GENESIS HEALTH VENTURES INC /PA
Form 10-Q
August 14, 2003
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 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 June 30, 2003

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: 000-33217

GENESIS HEALTH VENTURES, INC.
(Exact name of registrant as specified in its charter)

Pennsylvania	**06-1132947**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

101 East State Street	
Kennett Square, Pennsylvania	**19348**
(Address of principal executive offices)	(Zip code)

(610) 444-6350
(Registrant s telephone number, including area code)

N/A
(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 an accelerated filer (as defined by Rule 12b-2 of the Act).

YES (1) NO

(1) The registrant meets the definition of accelerated filer (as defined by Rule 12b-2 of the Act). However, the registrant notes that the phase-in period for accelerated deadlines of quarterly and annual reports will begin for reports filed by companies that meet the definition of accelerated filer as of the end of their first fiscal year ending after December 15, 2002. Accordingly, such rules do not currently apply to the

registrant.

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS.

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

YES NO

APPLICABLE ONLY TO CORPORATE ISSUERS.

As of August 13, 2003: 39,513,518 shares of the registrant s common stock were outstanding and 261,326 shares are to be issued in connection with the registrant s joint plan of reorganization confirmed by the Bankruptcy Court on September 20, 2001.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

As used herein, unless the context otherwise requires, Genesis, the Company, we, our or us refers to Genesis Health Ventures, Inc. and our subsidiaries.

Statements made in this report and in our other public filings and releases, which are not historical facts, contain forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995) that involve risks and uncertainties and are subject to change at any time. These forward-looking statements may include, but are not limited to:

Certain statements in Management s Discussion and Analysis of Financial Condition and Results of Operations, and the notes to our unaudited condensed consolidated financial statements, such as our ability to meet our liquidity needs, scheduled debt and interest payments, and expected future capital expenditure requirements; the expected effects of government regulation on our business; the expected increase in Medicare rates projected for fiscal 2004; our ability to successfully implement our strategic objectives, including the completion and the effects of the proposed spin-off of our eldercare business, the achievement of certain performance improvement initiatives within our pharmacy services segment in order to improve current pharmacy profitability, the completion of our transactions with ElderTrust and the sale of certain assets; the expected reduction of pharmacy service revenue as a result of the medical supplies service agreement with Medline; the expected effects of the termination of our pharmacy services agreement with Mariner; the expected strategic planning, severance and other related costs for the remainder of fiscal 2003 and the foreseeable future; estimates in our critical accounting policies including, our allowance for doubtful accounts, any anticipated impact of long-lived asset impairments and our ability to provide for loss reserves for self-insured programs; and the expected repayments of Senior Credit Facility debt.

The forward-looking statements involve known and unknown risks, uncertainties and other factors that are, in some cases, beyond our control. You are cautioned that these statements are not guarantees of future performance, and that actual results and trends in the future may differ materially.

Factors that could cause actual results to differ materially include, but are not limited to the following:

changes in the reimbursement rates or methods of payment from Medicare and Medicaid, or the implementation of other measures to reduce the reimbursement for our services;

the expiration of enactments providing for additional governmental funding;

changes in pharmacy legislation and payment formulas;

the impact of federal and state regulations;

changes in payor mix and payment methodologies;

further consolidation of managed care organizations and other third party payors;

competition in our businesses;

an increase in insurance costs and potential liability for losses not covered by, or in excess of, our insurance;

competition for qualified staff in the healthcare industry;

our ability to control operating costs and generate sufficient cash flow to meet operational and financial requirements;

an economic downturn or changes in the laws affecting our business in those markets in which we operate;

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the impact of our reliance on one pharmacy supplier to provide a significant portion of our pharmacy products;

the impact of acquisitions and the proposed spin-off of our eldercare business;

the ability to implement and achieve certain strategic objectives;

the difficulty in evaluating certain of our financial information due to a lack of comparability following the emergence from bankruptcy; and

acts of God or public authorities, war, civil unrest, terrorism, fire, floods, earthquakes and other matters beyond our control.

Certain of these risks are described in more detail in our Annual Report on Form 10-K for the fiscal year ended September 30, 2002.

In addition to these factors and any risks and uncertainties specifically identified in the text surrounding forward-looking statements, any statements in this report or the reports and other documents filed by us with the SEC that warn of risks or uncertainties associated with future results, events or circumstances also identify factors that could cause actual results to differ materially from those expressed in or implied by the forward-looking statements.

We do not undertake any obligation to release publicly any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except as may be required under applicable securities law.

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

GENESIS HEALTH VENTURES, INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
JUNE 30, 2003 AND SEPTEMBER 30, 2002
(IN THOUSANDS)

	June 30, 2003	September 30, 2002
Assets:		
Current assets:		
Cash and equivalents	$ 134,086	$ 148,030
Restricted investments in marketable securities	16,350	15,074
Accounts receivable, net	363,854	369,969
Inventory	68,092	64,734
Prepaid expenses and other current assets	57,225	47,850
Assets held for sale		46,134
Total current assets	639,607	691,791
Property, plant and equipment, net	744,711	795,928
Assets held for sale	18,276	
Restricted investments in marketable securities	77,381	71,073
Other long-term assets	50,593	51,042
Investments in unconsolidated affiliates	11,942	14,143
Identifiable intangible assets, net	22,821	25,795
Goodwill	342,304	339,723
Total assets	$ 1,907,635	$ 1,989,495
Liabilities and Shareholders Equity:		
Current liabilities:		
Current installments of long-term debt	$ 46,649	$ 40,744
Accounts payable and accrued expenses	174,331	202,041
Total current liabilities	220,980	242,785
Long-term debt	575,702	648,939
Deferred income taxes	48,896	37,191
Self-insurance liability reserves	49,862	42,019
Other long-term liabilities	46,862	48,989
Minority interests	11,708	10,684
Redeemable preferred stock, including accrued dividends	46,723	44,765
Shareholders equity	906,902	914,123
Total liabilities and shareholders equity	$ 1,907,635	$ 1,989,495

