

CAPITAL SENIOR LIVING CORP

Form 10-Q

May 09, 2007

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**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 March 31, 2007**

**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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check One).

Large accelerated filer  Accelerated filer  Non-accelerated filer

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 May 4, 2007, the Registrant had 26,458,057 outstanding shares of its Common Stock, \$0.01 par value.

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

	<b>March 31, 2007 (Unaudited)</b>	<b>December 31, 2006 (Note 1)</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 20,521	\$ 25,569
Accounts receivable, net	6,422	3,838
Accounts receivable from affiliates	276	784
Federal and state income taxes receivable	527	241
Deferred taxes	672	672
Assets held for sale	1,611	2,034
Property tax and insurance deposits	5,678	6,460
Prepaid expenses and other	4,005	3,493
Total current assets	39,712	43,091
Property and equipment, net	312,278	313,569
Deferred taxes	15,530	15,448
Investments in limited partnerships	5,375	5,253
Other assets, net	15,420	17,127
Total assets	\$ 388,315	\$ 394,488
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,801	\$ 3,566
Accrued expenses	8,942	11,224
Current portion of notes payable	3,995	6,110
Current portion of deferred income	4,775	4,306
Customer deposits	2,361	2,478
Total current liabilities	22,874	27,684
Deferred income	25,605	26,073
Notes payable, net of current portion	194,452	196,647
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		

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Issued and outstanding shares	26,459, and 26,424 in 2006 and 2005, respectively	265	264
Additional paid-in capital		127,827	127,448
Retained earnings		17,292	16,372
Total shareholders' equity		145,384	144,084
Total liabilities and shareholders' equity		\$ 388,315	\$ 394,488

See accompanying notes to consolidated financial statements.

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
Revenues:		
Resident and health care revenue	\$ 41,305	\$ 31,396
Unaffiliated management services revenue	88	411
Affiliated management services revenue	539	308
Community reimbursement revenue	4,294	4,442
<b>Total revenues</b>	<b>46,226</b>	<b>36,557</b>
Expenses:		
Operating expenses (exclusive of facility lease expense and depreciation and amortization shown below)	25,385	20,222
General and administrative expenses	3,135	2,886
Facility lease expense	6,525	2,128
Stock-based compensation expense	251	169
Depreciation and amortization	2,745	3,257
Community reimbursement expense	4,294	4,442
<b>Total expenses</b>	<b>42,335</b>	<b>33,104</b>
Income from operations	3,891	3,453
Other income (expense):		
Interest income	151	70
Interest expense	(3,285)	(5,224)
Gain on sale of assets	872	197
Write-off of deferred loan costs	(187)	(105)
Other income	55	54
Income (loss) before income taxes	1,497	(1,555)
(Provision) benefit for income taxes	(577)	556
<b>Net income (loss)</b>	<b>\$ 920</b>	<b>\$ (999)</b>
Per share data:		
Basic income (loss) per share	\$ 0.04	\$ (0.04)
Diluted income (loss) per share	\$ 0.03	\$ (0.04)
Weighted average shares outstanding basic	26,149	25,940
Weighted average shares outstanding diluted	26,636	25,940

See accompanying notes to consolidated financial statements.



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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Operating Activities</b>		
Net income (loss)	\$ 920	\$ (999)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation	2,733	3,114
Amortization	12	143
Amortization of deferred financing charges	120	324
Amortization of deferred lease costs	85	38
Amortization of imputed interest	44	55
Deferred income from affiliates		16
Deferred income	410	441
Deferred income taxes	(147)	(1,049)
Equity in the earnings of unconsolidated affiliates	(55)	(54)
Gain on sale of assets	(872)	(197)
Provision for bad debts	(25)	24
Write-off of deferred loan costs	187	105
Stock based compensation expense	251	169
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(2,559)	(114)
Accounts receivable from affiliates	508	(84)
Property tax and insurance deposits	782	(465)
Prepaid expenses and other	(512)	747
Other assets	1,685	(1,665)
Accounts payable	(765)	(336)
Accrued expenses	(2,281)	(1,149)
Federal and state income taxes receivable/payable	(286)	412
Customer deposits	(117)	(10)
Net cash provided by (used in) operating activities	118	(534)
<b>Investing Activities</b>		
Capital expenditures	(1,442)	(1,096)
Proceeds from the sale of assets	885	29,153
Net (investment in) distributions from limited partnerships	(67)	(2,722)
Net cash (used in) provided by investing activities	(624)	25,335
<b>Financing Activities</b>		
Proceeds from notes payable	9,500	
Repayments of notes payable	(13,854)	(19,094)
Restricted cash		973
Cash proceeds from the exercise of stock options	129	46



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Excess tax benefits on stock options exercised	65	22
Cash paid to settle interest rate lock agreement		(1,823)
Deferred financing charges paid	(382)	(493)
Net cash used in financing activities	(4,542)	(20,369)
(Decrease) increase in cash and cash equivalents	(5,048)	4,432
Cash and cash equivalents at beginning of period	25,569	21,831
Cash and cash equivalents at end of period	\$ 20,521	\$ 26,263
<b>Supplemental Disclosures</b>		
Cash paid during the period for:		
Interest	\$ 3,411	\$ 5,097
Income taxes	\$ 946	\$ 82
Non-cash transactions:		
Conversion of interest rate cap agreement to notes payable	\$	\$ 5,727

See accompanying notes to consolidated financial statements.

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**CAPITAL SENIOR LIVING CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**March 31, 2007**

**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 March 31, 2007, the Company operated 64 senior living communities in 23 states with an aggregate capacity of approximately 9,500 residents, including 25 senior living communities which the Company owned, 12 senior living communities in which the Company had an ownership interest, 23 senior living communities that the Company leased and four senior living communities it managed for third parties. As of March 31, 2007, 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. The Company accounts for significant investments in unconsolidated affiliated companies using the equity method of accounting. All material intercompany balances and transactions have been eliminated in consolidation.

The accompanying consolidated balance sheet, as of December 31, 2006, has been derived from audited consolidated financial statements of the Company for the year ended December 31, 2006, and the accompanying unaudited consolidated financial statements, as of March 31, 2007 and 2006, 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, 2006 included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 16, 2007.

