ARV ASSISTED LIVING INC
Form 10-K
March 28, 2003
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2002

Commission File Number: 0-26980

ARV ASSISTED LIVING, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	**33-0160968** (I.R.S. Employer Identification No.)
245 Fischer Avenue, Suite D-1, Costa Mesa, California (Address of Principal Executive Offices)	**92626** (Zip Code)

Registrant s Telephone Number, Including Area Code: (714) 751-7400

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Class	Name of Each Exchange on Which Registered
Common Stock, $0.01 Par Value	**American Stock Exchange**

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
x o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Yes No
x o

As of March 14, 2003, the aggregate market value of the voting stock held by non-affiliates of the registrant was $30,936,822 (for purposes of calculating the preceding amount only, all directors, executive officers and shareholders holding 5% or greater of the registrant s Common Stock are assumed to be affiliates). The number of shares of Common Stock of the registrant outstanding as of March 14, 2003 was 17,459,689.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act)

Yes	No
o	x

As of June 30, 2002, the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold of such common equity, was $17,643,016.

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PART I

Item 1. ***Business***

General

ARV Assisted Living, Inc. (ARV or the Company), originally incorporated in California in 1980 and subsequently merged into a Delaware corporation in 1998, is one of the largest operators of licensed assisted living communities (ALCs) in the United States. ARV is a fully integrated provider of assisted living accommodations and services that operates, acquires and develops ALCs. We have been involved in the senior housing business for more than 20 years. Our operating objective is to provide high quality, personalized assisted living services to senior residents in a cost-effective manner, while maintaining residents independence, dignity and quality of life. Our ALCs offer a combination of housing, personalized support services and assistance in activities of daily living in a non-institutional setting. Our ALCs are designed to respond to the individual needs of elderly residents who require assistance with certain activities of daily living, but who do not require the intensive nursing care provided in a skilled nursing facility.

Since commencing operation of ALCs, we embarked upon an expansion strategy and achieved significant growth in revenue resulting primarily from the acquisition of ALCs. We focused our growth efforts on the acquisition and development of additional ALCs and expansion of services to our residents as they age in place. In the last four years we have focused on improving the operations of our existing ALCs. In December 2001 and through December 31, 2002, as part of a response to a hostile tender offer for outstanding units of American Retirement Villas Properties III, L.P., (ARVP III) one of the partnerships for which we are the managing general partner, we acquired 52.5% of the outstanding partnership units of ARVP III. With this acquisition of ARVP III, two ALCs were added to our portfolio of owned ALCs bringing our total number of owned ALCs to 18. As of December 31, 2002, a substantial portion of our business and operations are conducted in California, where 38 of the 60 ALCs we own or operate are located. We intend to continue to make the western United States one of our primary focuses. Our current attention and resources are focused on enhancing the profitability of our existing core operations. In addition, we plan to divest ALCs that do not expand or enhance one of our geographic clusters or do not meet our financial objectives.

As of December 31, 2002, we owned or operated a total of 60 ALCs containing 6,997 units: 18 of which are owned, 33 that are leased and 9 that are managed. Owned ALCs (Owned ALCs) are owned by us directly, or by affiliated limited partnerships or limited liability companies for which we serve as managing general partner or member and community manager and in which we have a majority ownership interest (Affiliated Partnerships). Leased ALCs (Leased ALCs) are operated under long-term operating leases for our own account or for Affiliated Partnerships in which we have a majority ownership interest. Managed ALCs (Managed ALCs) are operated on behalf of joint ventures or unrelated third-parties. We believe that this blend of ownership and leasehold and management interests in our ALCs allows us to fund our operations in a balanced, efficient manner.

We have financed our capital expenditures and operations through leasehold and mortgage financing with healthcare real estate investment trusts (REITs), private companies, commercial banks and a convertible subordinated debt issuance. In order to implement our refocusing strategy, we planned to dispose of those ALCs that did not meet our financial objectives or that did not lie within our primary geographic focus, the western United States. To this end, in December 1999, we commenced efforts to sell or transfer certain non-core assets and reclassified the assets to property held for sale. Due to market conditions, no buyer could be found for the leasehold interest in the nine ALCs held for sale at December 31, 2000. In June of 2001, the Company decided to retain these ALCs.

We intend to continue our focus on private-pay residents who pay for our services from their own funds or through private insurance. Currently, approximately 97% of our residents are private-pay, while the remaining 3% of the residents participate in the Supplemental Security Income (SSI) program. Certain states have enacted legislation enabling ALCs to receive Medicaid funding similar to funding generally provided to skilled nursing facilities.

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Our ALCs provide residents with accommodations and basic care services and offer assisted living services for additional charges. Our resident s average age is approximately 85 years and he/she often requires assistance with certain basic activities of daily living. We provide our residents with private or semi-private housing accommodations, meals in a restaurant-style setting, housekeeping, linen and laundry services, activities programs, utilities, and transportation in a van or minibus. For an additional cost, we also provide assisted living services to residents who require help with other activities of daily living, such as bathing, grooming, dressing, personal hygiene, medication management and escort services to meals and activities.

Most ALCs offer a Wellness Program that arranges for professional care providers to deliver certain healthcare services to our residents that our ALCs are not licensed or equipped to provide.