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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GENESIS HEALTH VENTURES, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
THREE MONTHS ENDED JUNE 30, 2003 AND 2002
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	Three Months Ended June 30, 2003	Three Months Ended June 30, 2002
Net revenues:		
Inpatient services	$ 303,645	$ 302,672
Pharmacy services	316,965	283,644
Other revenue	48,049	41,742
Total net revenues	668,659	628,058
Operating expenses:		
Salaries, wages and benefits	279,202	262,234
Cost of sales	201,886	179,563
Other operating expenses	126,833	125,117
Strategic planning, severance and other related costs	11,474	12,568
Net gain from break-up fee and other settlements		(229)
Depreciation and amortization expense	16,622	15,077
Lease expense	6,879	6,971
Interest expense	9,848	9,459
Income before debt restructuring and reorganization costs, income tax expense, equity in net income of unconsolidated affiliates and minority interests	15,915	17,298
Debt restructuring and reorganization costs		2,570
Income before income tax expense, equity in net income of unconsolidated affiliates and minority interests	15,915	14,728
Income tax expense (benefit)	2,154	(4,567)
Income before equity in net income of unconsolidated affiliates and minority interests	13,761	19,295
Equity in net income of unconsolidated affiliates	569	99
Minority interests	(1,272)	(592)
Income from continuing operations before preferred stock dividends	13,058	18,802
Preferred stock dividends	660	656
Income from continuing operations	12,398	18,146
Loss from discontinued operations, net of taxes	(5,926)	(693)
Net income attributed to common shareholders	$ 6,472	$ 17,453
Per Common Share Data:		
Basic:		
Income from continuing operations	$ 0.31	$ 0.44
Loss from discontinued operations	(0.15)	(0.02)
Net income	$ 0.16	$ 0.42
Weighted average shares	40,097,289	41,341,830
Diluted:		
Income from continuing operations	$ 0.31	$ 0.43
Loss from discontinued operations	(0.15)	(0.02)
Net income	$ 0.16	$ 0.42
Weighted average shares - income from continuing operations	42,370,934	43,470,082

Weighted average shares - net income	40,097,289	43,470,082

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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GENESIS HEALTH VENTURES, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
NINE MONTHS ENDED JUNE 30, 2003 AND 2002
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	Nine Months Ended June 30, 2003	Nine Months Ended June 30, 2002
Net revenues:		
Inpatient services	$ 905,178	$ 899,306
Pharmacy services	914,876	835,428
Other revenue	137,168	123,189
Total net revenues	1,957,222	1,857,923
Operating expenses:		
Salaries, wages and benefits	832,670	775,141
Cost of sales	578,655	530,087
Other operating expenses	371,854	372,520
Strategic planning, severance and other related costs	21,312	12,568
Net gain from break-up fee and other settlements	(11,337)	(21,907)
Depreciation and amortization expense	48,817	44,387
Lease expense	20,782	20,055
Interest expense	30,657	31,386
Income before debt restructuring and reorganization costs, income tax expense, equity in net income of unconsolidated affiliates and minority interests	63,812	93,686
Debt restructuring and reorganization costs		4,270
Income before income tax expense, equity in net income of unconsolidated affiliates and minority interests	63,812	89,416
Income tax expense	20,834	24,562
Income before equity in net income of unconsolidated affiliates and minority interests	42,978	64,854
Equity in net income of unconsolidated affiliates	1,161	490
Minority interests	(3,567)	(1,344)
Income from continuing operations before preferred stock dividends	40,572	64,000
Preferred stock dividends	2,009	1,916
Income from continuing operations	38,563	62,084
Loss from discontinued operations, net of taxes	(15,490)	(4,089)
Net income attributed to common shareholders	$ 23,073	$ 57,995
Per Common Share Data:		
Basic:		
Income from continuing operations	$ 0.94	$ 1.51
Loss from discontinued operations	(0.38)	(0.10)
Net income	$ 0.56	$ 1.41
Weighted average shares	41,135,170	41,211,603
Diluted:		
Income from continuing operations	$ 0.94	$ 1.48
Loss from discontinued operations	(0.38)	(0.10)
Net income	$ 0.56	$ 1.38
Weighted average shares - income from continuing operations	43,378,463	43,339,666

Weighted average shares - net income	41,135,170	43,339,666

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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GENESIS HEALTH VENTURES, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
NINE MONTHS ENDED JUNE 30, 2003 AND 2002
(IN THOUSANDS)

	Nine Months Ended June 30, 2003	Nine Months Ended June 30, 2002
Cash flows from operating activities:		
Net income attributed to common shareholders	$ 23,073	$ 57,995
Net charges included in operations not requiring funds	106,836	118,204
Changes in assets and liabilities:		
Accounts receivable	(23,835)	(21,134)
Accounts payable and accrued expenses	(16,606)	24,099
Refinancing of pharmacy supplier credit terms		(42,000)
Other, net	(6,673)	(4,827)
Net cash provided by operating activities before debt restructuring and reorganization costs	82,795	132,337
Cash paid for debt restructuring and reorganization costs	(1,677)	(44,299)
Net cash provided by operating activities	81,118	88,038
Cash flows from investing activities:		
Capital expenditures	(42,496)	(32,954)
Net purchases of restricted marketable securities	(7,372)	(12,722)
Acquisition of rehabilitation services business	(5,918)	
Sale (purchase) of eldercare assets	55,123	(10,453)
Other, net	8,425	5,397
Net cash provided by (used in) investing activities	7,762	(50,732)
Cash flows from financing activities:		
Repayment of long-term debt and payment of sinking fund requirements	(66,617)	(45,968)
Proceeds from issuance of long-term debt		80,000
Repurchase of common stock	(36,207)	
Net cash (used in) provided by financing activities	(102,824)	34,032
Net (decrease) increase in cash and equivalents	$ (13,944)	$ 71,338
Cash and equivalents:		
Beginning of period	148,030	32,139
End of period	$ 134,086	$ 103,477
Supplemental cash flow information:		
Interest paid	$ 31,446	$ 43,492
Income taxes paid, net of refunds	3,082	6,854
Non-cash financing activities:		
Capital leases	1,431	1,770

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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Genesis Health Ventures, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

1. Business

Genesis Health Ventures, Inc. was incorporated in May 1985 as a Pennsylvania corporation. As used herein, unless the context otherwise requires, Genesis, or the Company, refers to Genesis Health Ventures, Inc. and its subsidiaries.

Genesis is a leading provider of healthcare and support services to the elderly. The Company s operations are comprised of two primary business segments, inpatient services and pharmacy services. These segments are complemented by an array of other service capabilities. See note 3 Strategic Planning, Severance and Other Related Costs .