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 March 31, 2007, results of operations and cash flows for the three months ended March 31, 2007 and 2006. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of the results for the year ending December 31, 2007.

**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 joint ventures and owns member interests in a third joint venture. 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 has 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 each such investment for its share of earnings and losses of the joint venture.

*Assets Held for Sale*

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 Company has three parcels of land held for sale at March 31, 2007. The fair value of these properties is generally determined based on market rates, industry trends and recent comparable sales transactions. The actual sales price of these assets could differ significantly from the Company's estimates.

In June 2006, the Company acquired a senior living community in Arlington, Texas, (Meadow View) from the Covenant Group of Texas, Inc. (Covenant) and classified Meadow View as held for sale at June 30, 2006 and estimated at that time that the community had an aggregate fair value, net of costs of disposal, of \$2.4 million. In

July 2006, the Company sold Meadow View to an unrelated third party for \$2.6 million, resulting in net proceeds to the Company of approximately \$2.4 million.

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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 and net proceeds of approximately \$0.5 million.

The Company estimates the three parcels of land that were held for sale at March 31, 2007 have an aggregate fair value, net of costs of disposal, that exceeds the carrying value of \$1.6 million. The amounts that the Company will ultimately realize could differ materially from this estimate.

*Leases 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 March 31, 2007, the Company leased 23 communities and classified each of these leases as an operating lease. The Company incurs lease acquisition costs and amortizes these costs over the term of the lease agreement. Facility lease expense in the Company's statement of operations includes the actual rent paid plus amortization expense relating to leasehold acquisition costs.

Certain leases entered into by the Company qualified as sale/leaseback transactions under the provisions of Financial Accounting Standards No. 98, *Accounting for Leases* ( FAS 98 ) and, as such, any related gains have been deferred and are being amortized over the lease term. The amortization of the deferred gains is included in gain on sale of assets in the statement of operations.

*Financial Instruments*

Effective January 31, 2005, the Company entered into an interest rate cap agreement with a commercial bank to reduce the impact of increases in interest rates on the Company's variable rate loans. One interest rate cap agreement effectively limits the interest rate exposure on the notional amount to a maximum London Interbank Offered Rate ( LIBOR ) of 5%, as long as one-month LIBOR is less than 7%. If one-month LIBOR is greater than 7%, the agreement effectively limits the interest rate on the same notional amount to a maximum LIBOR of 7%. This interest rate cap agreement has \$33 million of notional amounts left and expires on January 31, 2008. During the three months ended March 31, 2007, the Company received \$28,000 under the terms of this interest rate cap agreement and recorded the amount received as a reduction in interest expense. The cost of this agreement is being amortized to interest expense over the life of the agreement.

*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. Management regularly evaluates the future realization of deferred tax assets and provides a valuation allowance, if considered necessary, based on such evaluation. The Company currently has a cumulative three year loss and therefore has evaluated various tax planning strategies that it believes are both prudent and feasible, including various strategies to utilize net built-in gains on the Company's appreciated assets. The Company believes that based upon these tax planning strategies, it will be able to realize the deferred tax asset.

*Net Income (Loss) Per Share*

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share considers the dilutive effect of outstanding options and non-vested stock calculated using the treasury stock method. Due to net losses in the three months ended March 31, 2006, no common stock equivalents were considered in the calculation of diluted earnings per share.

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

	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Net income (loss)	\$ 920	\$ (999)
Weighted average shares outstanding basic	26,149	25,940
Effects of dilutive securities:		
Employee equity compensation plans	487	
Weighted average shares outstanding diluted	26,636	25,940
Basic income (loss) per share	\$ 0.04	\$ (0.04)
Diluted income (loss) per share	\$ 0.03	\$ (0.04)

*Reclassifications*

Certain reclassifications have been made to prior year quarterly amounts to conform to year end and current year presentation. The Company's income statements now separately reflect community reimbursement revenue and expense. Pursuant to Emerging Issues Task Force ( EITF ) Issue No. 01-14, Income Statement Characterization of Reimbursements Received for Out of Pocket Expenses Incurred, and EITF Issue No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, management concluded during the fourth quarter of fiscal 2006 that the accounting for certain reimbursements (primarily salaries and related overhead charges) related to joint venture and third party community operations should be presented on a grossed up basis versus a net expense basis. Accordingly, the Company has classified these expense reimbursements as community reimbursement revenue and community reimbursement expense in the consolidated statements of operations for the three months ended March 31, 2006 in order to be consistent with the current presentation for the three months ended March 31, 2007. This classification resulted in an increase in total revenues and total operating expenses from the amounts previously reported of \$4.4 million for the three months ended March 31, 2006. This reclassification had no impact on operating income, net income, earnings per share or stockholders' equity.

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

The Company accounts for its investment in four joint ventures (collectively SHPII/CSL ) under the equity method of accounting and the Company recognized earnings in the equity of SHPII/CSL of \$0.1 million in each of the three months ended March 31, 2007 and 2006. In addition, the Company earned \$0.3 million in management fees on the four senior living communities owned by SHPII/CSL (the Spring Meadows Communities ) in each of the three months ended March 31, 2007 and 2006.

*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 \$27,000 and \$2,000 in the three months ended March 31, 2007 and 2006, respectively. The Company earned \$0.1 million and \$49,000 in management fees on the five communities owned by Midwest I in the three months ended March 31, 2007 and 2006, respectively. Midwest I has not completed its analysis of the purchase price of the five communities it acquired in fiscal 2006 and therefore the Company's equity information disclosed above should be considered preliminary.

*Midwest II*

The Company formed Midwest Portfolio Holdings II, LP ( Midwest II ) in fiscal 2006 and accounts for its investment in Midwest II under the equity method of accounting. The Company recognized a loss in the equity of Midwest II of

\$24,000 in the three months ended March 31, 2007. The Company earned \$0.1 million in management fees on the three communities owned by Midwest II in the three months ended March 31, 2007. Midwest II has not completed its analysis of the purchase price of the three communities it acquired in fiscal 2006 and therefore the Company's equity information disclosed above should be considered preliminary.

*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

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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 over the remaining initial lease term.

**4. DEBT REFINANCINGS**

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 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.