Recent Developments

On September 23, 2002, we received an unsolicited letter from Prometheus Assisted Living LLC (Prometheus), an affiliate of Lazard Freres & Co. LLC, in which Prometheus stated that it had decided to propose a transaction to acquire for cash all of the outstanding shares of common stock of ARV not currently owned by Prometheus or its affiliates. Prometheus also stated that it was not interested in selling its shares in the Company. On January 3, 2003, ARV, Prometheus, and Jenny Merger Corp., a wholly-owned subsidiary of Prometheus, entered into an Agreement and Plan of Merger (the Merger Agreement). Pursuant to the Merger Agreement, Jenny Merger Corp. will merge with and into ARV (the Merger) and ARV will be the surviving corporation. Upon consummation of the Merger, ARV will become a wholly-owned subsidiary of Prometheus. According to the Merger Agreement, at the effective time of the Merger (the Effective Time), each share of ARV s common stock outstanding immediately prior to the Effective Time will be converted into the right to receive $3.90 in cash, without interest, and each holder of a stock option granted by the Company to purchase shares of the Company s stock will receive in cash, without interest, for each share of common stock subject to such option, the excess, if any, of the Merger consideration of $3.90 per share over the exercise price of such option less any applicable withholding taxes.

The obligations of ARV and Prometheus to consummate the Merger are subject to certain closing conditions, including, among other things, that ARV obtains the affirmative vote of the holders of a majority of all the outstanding common stock of the Company. Prometheus currently owns approximately 43.5% of the Company s outstanding common stock and its affiliate holds a warrant, which if exercised, would result in Prometheus and its affiliates, together, owning approximately 45.8% of the Company s outstanding common stock. The Company has filed proxy materials with the Securities and Exchange Commission for a special meeting of the Company s stockholders to vote on the Merger. Prometheus has stated that following the completion of the transaction it intends to combine ARV with Atria, Inc. and Kapson Senior Quarters Corp. (also assisted living companies), subject to receipt of all necessary approvals and consents, but that its proposed acquisition of the remaining shares of the Company is not dependent on any subsequent transaction with Atria or Kapson.

The Assisted Living Market

Assisted Living. Assisted living is a stage in the elder care continuum, midway between home-based care for independent and lower acuity residents and the more acute level of care provided by skilled nursing facilities and acute care hospitals. Assisted living represents a combination of housing, personalized support services, and healthcare designed to respond to the individual needs of the members of the senior population who need help with activities of daily living, but do not need the medical care provided in a skilled nursing facility.

We strive to provide a wide variety of assisted living services in a professionally managed environment that allows our residents to maintain dignity and independence. Our residents are typically unable to live alone, but do not require the intensive care provided in skilled nursing facilities. Under our approach, seniors reside in a private or semi-private residential unit for a monthly fee based on each resident s individual service needs. We believe our residential assisted living communities allow seniors to maintain a more independent lifestyle than is possible in the institutional environment of skilled nursing facilities. In addition, we believe that our services, including assisting residents with activities of daily living, such as medication management, bathing, dressing, personal hygiene and grooming, are attractive to seniors who are inadequately served by independent living facilities.

We believe our assisted living business benefits from significant trends affecting the long-term care industry. One such trend is the increase in the demand for elder care resulting from the continued aging of the U.S. population, with the average age of our residents falling within the fastest growing segment of the U.S. population. While increasing numbers of Americans are living longer and healthier lives, many gradually require increasing assistance with activities of daily living and are not able to continue to age in place at home. A second trend is the effort to contain healthcare costs by the government, private insurers and managed care organizations by limiting lengths of stay, services, and reimbursement to patients in acute care hospitals and skilled nursing facilities. Assisted living offers a cost-effective, long-term care alternative while preserving a more independent lifestyle for seniors who do not need the broader array of medical services that acute care hospitals and skilled nursing facilities are equipped to provide. For the year ended December 31, 2002, monthly revenue generated by our ALCs averaged $2,411 per occupied unit, compared with $2,259 per occupied unit for the year ended December 31, 2001. Other trends include increases in the financial net worth of the elderly population, the number of individuals living alone, and the number of women who work outside the home who are less able to care for their elderly relatives. We believe these trends will result in a growing demand for assisted living services and communities.

Aging Population. The primary consumers of long-term healthcare services are persons over the age of 65. This group represents one of the fastest growing segments of the population. According to U.S. Bureau of the Census data as of January 2000, the segment of the population over 65 years of age is 13% of the total population, or 35 million people. That number is projected to grow to 20% of the total population, or 70 million people, by the year 2030. Additionally, according to U.S. Bureau of the Census data, the number of people aged 85 and older, which comprises the largest percentage of residents at long-term care facilities, is currently 4.4 million and is projected to increase to 8.9 million by the year 2030.

Limitation on the Supply of Long-Term Care Facilities. The majority of states in the U.S. have enacted Certificate of Need or similar legislation, which generally limits the construction of skilled nursing facilities and the addition of beds or services in existing skilled nursing facilities. High construction costs, limitations on government reimbursement for the full cost of construction, and start-up expenses also constrain growth in the supply of such facilities. Such legislation benefits the assisted living industry by limiting the supply of skilled nursing beds for the elderly. Cost factors are placing pressure on skilled nursing facilities to shift their focus toward higher acuity care, which enables them to charge more. This contributes to a shortage of lower acuity care and thereby increases the pool of potential assisted living residents.