Genesis provides inpatient services through skilled nursing and assisted living centers primarily located in the eastern United States. As of June 30, 2003, Genesis owns or leases 159 eldercare centers with 20,456 beds, of which 5 centers having 718 beds have been identified as held for sale. See note 9 Assets Held for Sale and Discontinued Operations . Genesis includes the revenues of its owned and leased centers in inpatient services revenues in the unaudited condensed consolidated statements of operations. As of June 30, 2003, Genesis manages or jointly-owns 68 eldercare centers with 7,035 beds. Management fees earned from the Company s managed and / or jointly-owned eldercare centers are included in other revenues in the unaudited condensed consolidated statements of operations.

Genesis provides pharmacy services nationwide through its NeighborCare® integrated pharmacy operation that serves approximately 253,000 institutional beds in long-term care settings. The Company also operates 32 community-based retail pharmacies.

Genesis also provides rehabilitation services, diagnostic services, respiratory services, hospitality services, and group purchasing services, the revenues for which are included in other revenues in the unaudited condensed consolidated statements of operations.

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s annual report on Form 10-K for the fiscal year ended September 30, 2002.

The accompanying condensed consolidated financial statements are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, the unaudited condensed consolidated financial statements include all necessary adjustments consisting of normal recurring accruals and adjustments for a fair presentation of the financial position and results of operations for the periods presented.

The Company has made a number of estimates relating to the reporting of assets and liabilities, revenues and expenses and the disclosure of contingent assets and liabilities to prepare these unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Some of the more significant estimates impact accounts receivable, long lived assets and loss reserves for self insurance programs. Actual results could differ from those estimates and such differences could be significant.

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3. Strategic Planning, Severance and Other Related Costs

Genesis has incurred costs that are directly attributable to the Company s long-term objective of transforming to a pharmacy-based business and certain of its short-term strategic objectives. These costs are expected to continue for the foreseeable future and are segregated in the unaudited condensed consolidated statements of operations as Strategic planning, severance and other related costs . A summary of these costs at June 30, 2003 follows (in thousands):

	Accrued at September 30, 2002	Nine Months Ended June 30, 2003		Accrued at June 30, 2003
		Provision	Paid	
Severance and related costs	$ 1,100	$ 13,576	$ 13,376	$ 1,300
Strategic consulting costs	621	7,736	7,283	1,073
Total	$ 1,721	$ 21,312	$ 20,659	$ 2,373

4. Certain Significant Risks and Uncertainties

The Company receives revenues from Medicaid, Medicare, private insurance, self-pay residents, other third party payors and long-term care facilities which utilize the Company s other ancillary services.

The Medicaid and Medicare programs are highly regulated. The failure of the Company or its customers to comply with applicable reimbursement regulations could adversely affect the Company s business. The Company monitors its receivables from third party payor programs and reports such revenues at the net realizable value expected to be received.

On December 15, 2000, Congress passed the Benefit Improvement Protection Act that increased the nursing component of federal prospective payment system s rates by approximately 16.7% for the period from April 1, 2001 through September 30, 2002. The legislation also changed the 20% add-on to 3 of the 14 rehabilitation resource utilization group categories to a 6.7% add-on to all 14 rehabilitation resource utilization group categories beginning April 1, 2001. The Medicare Part B consolidated billing provision of the Balance Budget Refinement Act was repealed except for Medicare Part B therapy services and the moratorium on the $1,500 therapy caps was extended through calendar year 2002. These changes had a positive impact on operating results.

A number of provisions of the Balanced Budget Refinement Act and the Benefit Improvement and Protection Act enactments, providing additional funding for Medicare participating skilled nursing facilities, expired on September 30, 2002 (the Skilled Nursing Facility Medicare Cliff). Effective October 1, 2002, Medicare rates adjusted for the Skilled Nursing Facility Medicare Cliff were increased by a 2.6% annual market basket adjustment. For Genesis, the net impact of these provisions is estimated to adversely impact annual revenue beginning October 1, 2002 by approximately $24 million. The expiration of these provisions after considering the 2.6% annual market basket adjustment, has reduced our Medicare per diems per beneficiary, on average, by approximately $24, resulting in reduced revenue and EBITDA of approximately $18.0 million in the Company s first nine months of fiscal 2003.

The Skilled Nursing Facility Medicare Cliff could adversely impact the liquidity of the Company s other service related business customers, resulting in their inability to pay the Company, or to pay the Company timely, for its products and services. This factor, coupled with the adverse impact of the Skilled Nursing Facility Medicare Cliff to the liquidity of the Company s inpatient services segment, could require it to borrow in order to fund working capital needs, and in turn, cause Genesis to become more highly leveraged.

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In addition, effective January 1, 2003, the moratorium on implementing payment caps on Medicare Part B rehabilitation therapy services expired. The Centers for Medicare and Medicaid Services has issued instructions indicating that the agency will delay enforcement until September 1, 2003 and that the agency has clarified that any implementation would be prospective from the date that instructions are effective. If the caps are imposed September 1, 2003, such therapy caps are expected to reduce our annual net revenues by approximately $18.9 million and EBITDA by approximately $4.9 million. Congress may again intervene to extend a moratorium on the therapy caps for calendar year 2004. The House of Representatives included a moratorium provision in its version of the Comprehensive Prescription Drug and Medicare Improvement Act. While the Senate does not have a comparable provision, key Senate conferees pledged to support the House provision during Senate debate. No assurances can be made or given that Congress will extend the moratorium or take any other action to affect a discontinuance of the therapy caps.

On August 4, 2003, the Centers for Medicare & Medicaid Services published in the Federal Register the final prospective payment system rules to fiscal year 2004 skilled nursing facilities effective October 1, 2003. The final rules make two significant enhancements to the reimbursement rates for the fiscal year 2004 by increasing base rates by 6.26% (3% increase in the annual update factor and a 3.26% upward adjustment correcting for previous forecast errors). These two changes are estimated to increase Medicare payment rates per patient day by $19. The final rules also provide for the continuation through fiscal year 2004 of certain payment add-ons which were authorized in the Balanced Budget Refinement Act of 1999 to compensate for non-therapy ancillaries.