On June 9, 2006, the Company refinanced \$110.0 million of mortgage debt on 15 senior living communities with the Freddie Mac. As part of the refinancing, the Company repaid approximately \$14.8 million of mortgage debt on the 15 communities. The new mortgage loans each have a ten-year term with interest rates fixed at 6.29% for the first nine years and with principal amortized over a 25-year term. At the beginning of the tenth year, the loans will convert to a floating interest rate to provide flexibility regarding financing alternatives. The loans are cross-collateralized and cross-defaulted with release provisions. The Company incurred \$1.9 million in deferred financing costs related to these loans, which is being amortized over ten years. In addition, the Company wrote-off \$0.8 million in deferred loan costs on the loans refinanced and paid \$0.2 million in loan exit fees to the prior lender.

On June 20, 2006, the Company refinanced \$33.0 million of mortgage debt on four senior living communities with Capmark Finance Inc. ( Capmark ). The new mortgage loans have a three-year term plus options for two one-year extensions at the Company's option with variable interest rates tied to the 30-day LIBOR plus a spread of 260 basis points. Principal is being amortized over a 25-year term. The Company has an interest rate cap in place thru January 2008, which limits the maximum rate on these loans to approximately 7.60%. The loans are cross-collateralized and cross-defaulted with release provisions. The Company incurred \$0.5 million in deferred financing costs related to these loans, which is being amortized over three years. In addition, the Company wrote-off \$14,000 in deferred loan costs on the loans refinanced and paid \$0.5 million in loan exit fees to the prior lender.

**5. NEW ACCOUNTING STANDARDS**

Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 ( FIN 48 ). In July 2006, FASB issued FIN 48, which became effective for the Company on January 1, 2007. This standard clarifies the accounting for income tax benefits that are uncertain in nature. Under FIN 48, a 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. This accounting standard 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. Under the transition guidance for implementing FIN 48, any required cumulative-effect adjustment was required to be recorded to retained earnings as of January 1, 2007. 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 2003. The adoption of FIN 48 did not have a material effect on the Company's results of operations or financial position.

FASB Statement No. 157, Fair Value Measurements ( FAS 157 ). In September 2006, FASB issued FAS 157, which will become effective for the Company on January 1, 2008. 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 impact, if any, to the Company from the adoption of FAS 157 in 2008 will depend on the Company's assets and liabilities at the time that they are required to be measured at fair value.

**6. STOCK-BASED COMPENSATION**

The 1997 Omnibus Stock and Incentive Plan for Capital Senior Living Corporation (as amended, the 1997 Plan ), provides for the grant of restricted stock awards and stock options to purchase shares of the Company s common stock. The 1997 Plan authorizes the



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Company to issue 2.6 million shares of common stock and the Company has reserved 1.6 million shares of common stock for future issuance under the 1997 Plan.

*Stock Options*

The Company's stock option program is a long-term retention program that is intended to attract, retain and provide incentives for employees, officers and directors and to align 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 three months ended March 31, 2007 is presented below:

	Outstanding at Beginning of Period	Granted	Exercised	Forfeited	Outstanding End of Period	Options Exercisable
Shares	1,026,682		28,616	2,000	996,066	971,566
Weighted average price	\$ 4.80	\$	\$ 4.48	\$ 4.50	\$ 4.81	\$ 4.73

The options outstanding and the options exercisable at March 31, 2007 had an intrinsic value of \$6.8 million and \$6.7 million, respectively.

*Restricted Stock*

The Company grants restricted stock under the 1997 Plan and the 1997 Plan provides for the restricted stock to be awarded 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 three months ended March 31, 2007, is presented below:

	Outstanding at Beginning of Period	Issued	Vested	Forfeited	Outstanding End of Period
Shares	283,445	10,000	3,500	3,750	286,195

The restricted stock outstanding at March 31, 2007 had an intrinsic value of \$3.3 million.

During the three months ended March 31, 2007, the Company awarded 10,000 shares of restricted common stock to certain employees of the Company. The average market value of the common stock on the date of grant was \$10.41. These awards of restricted shares vest over a four-year period and had an intrinsic value of \$0.1 million on the date of issue.

*Stock Based Compensation*

The Company accounts for share-based compensation under the principles of Financial Accounting Standards No. 123 (revised) ( 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.

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The following table presents the Company's assumptions utilized to estimate the grant date fair value of stock options:

	<b>Three Months Ended March 31, 2007</b>	<b>Three Months Ended March 31, 2006</b>
Expected volatility	51-58%	54-63%
Expected dividend yield	0%	0%
Expected term in years	7.5	7.5
Risk free rate	4.3-5.1%	4.6-6.5%
Expected forfeiture rate	2.0%	8.0%

The Company has total stock-based compensation expense of \$1.8 million not recognized as of March 31, 2007 and expects this expense to be recognized over approximately a four-year period.

**7. CONTINGENCIES**

In April 2005, the Company filed a claim before the American Arbitration Association in Dallas, Texas against a former brokerage consultant and her company (collectively, Respondents) for (1) a declaratory judgment that it has fulfilled certain obligations to Respondents under contracts the parties had signed related to the acquisition by the Company of all the outstanding stock of CGI Management, Inc. (CGIM), a wholly owned subsidiary of Covenant, (2) damages resulting from alleged breach of a confidentiality provision, and (3) damages for unpaid referral fees. Respondent filed a counterclaim for causes of action including breach of contract, duress, and undue infliction of emotional distress. In March 2006, the claim and counterclaim were settled.

On January 11, 2006, the Company received a demand letter from the Texas Property and Casualty Insurance Guaranty Association (TPCIGA) for repayment of \$199,737 in worker's compensation payments allegedly made by TPCIGA on behalf of Company employees. The Company has also received other correspondence for repayment of \$45,358 on the same basis. TPCIGA's letter states that it has assumed responsibility for insureds of Reliance Insurance Company (Reliance), which was declared insolvent and ordered into liquidation in October of 2001 by the Commonwealth Court of Pennsylvania. Reliance had previously been the Company's worker's compensation carrier. The Company had requested additional information from TPCIGA to verify that the Company was indeed the employer of the individuals on whose behalf TPCIGA had paid claims. TPCIGA had not provided sufficient documentation at that time for the Company to fully evaluate such claims. On July 19, 2006, TPCIGA filed a petition in the 53rd Judicial District Court of Travis County, Texas seeking repayment of approximately \$50,000 in claims and allocated loss adjustment expenses in connection with claims payable under the Reliance policy issued to the Company as well as future payments and attorneys' fees. On March 1, 2007, the Company and TPCIGA settled all claims between the parties.