While Certificates of Need generally are not required for ALCs, except in a few states, most states do require assisted living providers to license their communities and comply with various regulations regarding building requirements and operating procedures and regulations. States typically impose additional requirements on ALCs over and above the standard congregate care requirements. Further, the limited pool of experienced assisted living staff and management, as well as the costs and start-up expenses to construct an ALC, provide an additional barrier to entry into the assisted living business.

Cost Containment Pressures of Health Reform. In response to rapidly rising healthcare costs, both government and private pay sources have adopted cost containment measures that encourage reduced lengths of stay in hospitals and skilled nursing facilities. The federal government has acted to curtail increases in healthcare costs under Medicare by limiting acute care hospital and skilled nursing facility reimbursement to pre-established fixed amounts. Private insurers have also begun to limit reimbursement for medical services in general to predetermined reasonable charges. Managed care organizations, such as health maintenance organizations (HMOs) and preferred provider organizations (PPOs), are reducing hospitalization costs by negotiating discounted rates for hospital services and by monitoring and decreasing hospitalization. We anticipate that both HMOs and PPOs increasingly may direct patients away from higher cost nursing care facilities into less expensive ALCs.

These cost containment measures have produced a push-down effect. As the number of patients being pushed down from acute care hospitals to skilled nursing facilities increases, the demand for residential options such as ALCs to serve patients who historically have been served by skilled nursing facilities will also increase. In addition, skilled nursing facility operators are continuing to focus on improving occupancy and expanding services (and fees) to subacute patients requiring very high levels of nursing care. As the acuity level of skilled nursing facility patients rises, the supply of nursing facility beds will be filled by patients with higher acuity needs who pay higher fees. This

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will provide opportunities for ALCs to increase their occupancy and services to residents requiring lower levels of care than patients in skilled nursing facilities generally receive.

Our Assisted Living Services

We provide services and care which are designed to meet the individual needs of our residents while offering a supportive home-like environment. The services provided are designed to enhance both the physical and mental well being of seniors in each of our ALCs by promoting their independence and dignity. Our assisted living program includes the following:

Personalized Care Plan. The focus of our strategy is to meet the specific needs of each resident. We customize our services beginning with the admissions process, at which time the ALC s management staff, the resident, the resident s family, and the resident s physician discuss the resident s needs and develop a personalized care plan. If recommended by the resident s physician, additional healthcare or medical services may be provided at the community by a third-party home healthcare agency or other medical provider. The care plan is reviewed and modified on a regular basis.

Basic Service and Care Package. The basic service and care package at our ALCs generally includes:

- meals in a restaurant-style, home-like setting;
- social and recreational activities;
- housekeeping;
- linen and laundry service;
- most utilities;
- transportation to appointments in a van or minibus.
- building and ground maintenance; and
- licensed nurses on staff to monitor health needs.

Other care services can be provided under the basic package based upon the individual s personalized healthcare plan. Our policy is to charge base rental rates that are competitive with similar ALCs in the local market. While the amount of the fee for the basic service package varies from community to community, the average basic monthly rental rate per unit was approximately $2,034 per month for the year ended December 31, 2002, compared with an average of $1,904 for the year ended December 31, 2001.

Additional Services. Our assisted living services program offers levels of care in addition to the services offered in the basic package. The level of care a resident receives is determined through an assessment of a resident s physical and mental health. The assessment is conducted by the community s assisted living director, with input from other staff members, physicians, and family members. The six-tiered level of care rate structure is based on a point system. We assign points to the various care tasks required by the resident, based on the amount of staff time and expertise needed to accomplish the tasks. The point scale and pricing are part of the admissions agreement between the community, the resident and the resident s family. The community performs reassessments after the initial 30 days and periodically throughout the resident s stay to ensure that the level of care we provide corresponds to changes in a resident s condition. The types of services included in the assessment point calculation are:

- Medication management
- Assistance with dressing and grooming

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- Assistance with showering and bathing
- Assistance with continence
- Escort services
- Status checks related to a recent hospitalization, illness, history of falls or injuries
- Special nutritional services and assistance with eating
- Behavior management

Special Programs We have certain Assisted Living Communities that have specialized medical and psychological programs for residents requiring these types of programs. Residents generally are afflicted with Alzheimer s or a similar memory deficit disorder. We provide:

- separate dining programs;
- enhanced behavior interpretations;
- structured activity planning;
- counseling for residents and their families;
- oversight of medication requirements; and
- secure environment.

In addition to the above services, we provide other levels of assistance to residents at selected ALCs in order to meet individual needs, such as assistance with diabetic care and monitoring, colostomy and ileosotomy care, and light to moderate transferring needs.

In addition to the base service package, we typically charge between $375 and $2,500 per month or more for higher levels of assisted living services. Fee levels vary from community to community and we may charge additional fees for other specialized assisted living services. We expect that an increasing number of residents will use additional levels of services as they age in our ALCs. Our internal growth plan is focused on increasing revenue by continuing to improve our ability to provide residents with these services.

The average monthly revenue per occupied unit for both the basic service package and the assisted living services increased to $2,411 from $2,259 for the year ended December 31, 2002 and 2001, respectively. There can be no assurance that any ALC will be substantially occupied at assumed rates at any time. In addition, we may only be able to lease up our ALCs to full occupancy at rates below our set rates due to limitations imposed on rates by local market conditions or other factors. Even if we achieve substantial occupancy at our set rates, our set rates may not allow for our projected cost recovery and profit if operating expenses increase. In addition, in order to increase our set rates, we must provide advance notice of rate increases, generally at least 30 days. Because of this advance notice requirement, we are not able to reflect cost increases in our set rates until at least several months after such cost increases occur.