There are additional provisions in the Medicare statute affecting pharmacy, rehabilitation therapy, diagnostic services and the payment for services in other health settings. In February 2003, Congress passed legislation adjusting practitioner fee schedules. The Congressional action prevented a formula driven reduction in fee schedules. This restoration of rates affected not only doctors, but also payment for most professional practitioners including licensed rehabilitation professionals.

Pharmacy coverage and cost containment are important policy debates at both the federal and state levels. In both his State of the Union Address and his budget message, the President has highlighted his appeal for Medicare modernization and enactment of a broader Medicare outpatient drug benefit. Transforming Medicare was a major theme of the President s State of the Union Address and his proposed fiscal year 2004 budget. The recently passed First Congressional Budget Resolution sets aside fiscal authority for implementing a new Medicare pharmacy benefit program. However, it should be noted that the budget resolution is non-binding.

During June 2003, both the U.S. House of Representatives and the U.S. Senate passed comprehensive proposals for implementing a new Medicare pharmacy benefit and restructuring Medicare administration (Comprehensive Prescription Drug and Medicare Improvement Act.). There are significant differences between the House-passed and Senate-passed measures. Provisions in both measures could impact long-term care pharmacies. Conferees have been appointed and are meeting to resolve these differences. The current schedule proposes that the conferees will have until late September 2003 to reconcile the differences and to report the compromise measure for final enactment. It is premature to predict the outcome of these Congressional deliberations.

Absent additional legislative authority, the Centers for Medicare and Medicaid Services has certain discretionary authority to adjust drug pricing. Effective January 2003, Centers for Medicare and Medicaid Services implemented a directive creating a single national calculation of average wholesale price for Medicare purchased drugs and biologicals.

A number of states have enacted or are considering containment initiatives affecting pharmacy services. Many have focused on reducing what the state Medicaid program will pay for drug acquisition costs. Most states have lowered payment to a negative percentage of average wholesale price. Some have attempted to impose more stringent pricing standards. Institutional pharmacies are often paid a dispensing

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fee over and above the payment for the drug. To the extent that changes in the payment for drugs are not accompanied by an increase in the dispensing fee, margins could erode. Some states have explored efforts to restrict utilization (preferred drug lists, prior authorization, formularies). A few states have attempted to extend the preferred Medicaid pricing to all Medicare beneficiaries.

It is not possible to quantify fully the effect of potential legislative or regulatory changes, the administration of such legislation or any other governmental initiatives on Genesis business. Accordingly, there can be no assurance that the impact of these changes or any future healthcare legislation will not further adversely affect the Company s business. There can be no assurance that payments under governmental and private third party payor programs will be timely, will remain at levels comparable to present levels or will, in the future, be sufficient to cover the costs allocable to patients eligible for reimbursement pursuant to such programs. Genesis financial condition and results of operations may be affected by the reimbursement process, which in the healthcare industry is complex and can involve lengthy delays between the time that revenue is recognized and the time that reimbursement amounts are settled.

5. Significant Transactions and Events

In February 2003, Genesis board of directors approved in principle a plan to spin-off its eldercare operations to the shareholders of Genesis.

The spin-off is motivated by two business purposes: (1) to allow each business to pursue strategies and focus on objectives appropriate to that business, and to assume only those risks inherent in the respective businesses; and (2) to resolve problems that Genesis pharmacy services segment (NeighborCare) has with existing or potential customers who object to NeighborCare s association with Genesis inpatient business segment that competes with those customers. The inpatient services segment and pharmacy services segment are distinct businesses with significant differences in their markets, products, investment needs and plans for growth. Genesis board of directors believes that a separation into two independent public companies will enhance the ability of each to focus on strategic initiatives and new business opportunities, and to improve cost structures and operating efficiencies. Following the spin-off, the operations of Genesis inpatient services segment, rehabilitation therapy business, management services and certain other ancillary service businesses will operate under the name Genesis Healthcare Corporation (GHC). In the spin-off, Genesis will distribute all of the shares of GHC common stock on a pro rata basis to the holders of Genesis common stock. GHC will then become a separately traded, publicly held company.

The spin-off is subject to several conditions, including financing and GHC s receipt of an Internal Revenue Service ruling that, for U.S. federal income tax purposes, the spin-off generally will not be taxable.

On April 1, 2003, the Company extended an offer to its employees, including executive officers except for its chief executive officer, to tender all options to purchase shares of its common stock, par value $.02 per share, outstanding under its 2001 stock option plan, for the following consideration: (a) for those holders of options who have received awards of more than 2,000 restricted shares of common stock under the stock incentive plan, the acceleration of vesting of all such restricted shares plus a cash payment of $2.50 per share underlying the option for options that had an exercise price below $20.00 per share, and (b) with respect to those holders of options who have not received awards of more than 2,000 restricted shares, (i) for those options that had an exercise price of at least $20.00 per share, a cash payment of $2.00 per share underlying the option, and (ii) for those options that had an exercise price below $20.00 per share, a cash payment of $2.50 per share subject to the option. The offer expired on May 12, 2003. Genesis accepted for exchange and cancellation options to purchase 1,724,000 shares of its common stock, which represented all of the eligible outstanding options properly tendered for exchange by eligible option holders. All eligible options held by the Company s employees were tendered in the offer, with the exception of options to purchase 35,000 shares. As a result of this offer and exchange, the Company expensed $7.2 million in the quarter ended June 30, 2003, of which $1.4 million was disbursed in cash, with the remainder distributed in common stock. This expense is classified as a component of strategic planning, severance and other related costs in the Company s unaudited condensed consolidated statements of operations.

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6. Long-Term Debt

Long-term debt at June 30, 2003 and September 30, 2002 consists of the following (in thousands):

	June 30, 2003	September 30, 2002
Secured debt		
Senior Credit Facility		
Term Loan	$ 247,075	$ 281,575
Delayed Draw Term Loan	68,874	79,239
Total Senior Credit Facility	315,949	360,814
Senior Secured Notes	240,176	242,602
Mortgage and other secured debt	66,226	86,267
Total debt	622,351	689,683
Less:		
Current installments of long-term debt	(46,649)	(40,744)
Long-term debt	$ 575,702	$ 648,939

The Senior Credit Facility contains a provision requiring prepayment of amounts determined to be excess cash flow calculated as 75% of cash operating profits, after capital investments, debt repayments and investments, including investments in working capital, by December 31st of each year based upon earnings for the previous fiscal year. The Company expects that the majority of any proceeds received upon the sale of assets classified as held for sale will be used to repay Senior Credit Facility debt unless reinvested in similar assets. During the quarter ended December 31, 2002, the Company repaid $24.8 million of debt under the Senior Credit Facility pursuant to the excess cash flow recapture provisions. During the nine months ended June 30, 2003, the Company repaid approximately $20.1 million of Senior Credit Facility debt, principally with proceeds from the sale of assets.