The Company has other pending claims not mentioned above (Other Claims) incurred in the normal course of its business. Most of these Other 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 Other 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.

**8. SUBSEQUENT EVENTS**

On April 11, 2007, Healthcare Properties Investors, Inc. (HCPI) acquired a senior living community (Crescent Place) previously owned by Covenant and managed by the Company in a transaction valued at approximately \$8.0 million and immediately leased Crescent Place to the Company. The lease has an initial term of ten years, with two ten-year renewal extensions available at the Company's option. The initial lease rate was 7.25% and is subject to certain conditional escalation clauses. The Company expects to account for this lease as an operating lease. The Company's previous management agreement with Covenant was terminated.

On April 26, 2007, the Company entered into a purchase and sale agreement to sell one of its communities for \$10.0 million subject to certain purchase price adjustments set forth in the purchase and sale agreement. The buyer has a 45-day due diligence period and a one time option to extend the due diligence period for an additional 45 days in

order to obtain financing. The date for closing the purchase and sale would be on or before 30 days after the expiration of the due diligence period.

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 ). The new mortgage loans have a ten-year term, interest fixed at 5.91% with principal amortized over a 30-year term. The new loans will replace \$32.7 million of variable rate debt with an effective interest rate of 7.6%.

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

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

**Overview**

The following discussion and analysis addresses (i) the Company's results of operations for the three months ended March 31, 2007 and 2006, 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 March 31, 2007, the Company operated 64 senior living communities in 23 states with an aggregate capacity of approximately 9,500 residents, including 25 senior living communities which the Company owned, 12 senior living communities in which the Company had an ownership interest, 23 senior living communities that the Company leased and four senior living communities it managed for third parties. As of March 31, 2007, the Company also operated one home care agency.

**Management Agreements**

As of March 31, 2007, the Company managed 12 communities owned by joint ventures in which the Company has a minority interest and four 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**

In January 2006, the Company announced the formation of Midwest I with GE Healthcare Financial Services (GE Healthcare) to acquire five senior housing communities from a third party. Midwest I is owned approximately 89% by GE Healthcare and 11% by the Company. The Company contributed \$2.7 million for its interests in Midwest I. Midwest I paid approximately \$46.9 million for the five communities. The five communities comprise 293 assisted living units with a resident capacity of 389. Effective as of February 1, 2006, Midwest I acquired four of the five

communities and on March 31, 2006, Midwest I closed on the fifth community. The Company manages the five acquired communities under long-term management agreements with Midwest I. The Company

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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 \$27,000 and \$2,000 in the three months ended March 31, 2007 and 2006, respectively. The Company earned \$0.1 million and \$49,000 in management fees on the Midwest I communities in each of the three months ended March 31, 2007 and 2006. Midwest I has not completed its analysis of the purchase price of the five communities it acquired in fiscal 2006 and therefore the Company's equity information disclosed above should be considered preliminary.

*Midwest II Transactions*

In August 2006, the Company announced the formation of Midwest II, with GE Healthcare to acquire three senior housing communities from a third party. Midwest II is owned approximately 85% by GE Healthcare and 15% by the Company. The Company contributed \$1.3 million for its interests in Midwest II. Midwest II paid approximately \$38.2 million for the three communities. The three communities comprise 300 assisted living units with a resident capacity of 319. On August 11, 2006, Midwest II acquired the three senior living communities. The Company manages the three acquired communities under long-term management agreements with Midwest II. 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 \$24,000 in the three months ended March 31, 2007. The Company earned \$0.1 million in management fees on the Midwest II communities in the three months ended March 31, 2007. Midwest II has not completed its analysis of the purchase price of the three communities it acquired in fiscal 2006 and therefore the Company's equity information disclosed above should be considered preliminary.

*SHPII/CSL and SHPII Transactions*

The Company and Senior Housing Partners II, LP ( SHPII ), a fund managed by Prudential Real Estate Investors ( Prudential), own SHPII/CSL. SHPII/CSL is owned 95% by SHPII and 5% by the Company. Effective as of November 30, 2004, SHPII/CSL acquired the Spring Meadows Communities. The Company contributed \$1.3 million to SHPII/CSL for its 5% interest. 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 \$0.1 million in each of the three months ended March 31, 2007 and 2006. In addition, the Company earned \$0.3 million in management fees on the Spring Meadows Communities in each of the three months ended March 31, 2007 and 2006.

From September 2003 to December 2006, the Company managed, for SHPII under a long-term management contract, one senior living community (the Atrium of Carmichael ). The Company earned \$45,000 in management fees on the Atrium of Carmichael in the three months ended March 31, 2006. In December 2006, SHPII sold the Atrium of Carmichael to HCPI and the Company subsequently leased the community from HCPI in a transaction valued at approximately \$18.0 million.

*CGIM Transaction*

Effective August 18, 2004, the Company acquired from Covenant all of the outstanding stock of Covenant's wholly owned subsidiary, CGIM. The Company paid approximately \$2.3 million in cash (including closing costs of approximately \$0.1 million) and issued a non-interest bearing note with a fair value of approximately \$1.1 million (face amount \$1.4 million discounted at 5.7%), subject to various adjustments set forth in the purchase agreement, to acquire all of the outstanding stock of CGIM. The note is due in three installments of approximately \$0.3 million, \$0.4 million and \$0.7 million due on the first, third and fifth anniversaries of the closing, respectively, subject to reduction if the management fees earned from the third party owned communities with various terms are terminated and not replaced by substitute agreements during the period, and certain other adjustments. This acquisition resulted in the Company assuming the management contracts on 14 senior living communities with a combined resident capacity of approximately 1,800 residents. The acquisition was accounted for as a purchase and the entire purchase price of \$3.5 million was allocated to management contract rights. The Company's first installment payment under the Covenant note was reduced by \$0.2 million under the terms of the stock purchase agreement and the \$0.2 million installment reduction was recorded as an adjustment to the purchase price. The Company earned \$0.1 million and \$0.4 million under the CGIM management agreement for the three months ended March 31, 2007 and 2006, respectively. As of March 31, 2007 the Company managed four communities under the CGIM management agreements.

