first nine months of fiscal 2007 primarily results from net income of \$3.1 million, net non-cash charges of \$9.4 million, a decrease in accounts receivable of \$0.6 million and a decrease in other assets of \$0.9 million offset by an increase in property tax and insurance deposits of \$0.8 million, an increase in prepaid and other assets of \$1.8 million, an increase in income tax receivable of \$2.0 million, a decrease in accounts payable and accrued expenses of \$0.3 million and a decrease in customer deposits of \$0.4 million.

*Investing Activities*

The net cash used in investing activities for the first nine months of fiscal 2008 primarily results from capital expenditures of \$5.7 million, net investments in joint ventures of \$0.8 million offset by proceeds from the sale of two parcels of land, one in Carmichael, California and the other in Lincoln, Nebraska, for \$1.4 million. The net cash used in investing activities for the first nine months of fiscal 2007 primarily results from capital expenditures of \$5.2 million, net investments in joint ventures of \$0.4 million offset by proceeds from the sale of two parcels of land for \$1.1 million and proceeds from a final distribution from BRE/CSL of \$0.3 million.

*Financing Activities*

The net cash used in financing activities for the first nine months of fiscal 2008 primarily results from net repayments of notes payable of \$3.7 million offset by proceeds from the issuance of common stock of \$0.2 million. The net cash used in financing activities for the first nine months of fiscal 2007 primarily results from net repayments of notes payable of \$5.6 million, deferred loan costs paid in connection with the refinancing of five communities of \$0.9 million offset by proceeds from the issuance of common stock of \$0.3 million, excess tax benefits on the issuance of common stock of \$0.1 million and proceeds from the sale of the Company's treasury rate lock of \$0.1 million.

*Debt Transactions / Refinancings*

In May 2008, the Company financed \$1.5 million in insurance premiums at a fixed interest rate of 3.75%. The insurance loan will be repaid in 12 equal payments of principal and interest payments of approximately \$0.1 million.

On May 3, 2007, the Company refinanced \$30.0 million of mortgage debt on four senior living communities with Fannie Mae. As part of the refinancing, the Company repaid approximately \$2.7 million of mortgage debt on the four communities. The new mortgage loans have a ten-year term with interest fixed at 5.91% and principal amortized over a 30-year term. The Company incurred \$0.5 million in deferred financing costs related to this loan, which is being amortized over ten years. In addition, as part of this refinancing,

**Table of Contents**

the Company wrote-off \$0.4 million in deferred loan costs. The new loans replaced \$32.7 million of variable rate debt with an effective interest rate of 7.6%.

On March 21, 2007, the Company refinanced \$9.5 million of mortgage debt on its Gramercy Hill community with Freddie Mac. As part of the refinancing, the Company received approximately \$2.1 million in cash proceeds, net of closing costs. The new mortgage loan has a ten-year term with a one-year extension available at the Company's option, interest fixed at 5.75% and requires interest only payments in the first two years with principal amortized thereafter over a 25-year term. The Company incurred \$0.2 million in deferred financing costs related to this loan, which is being amortized over ten years. In addition, as part of this refinancing, the Company wrote-off \$13,000 in deferred loan costs and paid \$0.2 million in loan exit fees to the prior lender. The loan exit fees are a component of write-off of deferred loan costs in the accompanying statement of operations.

**Recent Developments**

On May 29, 2008, the Company announced that a Special Committee of its Board of Directors had engaged Banc of America Securities LLC as its financial advisor to assist the Special Committee in exploring and considering a range of strategic alternatives for the Company. There can be no assurance, however, that this process will result in a transaction and the Company is not obligated to provide periodic updates.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

The Company's primary market risk is exposure to changes in interest rates on debt and lease instruments. As of September 30, 2008, the Company had \$191.2 million in outstanding debt comprised solely of fixed rate debt instruments. In addition, as of September 30, 2008, the Company had \$211.0 million in future lease obligations with contingent rent increases based on changes in the consumer price index.

Changes in interest rates would affect the fair market value of the Company's fixed rate debt instruments but would not have an impact on the Company's earnings or cash flows. Increase in the consumer price index could have an effect on future facility lease expense if the leased community exceeds the contingent rent escalation thresholds set forth in each of the Company's lease agreements.