During the quarter ended December 31, 2002, the Company satisfied $16.0 million of mortgage debt associated with three eldercare properties resulting in a gain on the early extinguishment of debt of $1.1 million. This gain was reflected in the unaudited condensed consolidated statements of operations under net gain from break-up fee and other settlements.

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7. Earnings (Loss) Per Share

The following table sets forth the computation of basic and diluted earnings (loss) per share for the three and nine month periods ended June 30, 2003 and 2002 (in thousands, except per share data):

	Three months ended June 30, 2003	Three months ended June 30, 2002	Nine months ended June 30, 2003	Nine months ended June 30, 2002
Earnings (loss) used in computation:				
Income from continuing operations basic computation	$ 12,398	$ 18,146	$ 38,563	$ 62,084
Elimination of preferred stock dividend requirements upon assumed conversion of preferred stock	660	656	2,009	1,916
Income from continuing operations diluted computation	$ 13,058	$ 18,802	$ 40,572	$ 64,000
Loss from discontinued operations basic and diluted computation	$ (5,926)	$ (693)	$ (15,490)	$ (4,089)
Net income attributed to common shareholders basic computation	$ 6,472	$ 17,453	$ 23,073	$ 57,995
Elimination of preferred stock dividend requirements upon assumed conversion of preferred stock		656		1,916
Net income diluted computation	$ 6,472	$ 18,109	$ 23,073	$ 59,911
Shares used in computation:				
Weighted average shares outstanding basic computation	40,097	41,342	41,135	41,212
Assumed conversion of preferred stock	2,274	2,095	2,243	2,095
Contingent consideration related to an acquisition		33		33
Weighted average shares outstanding diluted computation, income from continuing operations	42,371	43,470	43,378	43,340
Less assumed conversion of preferred stock	(2,274)		(2,243)	
Weighted average shares outstanding diluted computation, net income attributed to common shareholders	40,097	43,470	41,135	43,340
Earnings per common share:				
Basic:				
Income from continuing operations	$ 0.31	$ 0.44	$ 0.94	$ 1.51
Loss from discontinued operations	(0.15)	(0.02)	(0.38)	(0.10)
Net income attributed to common shareholders	0.16	0.42	0.56	1.41
Diluted:				
Income from continuing operations	$ 0.31	$ 0.43	$ 0.94	$ 1.48

Loss from discontinued operations *	(0.15)	(0.02)	(0.38)	(0.10)
Net income attributed to common shareholders	0.16	0.42	0.56	1.38

* The basic weighted average shares are used for all periods to calculate loss per share from discontinued operations.

Basic earnings per share is calculated by dividing earnings (numerator) by the weighted average number of shares of common stock outstanding during the respective reporting period (denominator). Included in the calculation of basic weighted average shares of 40,097,289 for the current quarter and 41,135,170 for the nine months ended are approximately 260,000 shares to be issued in connection with our joint plan of reorganization confirmed by the bankruptcy court.

Diluted earnings per share is calculated in a manner consistent with basic earnings per share except, where applicable, earnings are increased for the assumed elimination of preferred stock dividend requirements and the weighted average shares outstanding are increased to include additional shares from the assumed conversion of preferred stock. The conversion of preferred stock is assumed for the diluted per share calculation of income from continuing operations and net income attributed to common shareholders for the three and nine month periods ended June 30, 2002 since their effect is dilutive. The diluted per share calculation of income from continuing operations assumes the conversion of preferred stock for the three and nine months ended June 30, 2003 as the effect of their conversion is dilutive in those periods, however, the conversion of preferred shares is not assumed in the diluted per share calculation of net income attributed to common shareholders in those periods since their effect is antidilutive. In all periods, the diluted per share calculation of loss on discontinued operations does not assume conversion of preferred shares since their effect is antidilutive. No exercise of warrants or employee stock options is assumed for the three or nine month periods ended June 30, 2003 or 2002 since their effect is antidilutive.

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8. Comprehensive Income

The following table sets forth the computation of comprehensive income for the three and nine month periods ended June 30, 2003 and 2002 (in thousands):

	Three months ended June 30, 2003	Three months ended June 30, 2002	Nine months ended June 30, 2003	Nine months ended June 30, 2002
Net income attributed to common shareholders	$ 6,472	$ 17,453	$ 23,073	$ 57,995
Unrealized gain (loss) on marketable securities	240		211	(245)
Net change in fair value of interest rate swap and cap agreements	(1,869)		(3,430)	
Total comprehensive income	$ 4,843	$ 17,453	$ 19,854	$ 57,750

9. Assets Held for Sale and Discontinued Operations

In the normal course of business, Genesis evaluates the performance of its operating units, with an emphasis on selling or closing under-performing or non-strategic assets. On September 30, 2001, the Company adopted the provisions of Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* , (SFAS 144). Under SFAS 144, discontinued businesses, including assets held for sale, are removed from the results of continuing operations. The results of operations in the current and prior year periods, along with any cost to exit such businesses in the current year period, are classified as discontinued operations in the unaudited condensed consolidated statements of operations. Businesses sold or closed prior to our adoption of SFAS 144 continue to be reported in the results of continuing operations.

Since the Company s adoption of SFAS 144, it has classified several businesses as held for sale or closed. An increasing trend in malpractice litigation claims, rising costs of eldercare malpractice litigation, losses associated with these malpractice lawsuits and a constriction of insurers have caused many insurance carriers to raise the cost of insurance premiums or refuse to write insurance policies for nursing homes. These problems are particularly acute in the state of Florida where, because of higher claim amounts, general liability and professional liability costs have become increasingly expensive. This increase in insurance costs prompted the Company to sell its otherwise profitable operations in the state of Florida. Since the Company s inception, it has continued to develop its eldercare network in concentrated geographic markets in the eastern United States. The geographic location of its eldercare centers in the states of Illinois and Wisconsin relative to its strategic geographic markets, combined with the operating performance of those centers, has prompted Genesis to identify those assets as held for sale. In addition to these assets, the Company has identified 12 eldercare centers in other states, one medical supply distribution site, one rehabilitation services clinic, one physician services practice and its ambulance business as held for sale or closed due to under-performance.