We rely primarily on our residents ability to pay our charges for services from their own or family resources and expect that we will do so for the foreseeable future. Although care in an assisted living community is typically less expensive than in a skilled nursing facility, we believe generally that only seniors with income or assets meeting or exceeding the regional median can afford to reside in our communities. Inflation or other circumstances that

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adversely affect seniors and their ability to pay for assisted living services could therefore have an adverse effect on our business.

As third party reimbursement programs and other forms of payment continue to grow, we intend to pursue these alternative forms of payment, depending on the level of reimbursement provided in relation to the level of care provided. We also believe that private long-term care insurance will increasingly become a revenue source in the future, although it is currently not a material factor. All sources of revenue other than residents private resources constitute less than 10% of our total revenues.

Wellness Program. We have implemented a Wellness Program for residents of our communities designed to identify and respond to changes in a resident s health or condition. Together with the resident and the resident s family and physician, as appropriate, we design a solution to fit that resident s particular needs. We monitor the physical and mental well being of our residents, usually at meals and other activities, and informally as the staff performs services around the facility. Through the Wellness Program we work with:

- home healthcare agencies to provide services the community cannot provide;
- physical and occupational therapists to provide services to residents in need of such therapy; and
- long-term care pharmacies to facilitate cost-effective and reliable ordering and distribution of medications.

We arrange for these independent third party services to be provided to residents as needed in consultation with their physicians and families. At the present time, most of our ALCs have a comprehensive Wellness Program.

Growth Strategies

Overview. In order to grow earnings and achieve profitability, we have devised a strategy to increase our focus on the operations of our current ALCs and reduce the level of development and acquisition activity we historically pursued. To strengthen the operations of our ALCs, we will focus on improving margins by increasing occupancy rates, raising or maintaining pricing structures to ensure that our rates are competitive with comparable facilities in our local markets, and expanding the level and depth of our assisted living services. Although we have currently halted the development and construction of new communities, we will continue efforts to cluster our portfolio of ALCs within certain geographic areas through the acquisition or divestiture of selected assets. By concentrating on a clustering strategy we expect to increase the efficiency of our management and marketing resources and to achieve broader economies of scale. However, in the event of the consummation of the Merger and the subsequent combination of the Company with Atria, Inc. and Kapson Senior Quarters Corporation, we expect these strategies to change, see Recent Developments .

Our strategy is to target areas where there is a need for ALCs based on demographics and market studies. In addition to acquiring ALCs through direct ownership and the use of long-term leases, we may also divest our ALCs that do not expand or enhance one of our clusters or do not meet our financial objectives. In 1999, we sold five ALCs that were located outside of the western United States. During 2000, we completed the sale of three of our ALCs that were located outside of the western United States. As of December 31, 2002, a substantial portion of our business and operations were conducted in California, where 38 of the 60 ALCs we operate are located. We have no operations or customers in foreign countries.

The market value of our properties and the income generated from ALCs we own, manage or lease could be negatively affected by changes in local and regional economic conditions and by acts of nature.

Development. Due to market conditions, the development of new ALCs has been curtailed during 2001 and 2002. We do not expect to develop any new facilities in the foreseeable future.

In 1998, we entered into several joint venture arrangements operating as limited liability companies (LLCs) designed to help us finance development and renovation projects and to mitigate the impact of start-up losses associated with the opening of newly constructed ALCs. The joint ventures were formed to finance and manage the substantial renovation of two existing ALCs acquired in 1998 in the Hillsdale Transaction and to construct three new

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communities on land sites we owned. Participants in the joint ventures with us include a third-party investor and a third-party developer. The LLCs contracted with the developer to provide development services to perform the renovation and construction. We account for our investment in the joint ventures using the equity method and losses incurred by the LLCs will be allocated disproportionately to the joint venture partners based upon their assumption of risk. In 2000 and 2001, certain joint venture partner s capital was reduced to zero, consequently, the losses from the joint venture were allocated to us based upon our capital or percentage interest. The Company has agreed to fund any operating deficits incurred in connection with the operation of these joint venture projects operating as LLCs, up to an aggregate amount of $6.0 million for all of the development properties and $6.0 million for all of the renovation properties subject to a $9.0 million cap. The advances, which are considered capital contributions to the LLC, are non-interest bearing and will be repaid only if sufficient funds are available in accordance with the terms of the operating agreements of the respective LLCs. These agreements will remain in effect from the commencement of operations of the project until the earlier to occur of 18 months after the project has achieved stabilization, the sale of the project to a third-party, or the purchase by the Company of the membership interests of the venture partners. Our current funding of operating deficits since inception in 1998 is $2.4 million. According to the LLC operating agreements we have an option to purchase the joint venturers interest in the LLCs when the ALCs reach stabilization, at a purchase price that is the greater of fair market value or an amount that generates a guaranteed rate of return on the joint ventures capital contribution. The LLC operating agreements further provide that if we do not exercise an option during the exercise period, we can be terminated as a manager of the LLC. In December 2000, we determined that the value of our investment in the LLCs was impaired based upon projected cash flow, and wrote down the investment by $5.7 million to reflect the fair value. In 2001 we declined to exercise the option to purchase two of the LLCs that had reached stabilization and in accordance with the LLCs operating agreement, we no longer serve as a manager of the two LLCs. We no longer manage one of the LLCs that is outside our geographic clustering strategy. In February 2003, we were notified that we would no longer manage the remaining LLCs as a result of our election not to exercise the related purchase option. We felt the required purchase prices were excessive and, consequently, did not exercise our right to purchase the LLCs.