**Item 4. CONTROLS AND PROCEDURES.****Effectiveness of Controls and Procedures**

The Company's management, with the participation of the Company's Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act )) as of the end of the period covered by this report. The Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The Company's disclosure controls and procedures are also designed to ensure that such information is accumulated and communicated to the Company's management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Based upon the controls evaluation, the Company's CEO and CFO have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective.

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the Company's fiscal quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Part II. OTHER INFORMATION****Item 1. LEGAL PROCEEDINGS.**

The Company has claims incurred in the normal course of its business. Most of these claims are believed by management to be covered by insurance, subject to normal reservations of rights by the insurance companies and possibly subject to certain exclusions in

**Table of Contents**

the applicable insurance policies. Whether or not covered by insurance, these claims, in the opinion of management, based on advice of legal counsel, should not have a material effect on the consolidated financial statements of the Company if determined adversely to the Company.

**Item 1A. RISK FACTORS.**

Our business involves various risks. When evaluating our business the following information should be carefully considered in conjunction with the other information contained in our periodic filings with the SEC. Additional risks and uncertainties not known to us currently or that currently we deem to be immaterial also may impair our business operations. If we are unable to prevent events that have a negative effect from occurring, then our business may suffer. Negative events are likely to decrease our revenue, increase our costs, make our financial results poorer and/or decrease our financial strength, and may cause our stock price to decline.

***We have significant debt and our failure to generate cash flow sufficient to cover required interest and principal payments could result in defaults of the related debt.***

As of September 30, 2008, we had mortgage and other indebtedness totaling approximately \$191.2 million. We cannot assure you that we will generate cash flow from operations or receive proceeds from refinancings, other financings or the sales of assets sufficient to cover required interest and principal payments. Any payment or other default could cause the applicable lender to foreclose upon the communities securing the indebtedness with a consequent loss of income and asset value to us. Further, because some of our mortgages contain cross-default and cross-collateralization provisions, a payment or other default by us with respect to one community could affect a significant number of our other communities.

***We have significant operating lease obligations and our failure to generate cash flows sufficient to cover these lease obligations could result in defaults under the lease agreements.***

As of September 30, 2008, we leased 25 communities with future lease obligations totaling approximately \$211.0 million, with minimum lease obligations of \$27.7 million in fiscal 2008. We cannot assure you that we will generate cash flow from operations or receive proceeds from refinancings, other financings or the sales of assets sufficient to cover these required operating lease obligations. Any payment or other default under any such lease could result in the termination of the lease, with a consequent loss of income and asset value to us. Further, because our leases contain cross-default provisions, a payment or other default by us with respect to one leased community could affect all of our other leased communities with related lessors. Certain of our leases contain various financial and other restrictive covenants, which could limit our flexibility in operating our business. Failure to maintain compliance with the lease obligations as set forth in our lease agreements could have a material adverse impact on us.

***Our failure to comply with financial covenants and other restrictions contained in debt instruments and lease agreements could result in the acceleration of the related debt or lease obligations.***

There are various financial covenants and other restrictions in certain of our debt instruments and lease agreements, including provisions which:

require us to meet specified financial tests at the subsidiary company level, which include, but are not limited to, tangible net worth requirements;

require us to meet specified financial tests at the community level, which include, but are not limited to, occupancy requirements and lease coverage tests; and

require consent for changes in control of us.

If we fail to comply with any of these requirements, then the related indebtedness or lease obligations could become due and payable prior to their stated dates. We cannot assure that we could pay these debt or lease obligations if they became due.

***We will require additional financing and/or refinancings in the future and may issue equity securities.***

Our ability to obtain such financing or refinancing on terms acceptable to us could have a material adverse effect on our business, financial condition and results of operations. Our ability to meet our long-term capital requirements, including the repayment of certain long-term debt obligations, will depend, in part, on our ability to obtain additional financing or refinancings on acceptable





**Table of Contents**

terms from available financing sources, including through the use of mortgage financing, joint venture arrangements, by accessing the debt and/or equity markets and possibly through operating leases or other types of financing, such as lines of credit. There can be no assurance that financing or refinancings will be available or that, if available, will be on terms acceptable to us. Moreover, raising additional funds through the issuance of equity securities could cause existing stockholders to experience dilution and could adversely affect the market price of our common stock. Our inability to obtain additional financing or refinancings on terms acceptable to us could delay or eliminate some or all of our growth plans, necessitate the sales of assets at unfavorable prices or both, and would have a material adverse effect on our business, financial condition and results of operations.