Consolidated interest expense has been allocated to discontinued operations for all periods presented based on allocated debt expected to be repaid in connection with the sale of the assets, as required under the Company s Senior Credit Facility. The amount of after-tax interest expense allocated to discontinued operations for the quarters ended June 30, 2003 and 2002 was $0.4 million and $1.1 million, respectively. The amount of after-tax interest expense allocated to discontinued operations for the year to date periods ended June 30, 2003 and 2002 was $2.1 million and $3.1 million, respectively.

The Company s $18.3 million of assets held for sale at June 30, 2003 are primarily related to its properties located in the state of Wisconsin ($14.4 million).

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The following table sets forth the components of loss from discontinued operations for the current quarter and year-to-date compared to the same periods last year (in thousands):

	Three months ended June 30, 2003	Three months ended June 30, 2002	Nine months ended June 30, 2003	Nine months ended June 30, 2002
Net revenues	$ 17,170	$ 58,076	$ 113,580	$ 179,590
Net operating loss of discontinued businesses	$ (4,841)	$ (191)	$ (12,922)	$ (675)
Loss on discontinuation of businesses	(4,874)	(945)	(12,471)	(6,028)
Income tax benefit	3,789	443	9,903	2,614
Loss from discontinued operations, net of taxes	$ (5,926)	$ (693)	$ (15,490)	$ (4,089)

The loss on discontinuation of businesses includes the write-down of assets to estimated net realizable value.

10. Segment Information

The Company s principal operating segments are identified by the types of products and services from which revenues are derived and are consistent with the reporting structure of the Company s internal organization. The Company has two reportable segments: (1) inpatient services and (2) pharmacy services.

The Company includes in inpatient services revenues all room and board charges and ancillary service revenue for its eldercare customers at its 159 owned and leased eldercare centers. The centers offer three levels of care for their customers: skilled, intermediate and personal.

The Company provides pharmacy services through its NeighborCare® pharmacy subsidiaries. Included in pharmacy service revenues are institutional pharmacy revenues, which include the provision of infusion therapy, medical supplies and equipment provided to eldercare centers operated by Genesis, as well as to independent healthcare providers by contract. The Company provides these services through 60 institutional pharmacies and 16 medical supply and home medical equipment distribution centers located in its various market areas. In addition, the Company operates 32 community-based pharmacies which are located in or near medical centers, hospitals and physician office complexes. For the current year-to-date, 94% of the sales attributable to all pharmacy operations are generated through external contracts with independent healthcare providers with the balance attributable to centers owned or leased by the Company.

The accounting policies of the segments are the same as those of the consolidated organization. All intersegment sales prices are market based.

Summarized financial information concerning the Company s reportable segments is shown in the following table for the current quarter and year-to-date, compared with the same periods last year. The All other services category of revenues and EBITDA represents operating information of business units below the prescribed quantitative thresholds under the Financial Accounting Standards Board Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* . These business units derive revenues from the following services: rehabilitation therapy, management services, homecare services, physician services, diagnostic services, hospitality services, group purchasing fees, respiratory health services, staffing services and other healthcare related services. The Corporate category consists of the Company s general and administrative function, for which there is generally no revenue generated. The Other adjustments category consists of expenses or gains that have not been allocated to our reportable segments or the All other services or Corporate categories. This approach to segment reporting is consistent with the Company s internal financial reporting and the information used by the chief operating decision maker regarding the performance of our reportable and non-reportable segments.

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(in thousands)	Three months ended June 30, 2003	Three months ended June 30, 2002 (1)	Nine months ended June 30, 2003	Nine months ended June 30, 2002 (1)
Revenues:				
Inpatient services - external	$ 303,645	$ 302,672	$ 905,178	$ 899,306
Pharmacy services:				
External	316,965	283,644	914,876	835,428
Intersegment	19,112	26,678	58,774	79,553
All other services:				
External	48,049	41,742	137,168	123,189
Intersegment	35,353	42,725	111,480	128,390
Elimination of intersegment revenues	(54,465)	(69,403)	(170,254)	(207,943)
Total net revenues	668,659	628,058	1,957,222	1,857,923
EBITDA (2):				
Inpatient services	28,869	34,708	85,433	106,888
Pharmacy services	33,446	27,276	92,649	80,407
All other services	11,548	10,652	30,377	34,543
Corporate	(20,004)	(18,463)	(55,198)	(61,718)
Other adjustments (3)	(11,474)	(14,909)	(9,974)	5,069
Total EBITDA	42,385	39,264	143,286	165,189
Capital and other:				
Consolidated:				
Depreciation and amortization	(16,622)	(15,077)	(48,817)	(44,387)
Interest expense	(9,848)	(9,459)	(30,657)	(31,386)
Income tax (provision) benefit	(2,154)	4,567	(20,834)	(24,562)
Equity in net income of unconsolidated affiliates	569	99	1,161	490
Minority interests	(1,272)	(592)	(3,567)	(1,344)
Preferred stock dividends	(660)	(656)	(2,009)	(1,916)
Income from continuing operations	12,398	18,146	38,563	62,084
Loss from discontinued operations, net of taxes	(5,926)	(693)	(15,490)	(4,089)
Net income attributed to common shareholders	$ 6,472	$ 17,453	$ 23,073	$ 57,995

The following asset information by segment is as of the end of each period presented.

(in thousands)	June 30, 2003	September 30, 2002 (4)
Assets:		
Inpatient services (5)	$ 831,774	$ 951,833
Pharmacy services	694,188	677,032
All other	381,673	360,630
	$ 1,907,635	$ 1,989,495

(1) Segment revenue and EBITDA data previously reported was adjusted to remove discontinued businesses from the results of continuing operations for the three and nine month periods ended June 30, 2002.

(2) EBITDA is defined as earnings before interest, taxes, depreciation and amortization of our continuing operations. EBITDA is calculated through our unaudited condensed consolidated statements of operations by adding back interest, income tax expense, depreciation and amortization, equity in net income of unconsolidated affiliates, minority interests, preferred stock dividends, and loss from discontinued operations, net of taxes to net income attributed to common shareholders. EBITDA of the operating segments include the direct overhead costs attributable to those segments.