In 2000, we completed three development projects that were in progress at December 31, 1999. We do not plan to develop new ALCs during 2003.

Cost Containment. To contain costs and maximize operating efficiency, we employ an integrated structure of management and financial systems and controls. We utilize a combination of centralized and decentralized accounting systems and computer systems that link each community with our executive offices to provide management with on-line revenue and expense information in a cost efficient manner. We provide an on-line analysis capability for resident billing, occupancy, marketing, financial and statistical information. We believe our current systems are adequate for our current operating needs and provide flexibility to meet the requirements of our operations without disruption or significant modifications beyond 2003. We use high quality hardware and operating systems from current and proven technologies to support our current technology infrastructure.

We have recruited experienced key employees from several established operators in the long-term-care services field and believe that we have assembled the administrative, operational and financial personnel that will enable us to manage our growth and operating strategies effectively. We also recruit individuals with strong backgrounds for our regional director positions. In addition we have developed internal procedures and policies that we believe are necessary for effective operation and management of our ALCs. Day to day community operations are supervised by an on-site executive director who, in certain jurisdictions, must satisfy certain licensing requirements. We provide management support services to each of our assisted living communities including establishing operating standards, recruiting, training and all financial services.

Acquisitions. In evaluating possible acquisitions, we consider:

- the location, construction quality, condition and design of the ALC;
- the current and projected cash flow of the community and its anticipated ability to increase revenue through rent and occupancy increases, additional assisted living services and management; and
- whether we can acquire the community below replacement cost.

Our sources for prospective acquisitions range from Affiliated Partnerships to management contracts with potential ALC sellers, to our local and regional personnel who monitor the assisted living market in their area. In 2001, we acquired two ALCs that we had managed since 1989. This acquisition was accomplished by means of the purchase of 51.8% of the outstanding partnership units in ARVP III pursuant to a tender offer. In certain cases we may also target additional third-party management contracts. In October 2001, we entered into four management contracts providing for the Company s management of certain ALCs, two in Texas totaling 126 units and two in New Mexico totaling 92 units. In January 2002, we entered into a fifth management contract for a newly completed ALC that is in the lease-up stage in California. However, we do not intend to continue our past growth rate and may not expand at all in the future.

Increase in Sales of Additional Assisted Living Services. We believe that many custodial services provided in skilled nursing facilities are available in our ALCs at approximately two-thirds of the cost. We believe that this differential will enable us to attract additional residents. By increasing the use of these services by our residents, we believe residents will be able to age in place at our ALCs over a longer period of time, and not have to transfer to more expensive skilled nursing facilities until absolutely necessary.

We seek to enhance and increase the amount and diversity of assisted living services we provide through:

- the continued education of the senior community, and particularly the residents and their families, concerning the cost-effectiveness of receiving additional services in an assisted living community;
- the continued development and refinement of assisted living programs designed to meet the needs of our residents as they age in place; and
- the consistent delivery of quality services for residents.

Employees

At December 31, 2002 we had approximately 3,070 employees. None of our employees are members of unions and the Company continues to enjoy good relations with its employees.

Capital Requirements

Our operating leases require the tender of security deposits. At December 31, 2002, the amount of security deposits was $9.3 million either in cash or letters of credit supported by cash. These deposits are classified as non-current assets in our consolidated balance sheets as of December 31, 2002 and 2001.

In 2002, we increased mortgage debt by $30.4 million. We increased mortgage debt by $4.0 million on one ALC with interest at 8.5% payable in monthly installments of principal and interest and maturing in January 2004. We also refinanced the mortgage debt on two other ALCs for $24.0 million with monthly interest only payments through October 2003 and monthly principal and interest payments thereafter, based on LIBOR plus 3.5% with a minimum interest rate of 7.0% maturing in August 2004. In addition, one other ALC was refinanced for $2.4 million at a fixed rate of 7.56% including a mortgage insurance premium of 0.5% with monthly principal and interest payments based on a 35 year amortization schedule. Proceeds were used as follows:

- pay off existing debt that matured in 2002 and 2003; and
- borrow against the increased value of these properties.

In January, 2001 we restructured 16 ALC leases into two lease pools of 8 ALCs each. In each restructured pool, the lease termination date was extended through fiscal 2021. As part of the restructure, we are allowed to finance the additional rent expense of up to $1.0 million during 2001, $1.0 million in 2002, $1.5 million in 2003, $1.0 million in 2004 and $0.5 million in 2005, converting this into a note payable with a due date of December 31, 2010 at a fixed interest rate of 7%. Interest only payments are required monthly with principal payments beginning in 2006 at $1.0 million per year. At December 31, 2002 we had $2.0 million outstanding. We also incurred a restructuring fee of

$4.5 million payable at $1.5 million for each of the first three years. The restructured lease agreements provide for reimbursement to us from the landlord of capital improvement expenditures up to $3.0 million. The lease agreements provide for a total rent as a percentage of revenue that changes annually, which was 28.3% for the year ended December 31, 2002. Total annual rent expense shall not be less than the immediately preceding year s rent expense.