HCPI acquired six of the seven communities that were previously owned by Covenant, during fiscal 2006 and the Company leased the six communities from HCPI under a ten-year master lease agreement. In June 2006, the Company acquired the other community that was owned by Covenant, Meadow View, and classified the community as held for sale at June 30, 2006 and estimated at that time that the community had an aggregate fair value, net of costs of disposal, of \$2.4 million. In July 2006, the Company sold Meadow View to an unrelated third party for \$2.6 million resulting in net proceeds to the Company of approximately \$2.4 million.



**Table of Contents*****Lease Agreements******Ventas Transactions***

Effective as of June 30, 2005, Ventas and the Company entered into certain master lease agreements (the "Ventas Lease Agreements") whereby the Company leased the six communities from Ventas. Effective as of September 30, 2005, Ventas completed the purchase of the six communities from BRE/CSL and the Company began including the operations of the six communities in its consolidated statement of operations under the terms of the Ventas Lease Agreements. The Ventas Lease Agreements each have an initial term of ten years, with two five-year renewal extensions available at the Company's option. The initial lease rate under each of the Ventas Lease Agreements was 8% and is subject to certain conditional escalation clauses. The Company incurred \$1.3 million in lease acquisition costs related to the Ventas Lease Agreements. These deferred lease acquisition costs are being amortized over the initial 10-year lease terms and are included in facility lease expense in the Company's statement of operations. The Company accounts for the Ventas Lease Agreements as operating leases. The sale of the six communities from BRE/CSL to Ventas resulted in the Company receiving cash proceeds of \$6.1 million and recording a gain of approximately \$4.2 million, which has been deferred and is being recognized in the Company's statement of operations over the initial 10-year lease term. In March 2007, the Company received a final joint venture distribution from BRE/CSL of \$0.4 million relating to the sale of the six communities 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 over the remaining initial lease term.

On October 18, 2005, the Company entered into an agreement with Ventas to lease a senior living community located in Fort Wayne, Indiana ("Georgetowne Place") which Ventas acquired from a third party for approximately \$19.5 million. Georgetowne Place is a 162-unit senior living community with a capacity of 247 residents. This lease has an initial term of ten years, with two five-year renewal extensions available at the Company's option. The initial lease rate was 8% and is subject to conditional escalation provisions. The Company incurred \$0.2 million in lease acquisition costs related to this lease. These deferred lease acquisition costs are being amortized over the initial 10-year lease term and are included in facility lease expense in the Company's statement of operations. The Company accounts for this lease as an operating lease.

On March 31, 2006, the Company sold its Towne Centre community ("Towne Centre") to Ventas in a sale/leaseback transaction valued at \$29.0 million. This lease was effective as of April 1, 2006 and has an initial term of nine and one-half years, with two five-year renewal extensions available at the Company's option. The initial lease rate was 8% and is subject to certain conditional escalation clauses. The Company incurred \$0.1 million in lease acquisition costs. These deferred lease acquisition costs are being amortized over the initial lease term and are included in facility lease expense in the Company's statement of operations. The Company accounts for this lease as an operating lease. As a result of this sale/leaseback transaction the Company received cash proceeds of approximately \$12.7 million, net of closing costs, retired debt of approximately \$16.2 million and recorded a gain of approximately \$14.3 million, which has been deferred and is being recognized in the Company's statement of operations over the initial lease term.

On June 8, 2006 the Company entered into an agreement with Ventas to lease a senior living community located in Maple Grove, Minnesota ("Rose Arbor") which Ventas acquired from a third party for approximately \$19.1 million. Rose Arbor is a 137-unit senior living community with a capacity of 179 residents. This lease has an initial term of approximately nine and one-half years, with two five-year renewal extensions available at the Company's option. The initial lease rate was 8% and is subject to conditional escalation provisions. The Company incurred \$0.4 million in lease acquisition costs related to this lease. These deferred lease acquisition costs are being amortized over the initial lease term and are included in facility lease expense in the Company's statement of operations. The Company accounts for this lease as an operating lease.

***HCPI Transactions***

Effective as of May 1, 2006, the Company sold three of its communities, Crosswood Oaks in Citrus Heights, California, Tesson Heights in St. Louis, Missouri and Veranda Club in Boca Raton, Florida, to HCPI in sale/leaseback transactions valued at approximately \$54.0 million. These leases were effective as of May 1, 2006 and have an initial term of ten years, with two ten-year renewal extensions available at the Company's option. The initial lease rates were 8% and are subject to certain conditional escalation clauses. The Company incurred \$0.2 million in lease acquisition

costs. These deferred lease acquisition costs are being amortized over the initial lease terms and are included in facility lease expense in the Company's statement of operations. The Company accounts for these leases as operating leases. As a result of these sale/leaseback transactions, the Company received cash proceeds of approximately \$23.0 million, net of closing costs, retired debt of approximately \$29.3 million and recorded a gain of approximately \$12.8 million, which has been deferred and is being recognized in the Company's statement of operations over the initial lease terms.

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Effective May 31, 2006, HCPI acquired six senior living communities previously owned by Covenant for \$43.0 million and leased the six senior living communities to the Company. This six-property lease was effective as of May 31, 2006 and has an initial term of ten years, with two ten-year renewal extensions available at the Company's option. The initial lease rate was 8% and is subject to certain conditional escalation clauses. The Company incurred \$0.2 million in lease acquisition costs. These deferred lease acquisition costs are being amortized over the initial lease term and are included in facility lease expense in the Company's statement of operations. The Company accounts for this lease as an operating lease. As a result of this lease transaction, the Company received cash proceeds of approximately \$3.3 million and recorded deferred rent of approximately \$0.6 million, which is being recognized in the Company's statement of operations over the initial lease term.

Effective December 1, 2006, HCPI acquired four senior living communities (the Hunt Communities) previously owned by a third party and leased the four senior living communities to the Company in a transaction valued at approximately \$51.0 million. This four-property lease has an initial term of ten years, with two ten-year renewal extensions available at the Company's option. The initial lease rate was 8% and is subject to certain conditional escalation clauses. The Company incurred \$0.6 million in lease acquisition costs. These deferred lease acquisition costs are being amortized over the initial lease term and are included in facility lease expense in the Company's statement of operations. The Company accounts for this lease as an operating lease.