(3) Other adjustments includes strategic planning, severance and other related costs, net gain from break-up fee and other settlements and debt restructuring and reorganization costs from our unaudited condensed consolidated statements of operations.

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(4) $6.8 million of assets previously reported as All other were reclassified at September 30, 2002 to the inpatient services segment.

(5) Assets of the inpatient services segment at June 30, 2003 and September 30, 2002 include $18.3 million and $46.1 million, respectively, of assets held for sale. See note 9 Assets Held for Sale and Discontinued Operations .

11. Restricted Investments in Marketable Securities

At June 30, 2003 and September 30, 2002, the Company reported restricted investments in marketable securities of $93.7 million and $86.1 million, respectively, which are held by Liberty Health Corp. LTD. (LHC), Genesis wholly-owned captive insurance subsidiary incorporated under the laws of Bermuda. The investments held by LHC are restricted by statutory capital requirements in Bermuda. In addition, certain of these investments are pledged as security for letters of credit issued by LHC. As a result of such restrictions and encumbrances, Genesis and LHC are precluded from freely transferring funds through inter-company loans, advances or cash dividends.

The Company s restricted investments in marketable securities are classified in the unaudited condensed consolidated balance sheets within both current and non-current assets. The current portion of restricted investments in marketable securities represents an estimate of the level of outstanding self-insured losses the Company expects to pay in the succeeding twelve months.

12. Net Gain from Break-up Fee and Other Settlements

In December 2002, the Company entered into a termination and settlement agreement with Omnicare, Inc., whereby the Company agreed to terminate a merger agreement it had entered into with NCS Healthcare, Inc., a provider of institutional pharmacy services. Pursuant to the termination and settlement agreement, the Company agreed to terminate the merger agreement with NCS and Omnicare agreed to pay the Company a $22.0 million break-up fee. On December 16, 2002, the Company terminated the merger agreement. The Company recognized the break-up fee net of $11.8 million of financing, legal and other costs directly attributable to the proposed merger with NCS. The Company collected $6.0 million of the break-up fee in December 2002, with the remaining $16.0 million received in January 2003.

In December 2002, the Company satisfied $16.0 million of mortgage debt associated with three eldercare properties resulting in a gain on the early extinguishment of debt of $1.1 million.

13. Derivative Financial Instruments

The Company follows the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* , and SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities an Amendment of FASB Statement No. 13* . The Company utilizes interest rate swaps and caps to manage changes in market conditions related to debt obligations. As of June 30, 2003, the Company has a $75.0 million swap maturing on September 13, 2005, to pay fixed (3.1%) / receive variable (one month LIBOR) and a $125.0 million swap maturing on September 13, 2007, to pay fixed (3.77%) / receive variable (one month LIBOR). In addition, the Company has a $75.0 million cap maturing on September 13, 2004. The interest rate cap pays interest to the Company when LIBOR exceeds 3%. The amount paid to the Company is equal to the notional principal balance of $75.0 million multiplied by (LIBOR plus 3%) in those periods in which LIBOR exceeds 3%. The Company purchased the interest rate cap for $0.7 million which is being amortized to interest expense over the two year term of the agreement. As a component of interest expense, we recorded $1.2 million and $3.4 million of net interest outflows in the current quarter and year-to-date, respectively, for the interest rate swaps and amortization of the rate cap.

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Based upon confirmations from third party financial institutions, the fair value of the interest rate swap agreements is a liability of $9.7 million at June 30, 2003, which is included in other long-term liabilities in our unaudited condensed consolidated balance sheet.

14. Stock Option Plan

The Company has adopted the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, (SFAS 123) and applies APB Opinion No. 25, *Accounting for Stock Issued to Employees*, in accounting for its plans and, accordingly, has not recognized compensation cost for stock options issued to employees and directors in its financial statements. Had the Company determined compensation cost based on the fair value at the grant date consistent with the provisions of SFAS 123, the Company s net income would have been changed to the pro forma amounts indicated below (in thousands):

	Three months ended June 30, 2003	Three months ended June 30, 2002	Nine months ended June 30, 2003	Nine months ended June 30, 2002
Net income - as reported	$ 6,472	$ 17,453	$ 23,073	$ 57,995
Deduct: Total stock-based employee compensation determined under fair value based method for all awards, net of related tax effects	(240)	(1,088)	(338)	(6,517)
Net income - pro forma	$ 6,232	$ 16,365	$ 22,735	$ 51,478
Earnings per share:				
Basic as reported	$ 0.16	$ 0.42	$ 0.56	$ 1.41
Basic pro forma	0.16	0.40	0.55	1.25
Diluted as reported	0.16	0.42	0.56	1.38
Diluted pro forma	0.16	0.39	0.55	1.23

The fair value of stock options granted in 2003 and 2002 is estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions for 2003 and 2002:

	Three months ended June 30, 2003	Three months ended June 30, 2002	Nine months ended June 30, 2003	Nine months ended June 30, 2002
Volatility	25.61%	18.01%	41.83%	35.13%
Expected life (in years)	3.3	7.6	3.3	7.6
Rate of return	2.54%	4.04%	2.54%	4.04%
Dividend yield	0.00%	0.00%	0.00%	0.00%

On April 1, 2003, the Company extended an offer to its employees, including executive officers except for its chief executive officer, to tender all options to purchase shares of its common stock. Details of this offer and exchange and costs related thereto are discussed further in note 5 Significant Transactions and Events .

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15. Income Taxes

The Company s provision for income taxes from continuing operations for the nine months ended June 30, 2003 and 2002 was $20.8 million and $24.6 million, respectively. This includes reductions to tax expense of $4.4 million and $10.3 million due to tax law changes realized in the third quarter of 2003 and 2002, respectively. The income tax benefit of any NOL carryforward utilization will be applied first as a reduction to goodwill and, thereafter, as a direct addition to paid in capital, pursuant to SOP 90-7, at such time it is assured.

16. Recently Adopted Accounting Pronouncements

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (SFAS 150). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and requires that an issuer classify a financial instrument that is within its scope as a liability. The Company believes that its Series A Convertible Preferred Stock meets the scope of SFAS 150. These instruments have been classified as a liability since issuance and excluded from shareholders equity in the Company s condensed consolidated balance sheets, and as such will not be impacted by the adoption of SFAS 150. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the first interim period beginning after June 15, 2003.