***Any future floating rate debt and lease obligations could expose us to rising interest rates.***

Future indebtedness and lease obligations, if applicable, may be based on floating interest rates prevailing from time to time. Therefore, increases in prevailing interest rates would increase in the future our interest or lease payment obligations and could in the future have a material adverse effect on our business, financial condition and results of operations.

***We cannot assure that we will be able to effectively manage our growth.***

We intend to expand our operations, directly or indirectly, through the acquisition of existing senior living communities, the expansion of some of our existing senior living communities, the development of new senior living communities and/or through an increase in the number of communities which we manage under management agreements. The success of our growth strategy will depend, in large part, on our ability to implement these plans and to effectively operate these communities. If we are unable to manage our growth effectively, our business, results of operations and financial condition may be adversely affected.

***We cannot assure that we will be able to acquire additional senior living communities, develop new senior living communities or expand existing senior living communities.***

The acquisition of existing communities or other businesses involves a number of risks. Existing communities available for acquisition frequently serve or target different markets than those presently served by us. We may also determine that renovations of acquired communities and changes in staff and operating management personnel are necessary to successfully integrate those communities or businesses into our existing operations. The costs incurred to reposition or renovate newly acquired communities may not be recovered by us. In undertaking acquisitions, we also may be adversely impacted by unforeseen liabilities attributable to the prior operators of those communities or businesses, against whom we may have little or no recourse. The success of our acquisition strategy will be determined by numerous factors, including our ability to identify suitable acquisition candidates; the competition for those acquisitions; the purchase price; the requirement to make operational or structural changes and improvements; the financial performance of the communities or businesses after acquisition; our ability to finance the acquisitions; and our ability to integrate effectively any acquired communities or businesses into our management, information, and operating systems. We cannot assure that our acquisition of senior living communities or other businesses will be completed at the rate currently expected, if at all, or if completed, that any acquired communities or businesses will be successfully integrated into our operations.

Our ability to successfully develop new senior living communities or expand existing senior living communities will depend on a number of factors, including, but not limited to, our ability to acquire suitable sites at reasonable prices; our success in obtaining necessary zoning, licensing, and other required governmental permits and authorizations; and our ability to control construction costs and accurately project completion schedules. Additionally, we anticipate that the development of new senior living communities or the expansion of existing senior living communities may involve a substantial commitment of capital for a period of time of two years or more until the new senior living communities or expansions are operating and producing revenue, the consequence of which could be an adverse impact on our liquidity. We cannot assure that our developments or expansion of existing senior living communities will be completed at the rate currently expected, if at all, or if completed, that such developments or expansions will be profitable.

***Termination of resident agreements and resident attrition could affect adversely our revenues and earnings.***

State regulations governing assisted living facilities require written resident agreements with each resident. Most of these regulations also require that each resident have the right to terminate the resident agreement for any reason on

reasonable notice. Consistent with these regulations, the resident agreements signed by us allow residents to terminate their agreement on 30 days notice. Thus, we cannot contract with residents to stay for longer periods of time, unlike typical apartment leasing arrangements that involve lease agreements with specified leasing periods of up to a year or longer. If a large number of residents elected to terminate their resident agreements at or around the same time, then our revenues and earnings could be adversely affected. In addition, the advanced age of our average resident means that the resident turnover rate in our senior living facilities may be difficult to predict.

**Table of Contents**

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

Approximately 95% of our total revenues from communities that we operated were attributable to private pay sources and approximately 5% of our revenues from these communities were attributable to reimbursements from Medicare and Medicaid during fiscal 2007. We expect to continue to rely primarily on the ability of residents to pay for our services from their own or familial 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.