Effective December 14, 2006, HCPI acquired the Atrium of Carmichael and leased the Atrium of Carmichael to the Company in a transaction valued at approximately \$18.0 million. This lease has an initial term of ten years, with two ten-year renewal extensions available at the Company's option. The initial lease rate was 7.75% and is subject to certain conditional escalation clauses. The Company incurred \$0.3 million in lease acquisition costs. These deferred lease acquisition costs are being amortized over the initial lease term and are included in facility lease expense in the Company's statement of operations. The Company accounts for this lease as an operating lease.

**Recent Events**

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%, 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 these loans, which is being amortized over ten years. In addition, the Company wrote-off \$13,000 in deferred loan costs on the loans refinanced 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.

On April 11, 2007, HCPI acquired Crescent Place, previously owned by Covenant, in a transaction valued at approximately \$8.0 million and leased Crescent Place to the Company. The lease has an initial term of ten years, with two ten-year renewal extensions available at the Company's option. The initial lease rate was 7.25% and is subject to certain conditional escalation clauses. The Company expects to account for this lease as an operating lease.

On April 26, 2007, the Company entered into a purchase and sale agreement to sell one of its communities for \$10.0 million subject to certain purchase price adjustments set forth in the purchase and sale agreement. The buyer has a 45-day due diligence period and a one time option to extend the due diligence period for an additional 45 days in order to obtain financing. The date for closing the purchase and sale would be on or before 30 days after the expiration of the due diligence period.

On May 3, 2007, the Company refinanced \$30.0 million of mortgage debt on four senior living communities with Fannie Mae. The new mortgage loans have a ten-year term, interest fixed at 5.91% with principal amortized over a 30-year term. The new loans will replace \$32.7 million of variable rate debt with an effective interest rate of 7.6%. The new loans are expected to save the Company approximately \$0.7 million in interest expense annually.

**Recently Issued Accounting Standards**

In July 2006, FASB issued FIN 48, which became effective for the Company on January 1, 2007. This standard clarifies the accounting for income tax benefits that are uncertain in nature. Under FIN 48, a 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. This accounting standard also provides guidance on thresholds, measurement, derecognition, classification, interest and penalties, accounting in

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interim periods, disclosure, and transition that is intended to provide better financial-statement comparability among different companies. Under the transition guidance for implementing FIN 48, any required cumulative-effect adjustment was required to be recorded to retained earnings as of January 1, 2007. 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 2003. The adoption of FIN 48 did not have a material effect on the Company's results of operations or financial position.

In September 2006, FASB issued FAS 157, which will become effective for the Company on January 1, 2008. 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 impact, if any, to the Company from the adoption of FAS 157 in 2008 will depend on the Company's assets and liabilities at the time that they are required to be measured at fair value.

**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).

**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 March 31,		2006	
	2007			
	\$	%	\$	%
Revenues:				
Resident and healthcare revenue	\$ 41,305	89.3	\$ 31,396	85.9
Unaffiliated management service revenue	88	0.2	411	1.1
Affiliated management service revenue	539	1.2	308	0.8
Community reimbursement income	4,294	9.3	4,442	12.2
Total revenues	46,226	100.0	36,557	100.0
Expenses:				
Operating expenses (exclusive of facility lease expense and depreciation and amortization shown below)	25,385	54.9	20,222	55.3
General and administrative expenses	3,135	6.8	2,886	7.9
Facility lease expense	6,525	14.1	2,128	5.8
Stock-based compensation expense	251	0.5	169	0.5
Depreciation and amortization	2,745	5.9	3,257	8.9
Community reimbursement expense	4,294	9.3	4,442	12.2
Total expenses	42,335	91.6	33,104	90.6
Income from operations	3,891	8.4	3,453	9.4
Other income (expense):				
Interest income	151	0.3	70	0.2
Interest expense	(3,285)	(7.1)	(5,224)	(14.3)
Gain on sale of assets	872	1.9	197	0.5
Write-off of deferred loan costs	(187)	(0.4)	(105)	(0.3)

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Other income	55	0.1	54	0.1
Income (loss) before income taxes	1,497	3.2	(1,555)	(4.3)
(Provision) benefit for income taxes	(577)	(1.2)	556	1.5
Net income (loss)	\$ 920	2.0	\$ (999)	(2.7)

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**Three Months Ended March 31, 2007 Compared to the Three Months Ended March 31, 2006**

*Revenues.*

Total revenues were \$46.2 million for the three months ended March 31, 2007 compared to \$36.6 million for the three months ended March 31, 2006 representing an increase of approximately \$9.7 million or 26.4%. This increase in revenue is primarily the result of a \$9.9 million increase in resident and healthcare revenue, an increase in affiliated management services revenue of \$0.2 million offset by a decrease in unaffiliated management services revenue of \$0.3 million and a decrease in community reimbursement revenue of \$0.1 million.

Resident and healthcare revenue increased 31.6% as a result of an increase of \$2.9 million from the addition of the Covenant communities which the Company leased from HCPI on May 31, 2006, an increase of \$1.2 million from the addition of Rose Arbor which was leased from Ventas on June 8, 2006, an increase of \$3.2 million from the addition of the four Hunt Communities which were leased from HCPI on December 1, 2006, an increase of \$0.8 million from the addition of the Atrium of Carmichael which was leased from HCPI on December 14, 2006 and an increase in resident and healthcare revenue at the Company's other communities of \$1.8 million as a result of higher occupancy and rental rates in the current fiscal year.

Affiliated management services revenue increased due to an increase in management fees earned on the communities owned by SHPII/CSL, Midwest I and Midwest II. The Company earned affiliated management fees on 12 communities in the first quarter of fiscal 2007 compared to eight communities in the first quarter of fiscal 2006.

The decrease in unaffiliated management services revenue primarily results from the expiration of third party management agreements and the sale of the seven communities previously owned by Covenant and managed by the Company, six of which the Company now leases from HCPI.

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 \$42.3 million in the first quarter of fiscal 2007 compared to \$33.1 million in the first quarter of fiscal 2006, representing an increase of \$9.2 million or 27.9%. This increase is primarily the result of a \$5.2 million increase in operating expenses, a \$0.2 million increase in general and administrative expenses, a \$4.4 million increase in facility lease expense, a \$0.1 million increase in stock-based compensation offset by a \$0.5 million decrease in depreciation and amortization expense and a decrease in community reimbursement expense of \$0.1 million.