The Company s various debt and lease agreements contain restrictive covenants requiring us to maintain certain financial ratios, including current ratio, working capital, minimum net worth, and debt service coverage, among others. At December 31, 2002, we were in compliance with all such covenants or waivers were obtained.

In 1999, we began retiring portions of our 6 3/4% convertible subordinated debt. During 1999, we issued a total of 799,566 shares of our common stock and paid a total of $1.0 million to certain of our bondholders in exchange for a total of $9.2 million principal amount of the subordinated notes due 2006 that were held by those bondholders. These transactions resulted in an extraordinary gain of $7.0 million net of tax for the fiscal year ended December 31, 1999. During 2000, we issued a total of 781,025 shares of our common stock and paid a total of $9.6 million to additional bondholders in exchange for a total of $33.0 million in principal amount of the subordinated notes held by those bondholders. This yielded an extraordinary gain of $20.6 million net of tax and costs. In 2001 we paid a total of $5.7 million to certain of our bondholders in exchange for a total of $8.0 million principal amount of the subordinated notes. The transactions for the year ended December 31, 2001, resulted in an extraordinary gain of $2.1 million net of tax and costs. Out of $57.5 million we have retired a total of $50.2 million of our public debt resulting in extraordinary gains of $29.5 million to date net of tax and costs. Prometheus has stated that it intends to redeem all of the 6 3/4% notes after the completion of the Merger.

We obtained a $10.0 million unsecured revolving line of credit from our major shareholder Lazard Freres, through its affiliates, to be used for retirement of the subordinated 6 3/4% public debt. At December 31, 2002, we had $10.0 million outstanding on the line of credit at LIBOR plus 9.54% interest payable monthly.

In 1998, we entered into several joint venture arrangements operating as limited liability companies (LLCs) designed to help us finance development and renovation projects and to mitigate the impact of start-up losses associated with the opening of newly constructed ALCs. The joint ventures were formed to finance and manage the substantial renovation of two existing ALCs acquired in 1998 in the Hillsdale Transaction and to construct three new communities on land sites we owned. Participants in the joint ventures with us include a third-party investor and a third-party developer. The LLCs contracted with the developer to provide development services to perform the renovation and construction. We account for our investment in the joint ventures using the equity method and losses incurred by the LLCs will be allocated disproportionately to the joint venture partners based upon their assumption of risk. In 2000 and 2001, certain joint venture partner s capital was reduced to zero, consequently, the losses from the joint venture were allocated to us based upon our capital or percentage interest. The Company has agreed to fund any operating deficits incurred in connection with the operation of these joint venture projects operating as LLCs, up to an aggregate amount of $6.0 million for all of the development properties and $6.0 million for all of the renovation properties subject to a $9.0 million cap. The advances, which are considered capital contributions to the LLC, are non-interest bearing and will be repaid only if sufficient funds are available in accordance with the terms of the operating agreements of the respective LLCs. These agreements will remain in effect from the commencement of operations of the project until the earlier to occur of 18 months after the project has achieved stabilization, the sale of the project to a third-party, or the purchase by the Company of the membership interests of the venture partners. Our current funding of operating deficits since inception in 1998 is $2.4 million. According to the LLC operating agreements we have an option to purchase the joint venturers interest in the LLCs when the ALCs reach stabilization, at a purchase price that is the greater of fair market value or an amount that generates a guaranteed rate of return on the joint ventures capital contribution. The LLC operating agreements further provide that if we do not exercise an option during the exercise period, we can be terminated as a manager of the LLC. In December 2000, we determined that the value of our investment in the LLCs was impaired based upon projected cash flow, and wrote down the investment by $5.7 million to reflect the fair value. In 2001 we declined to exercise the option to purchase two of the LLCs that had reached stabilization and in accordance with the LLCs operating agreement, we no longer serve as a manager of the two LLCs. We no longer manage one of the LLCs that is outside our geographic clustering strategy. In February 2003, we were notified that we would no longer manage the remaining LLCs as a result of our election not to exercise the related purchase option. We felt the required purchase prices were excessive and, consequently, did not exercise our right to purchase the LLCs.

We believe that our existing liquidity, cash provided by operating activities, our ability to sell ALCs and land sites which do not meet our financial objectives or geographic clustering strategy, and our ability to refinance certain owned ALCs and investments will provide us with adequate resources to meet our current operating and investing needs. Historically we have not generated sufficient cash from operations to fund recurring working capital and capital expenditure requirements. We had not anticipated incurring the additional expenses required in a merger transaction and, consequently, we may be required to incur additional indebtedness to finance the activity in the event the Merger is not completed. We may also be required from time to time to incur additional indebtedness or issue additional debt or equity securities to finance our strategy, including the rehabilitation of ALCs as well as other capital expenditures. We anticipate that we will be able to obtain the additional financing; however, we cannot assure that we will be able to obtain financing on favorable terms.

Factors Affecting Future Results and Forward-Looking Statements

Our business, results of operations and financial condition are subject to many risks, including those set forth below. Certain statements contained in this report, including without limitation, statements containing the words believes, anticipates, expects, and words of similar import, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. We have made forward-looking statements in this report concerning, among other things, the impact of future acquisitions and developments, if any, and the level of future capital expenditures. These statements are only predictions; however, actual events or results may differ materially as a result of risks we face. These risks include, but are not limited to, those items discussed below. Certain of these factors are discussed in more detail elsewhere in this report, including without limitation under the captions Business and Management s Discussion and Analysis of Financial Condition and Results of Operations. Given these uncertainties, we caution readers not to place undue reliance on such forward-looking statements, which speak only as of the date of this report. We disclaim any obligation to update any such factors or to publicly announce the result of any revisions to any of the forward-looking statements contained herein to reflect future events or developments.