***We are subject to risks related to third-party management agreements.***

At September 30, 2008, we managed two senior living communities for third parties and 13 senior living communities for joint ventures in which we have a minority interest pursuant to multi-year management agreements. The management agreements generally have initial terms of five years, subject to certain renewal rights. Under these agreements we provide management services to third party and joint venture owners to operate senior living communities and have provided, and may in the future provide, management and consulting services to third parties on market and site selection, pre-opening sales and marketing, start-up training and management services for facilities under development and construction. In most cases, either party to the agreements may terminate them upon the occurrence of an event of default caused by the other party. In addition, subject to our rights to cure deficiencies, community owners may terminate us as manager if any licenses or certificates necessary for operation are revoked, or if we have a change of control. Also, in some instances, a community owner may terminate the management agreement relating to a particular community if we are in default under other management agreements relating to other communities owned by the same community owner or its affiliates. In addition, in certain cases the community owner may terminate the agreement upon 30 days notice to us in the event of a sale of the community. In those agreements, which are terminable in the event of a sale of the community, we have certain rights to offer to purchase the community. The termination of a significant portion of our management agreements could have a material adverse effect on our business, financial condition and results of operations.

***Failure to perform our obligations under our joint venture arrangements could have a material adverse effect on us.***

We hold minority interests ranging from approximately 5% to 15% in several joint ventures with affiliates of Prudential and GE Healthcare. We also manage the communities owned by these joint ventures. Under the terms of the management agreements with Prudential covering five properties, we are obligated to meet certain cash flow targets and failure to meet these cash flow targets could result in termination of the management agreements. Under the terms of the joint venture agreements with GE Healthcare covering eight properties, we are obligated to meet certain net operating income targets and failure to meet these net operating income targets could result in termination of the management agreements and changes in the sharing ratios under the joint venture agreement.

We are currently developing two communities in two separate joint ventures with affiliates of Prudential. As part of development agreements, we are obligated to meet certain completion and costs guarantees. We are or will be providing pre-opening marketing services for each of the communities and upon completion we will manage the two communities owned by the joint ventures. Under the terms of the management agreements with Prudential covering the three communities, we will be obligated to meet certain cash flow targets and failure to meet these cash flow targets could result in termination of the management agreements.

All of the management agreements with the joint ventures contain termination and renewal provisions. We do not control these joint venture decisions covering termination or renewal. Performance of the above obligations or termination or non-renewal of the management agreements could have a material adverse effect on our business, financial condition and results of operations.

***The senior living services industry is very competitive and some competitors may have substantially greater financial resources than us.***

The senior living services industry is highly competitive, and we expect that all segments of the industry will become increasingly competitive in the future. We compete with other companies providing independent living, assisted living, skilled nursing, home health care and other similar services and care alternatives. We also compete with other

health care businesses with respect to attracting and retaining nurses, technicians, aides and other high quality professional and non-professional employees and managers. Although we believe there is a need for senior living communities in the markets where we operate residences, we expect that

**Table of Contents**

competition will increase from existing competitors and new market entrants, some of whom may have substantially greater financial resources than us. In addition, some of our competitors operate on a not-for-profit basis or as charitable organizations and have the ability to finance capital expenditures on a tax-exempt basis or through the receipt of charitable contributions, neither of which are available to us. Furthermore, if the development of new senior living communities outpaces the demand for those communities in the markets in which we have senior living communities, those markets may become saturated. Regulation in the independent and assisted living industry, which represents a substantial portion of our senior living services, is not substantial. Consequently, development of new senior living communities could outpace demand. An oversupply of those communities in our markets could cause us to experience decreased occupancy, reduced operating margins and lower profitability.

***We rely on the services of key executive officers and the loss of these officers or their services could have a material adverse effect on us.***

We depend on the services of our executive officers for our management. The loss of some of our executive officers and the inability to attract and retain qualified management personnel could affect our ability to manage our business and could adversely affect our business, financial condition and results of operations.