Operating expenses increased 25.5% primarily due to an increase of \$1.9 million from the addition of the Covenant communities, an increase of \$0.7 million from the addition of Rose Arbor, an increase of \$2.0 million from the addition of the four Hunt Communities, an increase of \$0.5 million from the addition of the Atrium of Carmichael and an increase in operating expenses at the Company's other communities of \$0.1 million.

General and administrative expenses increased \$0.2 million primarily due to an increase in administrative labor costs of \$0.1 million and an increase in insurance costs of \$0.1 million.

Facility lease expenses increased \$4.4 million primarily due to the Company leasing 23 senior living communities in the first quarter of fiscal 2007 compared to seven senior living communities in the first quarter of fiscal 2006.

Stock-based compensation increased \$0.1 million in the first quarter of fiscal 2007 compared to the first quarter of fiscal 2006 primarily due to the award of additional options and restricted shares to certain employees of the Company.

Depreciation and amortization expense decreased \$0.5 million primarily as a result of the sale/leaseback of four communities previously owned by the Company.

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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 increased to \$0.2 million in the first quarter of fiscal 2007 compared to \$0.1 million in first quarter of fiscal 2006. This increase results from the investment of cash balances and interest earned on escrowed funds.

Interest expense decreased \$1.9 million to \$3.3 million in the first quarter of 2007 compared to \$5.2 million in the comparable period of 2006. This decrease in interest expense primarily results from lower debt outstanding during first quarter of fiscal 2007 compared to the first quarter of fiscal 2006 primarily resulting from property sales, along with a lower average interest rate in the current fiscal year compared to the prior year as a result of the Company's debt refinancings.

Gain on sale of assets in the first quarter of fiscal 2007 represents the recognition of deferred gains associated with the Company's sale/leaseback transactions of \$0.8 million along with a gain of \$0.1 million from the sale of a parcel of land. As of March 31, 2007, the Company had deferred gains on sale/leaseback transactions of \$28.9 million that are being recognized into income over their respective initial lease terms. Gain on sale of assets in the first quarter of fiscal 2006 represents the recognition of deferred gains of \$0.1 million along with the recognition of a gain of \$0.1 million related to the sale of a portion of the Company's interest rate cap.

Other income in the first quarter of fiscal 2007 and 2006 relates to the Company's equity in the earnings of unconsolidated affiliates, which represents the Company's share of the earnings/losses on its investments in SHPII/CSL, Midwest I and Midwest II.

*Benefit for income taxes.*

Provision for income taxes in the first quarter of fiscal 2007 was \$0.6 million or 38.5% of income before taxes compared to a benefit for income taxes of \$0.6 million, or 35.8% of loss before taxes, in the first quarter of fiscal 2006. The effective tax rates for the first quarter of 2007 and 2006 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 March 31, 2007, 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 \$0.9 million for the three months ended March 31, 2007 compared to a net loss of \$1.0 million for the three months ended March 31, 2006.

**Liquidity and Capital Resources**

In addition to approximately \$20.5 million of cash balances on hand as of March 31, 2007, 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 and 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 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>Three Months Ended</b>	
<b>March 31,</b>	
<b>2007</b>	<b>2006</b>

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Net cash provided by (used in) operating activities	\$ 118	\$ (534)
Net cash (used in) provided by investing activities	(624)	25,335
Net cash used in financing activities	(4,542)	(20,369)
Net (decrease) increase in cash and cash equivalents	(5,048)	4,432

**Table of Contents***Operating Activities*

The net cash provided by operating activities in the first quarter of fiscal 2007 primarily results from net income of \$0.9 million, net non-cash charges of \$2.7 million, a decrease in property tax and insurance deposits of \$0.8 million and a decrease in other assets of \$1.7 million offset by an increase in accounts receivable of \$2.1 million, an increase in prepaid and other assets of \$0.5 million, an increase in income tax receivable of \$0.3 million, a decrease in accounts payable and accrued expenses of \$3.0 million, and a decrease in customer deposits of \$0.1 million. In the first quarter of fiscal 2006, net cash used in operating activities was primarily derived from a net loss of \$1.0 million, an increase in accounts receivable of \$0.2 million, an increase in property tax and insurance deposits of \$0.4 million, an increase in other assets of \$1.6 million, a decrease in accounts payable and accrued expenses of \$1.5 million offset by net non-cash charges of \$3.1 million, a decrease in federal and state income taxes receivable of \$0.4 million and a decrease in prepaid and other expenses of \$0.7 million.

*Investing Activities*

The net cash used in investing activities for the first quarter of fiscal 2007 primarily results from capital expenditures of \$1.4 million, net investments in joint ventures of \$0.1 million offset by proceeds from the sale of a parcel of land that the Company owned in Baton Rouge, Louisiana for \$0.5 million and proceeds from a final distribution from the BRE/CSL joint venture of \$0.4 million. In the first quarter of fiscal 2006, net cash provided by investing activities was primarily derived from proceeds from the sale of the Company's Towne Centre community of \$28.9 million, proceeds from the sale of an interest rate cap of \$0.2 million offset by capital expenditures of \$1.1 million and investments in the Midwest I joint venture of \$2.7 million.

*Financing Activities*

The net cash used in financing activities the first quarter of fiscal 2007 primarily results from net repayments of notes payable of \$4.4 million, deferred loan cost paid of \$0.4 million offset by proceeds from the issuance of common stock of \$0.1 million and excess tax benefits on the issuance of common stock of \$0.1 million. For the first quarter of fiscal 2006, net cash used in financing activities primarily results from the repayment of notes payable of \$19.1 million, cash paid to settle the Company's interest rate lock agreement of \$1.8 million and deferred financing charges paid of \$0.5 million offset by the release of restricted cash of \$1.0 million.