17. Subsequent Events

In July 2003, the Company entered into non-binding letters of intent with ElderTrust, a Maryland real estate investment trust from whom it currently leases or subleases 18 of its eldercare facilities and eight managed and jointly-owned facilities. The principal terms of the letters of intent are as follows:

- Genesis Healthcare Corporation (GHC) (see note 5 Significant Transactions and Events) will purchase two skilled nursing facilities having 210 skilled nursing beds and 67 assisted living beds, and three assisted living facilities having 257 beds, for $24.8 million, comprised of $18.6 million in cash and the assumption of $6.2 million in debt. The Company currently leases these properties from ElderTrust at an annual cash basis and accrual basis lease cost of $2.4 million and $1.5 million, respectively;
- GHC will provide ElderTrust $32.3 million of consideration ($20.7 million in cash and the assumption of $11.6 million in debt) to reduce annual cash basis and accrual basis lease cost associated with nine properties by $7.1 million and $1.6 million, respectively, and acquire options to purchase seven properties currently subleased to the Company by ElderTrust; and
- Genesis Health Ventures, Inc. will pay ElderTrust $5.0 million upon completion of the spin-off in exchange for ElderTrust s consent to the assignment of all remaining leases and guarantees from Genesis Health Ventures, Inc. to GHC.

On August 13, 2003, Genesis acquired the remaining ownership interest in an unconsolidated joint-venture partnership that operates four skilled nursing facilities with 600 skilled nursing beds and 125 assisted living beds. Each of the four eldercare centers had been leased to the partnership from ElderTrust. The Company purchased its joint venture partner s interest in the unconsolidated partnership for $3.1 million and purchased one of the four eldercare properties from ElderTrust for $2.6 million. This transaction is retroactive to July 1, 2003. Additionally, Genesis will pay ElderTrust $2.5 million to reduce the annual cash basis and accrual basis lease expense of one of the three remaining leased facilities by $0.4 million and $0.2 million, respectively. The lease terms of the three facilities that will continue to be leased from ElderTrust are expected to be extended from 2010 to 2015.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

General

We are a leading provider of healthcare and support services to the elderly. Our operations are comprised of two primary business segments, inpatient services and pharmacy services. These segments are complemented by an array of other service capabilities. See Certain Transactions and Events Change in Strategic Direction and Objectives.

We provide inpatient services through skilled nursing and assisted living centers primarily located in the eastern United States. As of July 2003, we own or lease 159 eldercare centers with 20,456 beds, of which 5 centers having 718 beds have been identified as either assets held for sale or closed. We include the revenues of our owned and our leased centers in inpatient services revenues in our unaudited condensed consolidated statements of operations. As of July 2003, we manage or jointly-own 68 eldercare centers with 7,035 beds. Management fees earned from our managed and / or jointly-owned centers are included in other revenues in our unaudited condensed consolidated statements of operations.

We provide pharmacy services nationwide to approximately 253,000 beds through 60 institutional pharmacies (five are jointly-owned) and 16 medical supply and home medical equipment distribution centers (four are jointly-owned). In addition, we operate 32 community-based retail pharmacies (two are jointly-owned) which are located in or near medical centers, hospitals and physician office complexes.

We also provide rehabilitation services, diagnostic services, respiratory services, hospitality services, group purchasing services and healthcare consulting services, the revenues for which are included in other revenues in our unaudited condensed consolidated statements of operations.

Certain Transactions and Events

Change in Strategic Direction and Objectives

Since our inception, our principal business plan was to build networks of skilled nursing and assisted living centers in concentrated geographic markets and broaden our array of higher margin specialty medical services; principally institutional pharmacy and rehabilitation services. This network strategy was in response to payors increasing desire to contract with fewer companies to meet their total delivery care needs. By offering a broad array of services, we sought to create an integrated delivery system connecting our eldercare centers and ancillary service capabilities to hospitals, physicians, managed care plans and other providers in a seamless delivery network.

In the mid to late 1990 s, we made significant acquisitions of, and investments in, both eldercare and pharmacy operations. These acquired businesses principally operated in existing market concentrations or in contiguous markets deemed attractive to build future eldercare networks. Our stated mission during this period was to redefine how eldercare is delivered in America by using a coordinated, comprehensive approach that helps older adults define and live a full life . Our eldercare centers were at the core of the network strategy and stated mission.

On June 22, 2000, we and certain of our direct and indirect subsidiaries filed for voluntary relief under Chapter 11 of the United States Code with the United States Bankruptcy Court for the District of Delaware (the Bankruptcy Court). On the same date, our 43.6% owned affiliate, The Multicare Companies, Inc., and certain of its direct and indirect subsidiaries, and certain of its affiliates also filed for relief under Chapter 11 of the United States Code with the Bankruptcy Court. We and Multicare emerged from bankruptcy on October 2, 2001 and Multicare became our wholly-owned subsidiary.

Leading up to and during our Chapter 11 proceedings, the eldercare segment of our business suffered from significant cuts and pressures in funding sources, nursing labor cost increases in excess of inflation, intensified regulatory oversight and intervention, and increases in the cost of medical malpractice

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insurance. Also, during this time period, changes in reimbursement policies caused a greater focus on drug costs and utilization by customers of our pharmacy segment, putting pressure on pharmacy pricing and revenue growth. Despite these pricing pressures, we were able to grow pharmacy services revenues at between 8%-9% per year between fiscal 1999 and 2001 through, among other things, new customer sales, higher drug pricing and higher drug utilization from existing customers. In fiscal 1997, 65% and 22% of our total revenues were from inpatient services and pharmacy services, respectively. By fiscal 2002, 51% and 43% of our total revenues were from inpatient services and pharmacy services, respectively.

Upon emergence from Chapter 11 proceedings in October 2001, a new board of directors was constituted. In the second fiscal quarter of 2002, the board of directors approved the engagement of strategic consulting firms in an effort to:

- evaluate our business portfolio;
- identify means to optimize each business line; and
- evaluate our market perceptions and to recommend strategic alternatives to enhance shareholder value and improve operating margins.

Strategic consultants were also engaged to evaluate certain components of our pharmacy operations in an effort to improve operating margins of that segment.