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

We compete with other providers of senior living services with respect to attracting and retaining qualified management personnel responsible for the day-to-day operations of each of our communities and skilled personnel responsible for providing resident care. A shortage of nurses or trained personnel may require us to enhance our wage and benefits package in order to compete in the hiring and retention of these personnel or to hire more expensive temporary personnel. We also will be dependent on the available labor pool of semi-skilled and unskilled employees in each of the markets in which we operate. No assurance can be given that our labor costs will not increase, or that, if they do increase, they can 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.

***There is an inherent risk of liability in the provision of personal and health care services, not all of which may be covered by insurance.***

The provision of personal and health care services in the long-term care industry entails an inherent risk of liability. In recent years, participants in the long-term care industry have become subject to an increasing number of lawsuits alleging negligence or related legal theories, many of which involve large claims and result in the incurrence of significant defense costs. Moreover, senior living communities offer residents a greater degree of independence in their daily living. This increased level of independence may subject the resident and, therefore, us to risks that would be reduced in more institutionalized settings. We currently maintain insurance in amounts we believe are comparable to those maintained by other senior living companies based on the nature of the risks, our historical experience and industry standards, and we believe that this insurance coverage is adequate. However, we may become subject to claims in excess of our insurance or claims not covered by our insurance, such as claims for punitive damages, terrorism and natural disasters. A claim against us not covered by, or in excess of, our insurance could have a material adverse effect upon us.

In addition, our insurance policies must be renewed annually. Based upon poor loss experience, insurers for the long-term care industry have become increasingly wary of liability exposure. A number of insurance carriers have stopped writing coverage to this market, and those remaining have increased premiums and deductibles substantially. Therefore, we cannot assure that we will be able to obtain liability insurance in the future or that, if that insurance is available, it will be available on acceptable economic terms.

***We are subject to government regulations and compliance, some of which are burdensome and some of which may change to our detriment in the future.***

Federal and state governments regulate various aspects of our business. The development and operation of senior living communities and the provision of health care services are subject to federal, state and local licensure, certification and inspection laws that regulate, among other matters, the number of licensed beds, the provision of services, the distribution of pharmaceuticals, billing practices and policies, equipment, staffing (including professional licensing), operating policies and procedures, fire prevention measures, environmental matters and compliance with

building and safety codes. Failure to comply with these laws and regulations could result in the denial of reimbursement, the imposition of fines, temporary suspension of admission of new residents, suspension or decertification from the Medicare program, restrictions on the ability to acquire new communities or expand existing communities and, in extreme cases, the revocation of a community's license or closure of a community. We believe that such regulation will

**Table of Contents**

increase in the future and we are unable to predict the content of new regulations or their effect on our business, any of which could materially adversely affect us.

Various states, including several of the states in which we currently operate, control the supply of licensed skilled nursing beds, assisted living communities and home health care agencies through CON or other programs. In those states, approval is required for the construction of new health care communities, the addition of licensed beds and some capital expenditures at those communities, as well as the opening of a home health care agency. To the extent that a CON or other similar approval is required for the acquisition or construction of new communities, the expansion of the number of licensed beds, services, or existing communities, or the opening of a home health care agency, we could be adversely affected by our failure or inability to obtain that approval, changes in the standards applicable for that approval, and possible delays and expenses associated with obtaining that approval. In addition, in most states, the reduction of the number of licensed beds or the closure of a community requires the approval of the appropriate state regulatory agency and, if we were to seek to reduce the number of licensed beds at, or to close, a community, we could be adversely affected by a failure to obtain or a delay in obtaining that approval.

Federal and state anti-remuneration laws, such as anti-kickback laws, govern some financial arrangements among health care providers and others who may be in a position to refer or recommend patients to those providers. These laws prohibit, among other things, some direct and indirect payments that are intended to induce the referral of patients to, the arranging for services by, or the recommending of, a particular provider of health care items or services. Federal anti-kickback laws have been broadly interpreted to apply to some contractual relationships between health care providers and sources of patient referral. Similar state laws vary, are sometimes vague, and seldom have been interpreted by courts or regulatory agencies. Violation of these laws can result in loss of licensure, civil and criminal penalties, and exclusion of health care providers or suppliers from participation in Medicare and Medicaid programs. There can be no assurance that those laws will be interpreted in a manner consistent with our practices. Under the Americans with Disabilities Act of 1990, all places of public accommodation are required to meet federal requirements related to access and use by disabled persons. A number of additional federal, state and local laws exist that also may require modifications to existing and planned communities to create access to the properties by disabled persons. Although we believe that our communities are substantially in compliance with present requirements or are exempt therefrom, if required changes involve a greater expenditure than anticipated or must be made on a more accelerated basis than anticipated, additional costs would be incurred by us. Further legislation may impose additional burdens or restrictions with respect to access by disabled persons, the costs of compliance with which could be substantial.