Certain risks are inherent in the operation of ALCs. These risks include, but are not limited to:

- our history of losses;
- our ability to access capital necessary for operations and acquisitions;
- competition;
- sales and marketing;
- our ability to meet our indebtedness, lease and other obligations;
- our liabilities as a general partner of Affiliated Partnerships or as a member of the joint venture LLC where we are required to fund operating deficits;
- dependence on reimbursement from third-party payers;
- governmental regulation; and
- risks common to the assisted living industry.

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Risks that the Merger will not be Completed

Although we executed a definitive Merger Agreement with Prometheus, it is subject to various closing conditions including approval by our stockholders and it is possible that the Merger may not be completed in the stated timeframe or at all. If the proposed merger is not completed we may be subject to the following risks:

if the Merger Agreement is terminated under specified circumstances controlled by the Company, we will be required to pay Prometheus a termination fee of approximately $2.2 million plus Prometheus expenses up to $1.5 million;

the price of our common stock may decline to the extent that the current market price reflects a market assumption that the proposed merger will be completed;

costs related to the Merger such as legal, accounting and certain financial advisory fees, must be paid even if the Merger is not completed; and

if the proposed merger is terminated and our board of directors determines to seek another merger or business combination, we may not be able to find a partner willing to pay an equivalent or more attractive price than that which would be paid by Prometheus in the Merger.

if the proposed merger is not completed by Prometheus then we will be reimbursed for our costs plus $4.5 million termination fee.

History of Losses

For the years ended December 31, 2002, 2001, and 2000, we had losses before extraordinary gains of approximately $3.3 million, $1.1 million, and $14.1 million, respectively. At December 31, 2002, our accumulated deficit was approximately $101.0 million.

Our loss before extraordinary gain for the year ended December 31, 2002 primarily resulted from:

merger costs and litigation judgement;

net interest expense;

equity in losses of partnerships; partially offset by

income from ALC operations.

Our loss before extraordinary gain for the year ended December 31, 2001 primarily resulted from:

income from ALC operations; and

gain on sale of properties and partnership interests; more than offset by

net interest expense; and

equity in losses of partnerships.

Our loss before extraordinary gain for the year ended December 31, 2000 primarily resulted from:

loss from ALC operations including impairment losses on joint venture LLCs; and

interest expense.

We cannot provide assurance that the risks associated with operating our ALCs can be managed to reduce or eliminate impairment, equity losses of partnerships or that other similar costs and expenses or losses will not occur in the future. See Indebtedness, Lease and Other Obligations, General Partner Liability and Status, and Management s Discussion and Analysis of Financial Condition and Results of Operations .

Dependence on the Availability of Adequate Capital

We depend heavily on our ability to obtain adequate capital to fund our operations. Our estimated capital expenditure needs over the next 12 months are $6.4 million, which we expect to fund from operations. As of December 31, 2002 we had $14.3 million in cash and cash equivalents and working capital of $3.7 million. We believe we have cash and cash equivalents to meet our estimated capital needs for operations for the next 12 months. If, however our operating costs exceed our projections, we may have to obtain additional financing. There is no assurance that we will be able to obtain the financing on a timely basis, if at all. If we are unable to obtain the required financing on a timely basis we may not be able to execute our business plan.

Competition

We compete in over 40 separate markets. Competition to increase or maintain high occupancies is significant with numerous other companies representing national, regional, and local fragmented ownership. No one competitor tends to have a dominant market share within our niche. The Company for the most part has created a market niche based on mid-range pricing and competes on quality of service, services offered, reputation, location, and market longevity. However, in select markets the Company enjoys market efficiencies due to multiple locations in a single market. We are continuing to grow within these competitive markets by providing excellent value in residential amenities, staff hospitality, and personal care services.

The healthcare industry is highly competitive and we expect that the assisted living business, in particular, will become more competitive in the future. Currently competition includes, family members providing care at home; numerous local, regional and national providers of retirement, assisted living and long-term care whose facilities and services range from home-based healthcare to skilled nursing facilities; and acute care hospitals. In addition, we believe that as assisted living receives increased attention among the public and insurance companies, new competitors focused on assisted living will enter the market, including hospitality companies expanding into the market. Some of our competitors operate on a not-for-profit basis or as charitable organizations, while others have, or are capable of obtaining, greater financial resources than those available to us.

We believe that our size gives us significant advantages over smaller operators. Given the scale of our operations, we have the opportunity to select the best operating systems and service alternatives and to develop a set of best practices for implementation on a national scale. We also believe that, because of our size, we are able to purchase such items as food, equipment, insurance and employee benefits at lower costs and to negotiate more favorable financing arrangements.

Sales and Marketing

The Company s marketing strategy focuses on enhancing the reputation of the Company s communities and creating awareness of the Company and its services among potential referral sources. The Company emphasizes outreach by developing relationships and creating awareness among referral sources. Referral sources include hospital discharge planners, physician offices, skilled nursing facilities, home healthcare providers and members of the clergy. We focus on our satisfied residents and family members who represent a key number of referrals. Each regional cluster generally has at least one sales and marketing specialist and in each ALC one sales and marketing director is responsible for implementing sales and marketing programs. In addition to the direct contacts with referral services we market our services through newspapers, direct mail and through internet based referral organizations.