*Community Refinancings*

On June 9, 2006, the Company refinanced \$110.0 million of mortgage debt on 15 senior living communities with the Freddie Mac. As part of the refinancing, the Company repaid approximately \$14.8 million of mortgage debt on the 15 communities. The new mortgage loans have a ten-year term with interest rates fixed at 6.29% for the first nine years and with principal amortized over a 25-year term. At the beginning of the tenth year, the loans will convert to a floating interest rate to provide flexibility regarding financing alternatives. Each of the loans are cross-collateralized and cross-defaulted with release provisions. The Company incurred \$1.9 million in deferred financing costs related to these loans, which is being amortized over ten years. In addition, the Company wrote-off \$0.8 million in deferred loan costs on the loans refinanced 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.

On June 20, 2006, the Company refinanced \$33.0 million of mortgage debt on four senior living communities with Capmark Finance Inc. (Capmark). The new mortgage loans have a three-year term plus options for two one-year extensions at the Company's option with variable interest rates tied to the 30-day LIBOR plus a spread of 260 basis points. Principal is being amortized over a 25-year term. The Company has an interest rate cap in place through January 2008, which limits the maximum rate on these loans to approximately 7.60%. Each of the loans are cross-collateralized and cross-defaulted with release provisions. The Company incurred \$0.5 million in deferred financing costs related to these loans, which is being amortized over three years. In addition, the Company wrote-off \$14,000 in deferred loan costs on the loans refinanced and paid \$0.5 million in loan exit fees to the prior lender.

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%, 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 these loans, which is being

amortized over ten years. In addition, the Company wrote-off \$13,000 in deferred loan costs on the loans refinanced and paid \$0.2 million in loan exit fees to the prior lender.

**Table of Contents****Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

The Company's primary market risk is exposure to changes in interest rates on debt instruments. As of March 31, 2007, the Company had \$198.4 million in outstanding debt comprised of various fixed and variable rate debt instruments of \$165.7 million and \$32.7 million, respectively.

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. Fluctuations in interest rates on the Company's variable rate debt instruments, which are tied to either LIBOR or the prime rate, would affect the Company's earnings and cash flows but would not affect the fair market value of the variable rate debt. Each percentage point change in interest rates would change the Company's annual interest expense by approximately \$0.3 million (subject to certain interest rate caps) based on the Company's outstanding variable debt as of March 31, 2007.

*Interest Rate Cap, Lock and Swap Agreements*

Effective January 31, 2005, the Company entered into an interest rate cap agreement with a commercial bank to reduce the impact of increases in interest rates on the Company's variable rate loans. One interest rate cap agreement effectively limits the interest rate exposure on the notional amount to a maximum LIBOR of 5%, as long as one-month LIBOR is less than 7%. If one-month LIBOR is greater than 7%, the agreement effectively limits the interest rate on the same notional amount to a maximum LIBOR of 7%. This interest rate cap agreement has \$33 million of notional amounts left and expires on January 31, 2008. During the three months ended March 31, 2007, the Company received \$28,000 under the terms of this interest rate cap agreement and recorded the amount received as a reduction in interest expense. The cost of this agreement is being amortized to interest expense over the life of the agreement.

**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 March 31, 2007 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.**

In April 2005, the Company filed a claim before the American Arbitration Association in Dallas, Texas against a former brokerage consultant and her company for (1) a declaratory judgment that it has fulfilled certain obligations to Respondents under contracts the parties had signed related to the acquisition by the Company of all the outstanding stock of CGIM, a wholly owned subsidiary of Covenant, (2) damages resulting from alleged breach of a confidentiality provision, and (3) damages for unpaid referral fees. Respondent filed a counterclaim for causes of action including breach of contract, duress, and undue infliction of emotional distress. In March 2006, the claim and counterclaim were settled.

On January 11, 2006, the Company received a demand letter from the TPCIGA for repayment of \$199,737 in worker's compensation payments allegedly made by TPCIGA on behalf of Company employees. The Company has also received other correspondence for



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repayment of \$45,358 on the same basis. TPCIGA's letter states that it has assumed responsibility for insureds of Reliance, which was declared insolvent and ordered into liquidation in October of 2001 by the Commonwealth Court of Pennsylvania. Reliance had previously been the Company's worker's compensation carrier. The Company had requested additional information from TPCIGA to verify that the Company was indeed the employer of the individuals on whose behalf TPCIGA had paid claims. TPCIGA had not provided sufficient documentation at that time for the Company to fully evaluate such claims. On July 19, 2006, TPCIGA filed a petition in the 53rd Judicial District Court of Travis County, Texas seeking repayment of approximately \$50,000 in claims and allocated loss adjustment expenses in connection with claims payable under the Reliance policy issued to the Company as well as future payments and attorneys' fees. On March 1, 2007, the Company and TPCIGA settled all claims between the parties.

The Company has Other Claims incurred in the normal course of its business. Most of these Other 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 Other 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. Our failure to generate cash flow sufficient to cover required interest and principal payments could result in defaults of the related debt.***

As of March 31, 2007, we had mortgage and other indebtedness totaling approximately \$198.4 million. We also have significant operating lease obligations as described below. 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, principal and, if applicable, operating lease payments. Any payment or other default could cause the applicable lender to foreclose upon the communities securing the indebtedness or, if applicable, in the case of an operating lease, could terminate the lease, with a consequent loss of income and asset value to us. Further, because some of our mortgages and our operating leases 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.

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

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 parent company level, which include, but are not limited to, liquidity requirements, earnings before interest, taxes and depreciation and amortization ( EBITDA ) requirements, and 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 debt service 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.





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***We will require additional financing and/or refinancings in the future.***

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 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 the financing or refinancings will be available or that, if available, it 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 could expose us to rising interest rates.***

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

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

As of March 31, 2007, we leased 23 communities with future lease obligations totaling approximately \$232.0 million, with minimum lease obligations of \$25.9 million in fiscal 2007. 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 our leases could result in the termination of the lease, with a consequent loss of income and asset value to us. Further, because all of our leases contain cross-default provisions, a payment or other default by us with respect to one leased community could affect a significant number of our other leased communities. 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 us.

***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 through the 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

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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.

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

Approximately 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 2006. 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 some particular risks related to third-party management agreements.***

At March 31, 2007, we managed four senior living communities for third parties and 12 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.

***Performance of 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 joint venture agreements with Prudential covering four 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. All of the management agreements with the joint ventures contain termination and renewal provisions. We do not control 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.

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***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 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.

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***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 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 Certificate of Need ( 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 ( HIPAA ), 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



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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.

**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.**

Exhibits:

- 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.

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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: May 8, 2007