The Health Insurance Portability and Accountability Act of 1996, in conjunction with the federal regulations promulgated thereunder by the Department of Health and Human Services, has established, among other requirements, standards governing the privacy of certain protected and individually identifiable health information that is created, received or maintained by a range of covered entities. HIPAA has also established standards governing uniform health care transactions, the codes and identifiers to be used by the covered entities and standards governing the security of certain electronic transactions conducted by covered entities. Penalties for violations can range from civil money penalties for errors and negligent acts to criminal fines and imprisonment for knowing and intentional misconduct. HIPAA is a complex set of regulations and many unanswered questions remain with respect to the manner in which HIPAA applies to businesses such as those operated by us.

***We may be subject to liability for environmental damages.***

Under various federal, state and local environmental laws, ordinances and regulations, a current or previous owner or operator of real estate may be required to investigate and clean up hazardous or toxic substances or petroleum product releases at the property, and may be held liable to a governmental entity or to third parties for property damage and for investigation and clean up costs incurred by those parties in connection with the contamination. These laws typically impose clean-up responsibility and liability without regard to whether the owner knew of or caused the presence of the contaminants, and liability under these laws has been interpreted to be joint and several unless the harm is divisible and there is a reasonable basis for allocation of responsibility. The costs of investigation, remediation or removal of the substances may be substantial, and the presence of the substances, or the failure to properly remediate the property, may adversely affect the owner's ability to sell or lease the property or to borrow using the property as

collateral. In addition, some environmental laws create a lien on the contaminated site in favor of the government for damages and costs it incurs in connection with the contamination. Persons who arrange for the disposal or treatment of hazardous or toxic substances also may be liable for the costs of removal or remediation of the substances at the disposal or treatment facility, whether or not the facility is owned or operated by the person. Finally, the owner of a site may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from a site. If we become subject to any of these claims the costs involved could be significant and could have a material adverse effect on our business, financial condition and results of operations.



**Table of Contents**

***Anti-takeover provisions in our governing documents, governing law, material agreements and our shareholder rights plan may discourage, delay or prevent a merger or acquisition that our stockholders may consider favorable or prevent the removal of our current board of directors and management.***

Certain provisions of our amended and restated certificate of incorporation and our amended and restated by-laws may discourage, delay or prevent a merger or acquisition that our stockholders may consider favorable or prevent the removal of our current board of directors and management. We have a number of anti-takeover devices in place that will hinder takeover attempts, including: a staggered board of directors consisting of three classes of directors, each of whom serve three-year terms; removal of directors only for cause, and only with the affirmative vote of at least a majority of the voting interest of stockholders entitled to vote; right of our directors to issue preferred stock from time to time with voting, economic and other rights superior to those of our common stock without the consent of our stockholders; provisions in our amended and restated certificate of incorporation and amended and restated by-laws limiting the right of our stockholders to call special meetings of stockholders; advance notice requirements for stockholders with respect to director nominations and actions to be taken at annual meetings; requirement for two-thirds stockholder approval for amendment of our by-laws and certain provisions of our certificate of incorporation; and no provision in our amended and restated certificate of incorporation for cumulative voting in the election of directors, which means that the holders of a majority of the outstanding shares of our common stock can elect all the directors standing for election.

Several of our leases, loan documents and other material agreements require approval in case of a change of control of our company. These provisions may have the effect of delaying or preventing a change of control of our company even if this change of control would benefit our stockholders.