Indebtedness, Lease and Other Obligations

We have financed, and may continue to finance, the acquisition of ALCs through a combination of loans, leases and other obligations. As of December 31, 2002, we had an outstanding consolidated indebtedness of $121.0 million, including $7.3 million of our 2006 Convertible Notes, whose holders have the right to convert such notes into our

common stock at any time on or before the notes mature. As a result, we will devote a significant portion of our cash flow to debt service. There is a risk that we will not be able to refinance our maturing note obligations on terms favorable to us, or that we will not be able to generate sufficient cash flow from operations to make required interest and principal payments.

At December 31, 2002, we have provided a limited guarantee of an indebtedness of $3.5 million for the benefit of an Affiliated Partnership for the term of the loan which ends May 2010. Under the terms of the guarantee, our payment obligation will be limited to 15% of the outstanding principal balance of the indebtedness at such time as (i) the outstanding principal balance does not exceed 75% of the appraised value of the security property, (ii) the security property has achieved a Debt Service Coverage ratio of not less than 1.0 to 1.0, and (iii) the security property achieves an occupancy level of 85% for the preceding 6 consecutive calendar months. In addition, at such time as the outstanding principal balance of the indebtedness does not exceed 75% of the appraised value of the security property and either (i) the security property achieves a Debt Service Coverage Ratio of not less than 1.25 to 1 for 6 consecutive months or (ii) the Affiliated Partnership prepays a portion of the indebtedness sufficient for the secured property to achieve a Debt Service Coverage ratio of not less than 1.25 to 1.0 for the preceding 6 months, our liability under the guarantee will be limited to liability based upon fraud, failure to remit insurance proceeds, failure to properly apply revenues of the secured property, commission of waste on the security property, or contamination of the secured property with hazardous waste. We also guarantee through January 2004, $1.0 million of debt on one of our consolidated partnerships in which we own 52.5%. In both cases the liability would be reduced by the sale proceeds of the underlying real estate asset secured by the loans. Another guarantee we have extended pertains to another partnership that we own more than 60.5%. The guaranteed amount is limited to a Curtailment Payment defined as the difference between the current debt service coverage ratio as defined by the lender, and 1.25 to 1.0 measured on a semi annual basis. At December 31, 2002 we had no liability for a Curtailment Payment. We are the general partner of certain limited partnerships that serve as the sole members of limited liability company borrowing entities which carried loan balances of $3.6 million at December 31, 2002. Although a member of a limited liability company is not personally liable for any contract or other obligation of that entity, we delivered limited guarantees in connection with the loans. Due to the limited guarantees, we assumed liability for repayment of the loan indebtedness as a result of fraudulent or intentional misconduct regarding the mortgaged properties, an unconsented transfer of a mortgaged property, a change of control by borrower, or violation of hazardous materials covenants.

In January 2001, we disposed of our interests in five of the eight remaining partnerships in our apartment group (the Apartment Group). As part of the tax credit agreements relating to the Apartment Group, we remain responsible for guarantees for the period of time we acted as the general partner for the tax credit apartment partnerships if sufficient projected tax credits were not generated in order to meet agreed-upon levels of tax credit benefits. The Apartment Group required $2.9 million to fund permanent loan shortfalls in 2000, the balance of which was paid in January 2001 from proceeds of the sale of the partnership interests. Concurrently, we sold our interests in the related partnerships for a gain of $2.9 million.

At December 31, 2002, approximately $39.1 million of our indebtedness bore interest at floating rates. We may incur indebtedness in the future that may also bear interest at a floating rate, or be fixed at some time in the future. Therefore, increases in prevailing interest rates could increase our interest payment obligations and could have an adverse effect on our business, financial condition and operating results.

As of December 31, 2002, we are party to long-term operating leases for certain of our leased ALCs. These require minimum annual lease payments in the aggregate amount of $33.7 million and $32.5 million for years ending December 31, 2003 and 2004, respectively.

In January 2001, we restructured 16 ALC leases into two lease pools of 8 ALCs each. In each restructured pool, the lease termination date was extended through fiscal 2021. As part of the lease restructure we are allowed to finance additional rent expense of up to $1.0 million during 2001, $1.0 million in 2002, $1.5 million in 2003, $1.0 million in 2004 and $0.5 million in 2005 converting this into a note payable with a due date of December 31, 2010 at a fixed rate of 7%. Interest only payments are required monthly with principal payments beginning in 2006 of $1.0 million per year. At December 31, 2002 we had $2.0 million outstanding. We also incurred a restructuring fee of $4.5 million payable at $1.5 million for each of the first three years. The restructuring fee is accounted for on a straight-line basis. The restructured lease agreements provide for reimbursement to us from the landlord of capital improvement expenditures up to $3.0 million. The lease agreements provide for a total rent as a percentage of

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revenue that changes annually, which was 28.3% for, the year ended December 31, 2002. Total annual rent expense shall not be less than the immediately preceding years rent expense.

The following table represents a list of our contractual obligations and other commercial commitments for the indicated periods (calculated as of December 31, 2002):

	Payments Due For The Twelve Month Periods Ending December 31,						
	2003	2004	2005	2006	2007	Thereafter	Total