In addition to the anti-takeover provisions described above, we are subject to Section 203 of the Delaware General Corporation Law. Section 203 generally prohibits a person beneficially owning, directly or in directly, 15% or more of our outstanding common stock from engaging in a business combination with us for three years after the person acquired the stock. However, this prohibition does not apply if (A) our directors approve in advance the person's ownership of 15% or more of the shares or the business combination or (B) the business combination is approved by our stockholders by a vote of at least two-thirds of the outstanding shares not owned by the acquiring person. Also, our board of directors adopted a stockholder rights plan, which may discourage a third party from making an unsolicited proposal to acquire us.

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

Not Applicable

**Item 3. DEFAULTS UPON SENIOR SECURITIES.**

Not Applicable

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

Not Applicable

**Item 5. OTHER INFORMATION.**

Not Applicable

**Item 6. EXHIBITS.**

The exhibits to this Form 10-Q are listed on the Exhibit Index page hereof, which is incorporated by reference in this Item 6.

**Table of Contents**

Signature

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

Capital Senior Living Corporation  
(Registrant)

By: /s/ Ralph A. Beattie  
Ralph A. Beattie  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer and Duly Authorized  
Officer)  
Date: November 4, 2008

**Table of Contents****INDEX TO EXHIBITS**

The following documents are filed as a part of this report. Those exhibits previously filed and incorporated herein by reference are identified below. Exhibits not required for this report have been omitted.

<b>Exhibit Number</b>	<b>Description</b>
3.1	Amended and Restated Certificate of Incorporation of the Registrant. (Incorporated by reference to exhibit 3.1 to the Registration Statement No. 333-33379 on Form S-1/A filed by the Company with the Securities and Exchange Commission on September 8, 1997.)
3.1.1	Amendment to Amended and Restated Certificate of Incorporation of the Registrant. (Incorporated by reference to exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1999, filed by the Company with the Securities and Exchange Commission.)
3.2	Bylaws of the Registrant. (Incorporated by reference to exhibit 3.2 to the Registration Statement No. 333-33379 on Form S-1/A filed by the Company with the Securities and Exchange Commission on September 8, 1997.)
3.2.2	Amended and Restated Bylaws of the Registrant. (Incorporated by reference to exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1999, filed by the Company with the Securities and Exchange Commission.)
3.2.3	Amendment No. 2 to the Amended and Restated Bylaws of the Registrant. (Incorporated by reference to exhibit 3.2.2 to the Company's Annual Report on Form 10-K for the year period ended December 31, 2002, filed by the Company with the Securities and Exchange Commission.)
4.1	Rights Agreement, dated as of March 9, 2000, between Capital Senior Living Corporation and ChaseMellon Shareholder Services, L.L.C., which includes the form of Certificate of Designation of Series A Junior Participating Preferred Stock, \$.01 par value, as Exhibit A, the form of Right Certificate as Exhibit B, and the Summary of Rights as Exhibit C. (Incorporated by reference to exhibit 4.1 to the Company's Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on March 20, 2000.)
4.2	Form of Certificate of Designation of Series A Junior Participating Preferred Stock, \$.01 par value. (Incorporated by reference to exhibit 4.1 to the Company's Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on March 20, 2000.)
4.3	Form of Right Certificate. (Incorporated by reference to exhibit 4.1 to the Company's Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on March 20, 2000.)
4.4	Form of Summary of Rights. (Incorporated by reference to exhibit 4.1 to the Company's Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on March 20, 2000.)
4.5	Specimen of legend to be placed, pursuant to Section 3(c) of the Rights Agreement, on all new Common Stock certificates issued after March 20, 2000 and prior to the Distribution Date upon transfer, exchange or new issuance. (Incorporated by reference to exhibit 4.1 to the Company's Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on March 20, 2000.)
4.6	2007 Omnibus Stock and Incentive Plan for Capital Senior Living Corporation. (Incorporated by reference to exhibit 4.6 to the Company's Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on May 31, 2007.)



**Table of Contents**

<b>Exhibit Number</b>	<b>Description</b>
4.7	First Amendment to 2007 Omnibus Stock and Incentive Plan for Capital Senior Living Corporation. (Incorporated by reference to exhibit 4.7 to the Company's Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on May 31, 2007.)
31.1*	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a)
31.2*	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a)
32.1*	Certification of Lawrence A. Cohen pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of Ralph A. Beattie pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Filed herewith.