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MANOR CARE INC
Form 10-Q
November 03, 2003

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FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(Mark One)

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

For the quarterly period ended September 30, 2003
OR

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

COMMISSION FILE NUMBER: 1-10858

MANOR CARE, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

34-1687107
(IRS Employer
Identification No.)

333 N. SUMMIT STREET, TOLEDO, OHIO
(Address of principal executive offices)

43604-2617
(Zip Code)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (419) 252-5500

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 the number of shares outstanding of each of the issuer's classes of common stock, as of the close of business on October 31, 2003.

Common stock, \$0.01 par value -- 89,138,022 shares

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

MANOR CARE, INC. Consolidated Balance Sheets

	September 30, 2003 ----
	(Unaudited)
	(In thousands, except
ASSETS	
Current assets:	
Cash and cash equivalents	\$ 83,631
Receivables, less allowances for doubtful	

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accounts of \$57,459 and \$60,093, respectively	383,789
Prepaid expenses and other assets	26,945
Deferred income taxes	63,685

Total current assets	558,050
Property and equipment, net of accumulated depreciation of \$789,052 and \$704,348, respectively	1,519,345
Goodwill	87,752
Intangible assets, net of amortization of \$3,439 and \$9,234, respectively	10,010
Other assets	171,613

Total assets	\$ 2,346,770
	=====
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	\$ 98,685
Employee compensation and benefits	145,506
Accrued insurance liabilities	105,753
Income tax payable	
Other accrued liabilities	46,877
Long-term debt due within one year	1,921

Total current liabilities	398,742
Long-term debt	661,808
Deferred income taxes	118,767
Other liabilities	216,184
Shareholders' equity:	
Preferred stock, \$.01 par value, 5 million shares authorized	
Common stock, \$.01 par value, 300 million shares authorized, 111.0 million shares issued	1,110
Capital in excess of par value	354,044
Retained earnings	1,065,581
Accumulated other comprehensive loss	(274)

	1,420,461
Less treasury stock, at cost (22.1 and 16.0 million shares, respectively)	(469,192)

Total shareholders' equity	951,269

Total liabilities and shareholders' equity	\$ 2,346,770
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See notes to consolidated financial statements.

MANOR CARE, INC.
Consolidated Statements Of Income
(Unaudited)

Three Months Ended
September 30

Nine Months Ended
September 30

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	2003 ----	2002 ----	2003 ----
	(In thousands, except earnings per s		
Revenues	\$ 761,279	\$ 732,920	\$ 2,242,385
Expenses			
Operating	638,235	603,025	1,882,746
General and administrative	36,649	29,227	113,995
Depreciation and amortization	32,058	30,826	95,595
Asset impairment		2,745	
	-----	-----	-----
	706,942	665,823	2,092,336
	-----	-----	-----
Income before other income (expenses) and income taxes	54,337	67,097	150,049
Other income (expenses):			
Interest expense	(10,842)	(9,436)	(31,034)
Gain on sale of assets	1,731	150	4,054
Equity in earnings of affiliated companies	2,090	1,741	5,230
Interest income and other	307	228	1,439
	-----	-----	-----
Total other income (expenses), net	(6,714)	(7,317)	(20,311)
	-----	-----	-----
Income before income taxes	47,623	59,780	129,738
Income taxes	16,584	22,717	48,652
	-----	-----	-----
Income before cumulative effect	31,039	37,063	81,086
Cumulative effect of change in accounting for goodwill			
	-----	-----	-----
Net income	\$ 31,039	\$ 37,063	\$ 81,086
	=====	=====	=====
Earnings per share-basic:			
Income before cumulative effect	\$.35	\$.38	\$.90
Cumulative effect			
	-----	-----	-----
Net income	\$.35	\$.38	\$.90
	=====	=====	=====
Earnings per share - diluted:			
Income before cumulative effect	\$.35	\$.38	\$.89
Cumulative effect			
	-----	-----	-----
Net income	\$.35	\$.38	\$.89
	=====	=====	=====
Weighted-average shares:			
Basic	88,060	97,239	90,272
Diluted	89,720	98,429	91,532
Cash dividends declared per common share	\$.125		\$.125
(a) Doesn't add due to rounding			

See notes to consolidated financial statements.

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MANOR CARE, INC. Consolidated Statements Of Cash Flows (Unaudited)

	Nine Months En
	2003

	(In th
OPERATING ACTIVITIES	
Net income	\$ 81,086
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	95,595
Asset impairment and other non-cash charges	
Provision for bad debts	23,930
Deferred income taxes	46,338
Net gain on sale of assets	(4,054)
Equity in earnings of affiliated companies	(5,230)
Changes in assets and liabilities, excluding sold facilities and acquisitions:	
Receivables	(21,564)
Prepaid expenses and other assets	(1,633)
Liabilities	40,081

Total adjustments	173,463

Net cash provided by operating activities	254,549

INVESTING ACTIVITIES	
Investment in property and equipment	(74,059)
Investment in systems development	(2,728)
Acquisitions	(12,556)
Acquisition of assets from development joint venture	
Proceeds from sale of assets	16,748

Net cash used in investing activities	(72,595)

FINANCING ACTIVITIES	
Net repayments under bank credit agreements	(259,300)
Principal payments of long-term debt	(13,896)
Proceeds from issuance of senior notes	299,372
Payment of deferred financing costs	(7,320)
Dividends paid	(11,150)
Proceeds from exercise of stock options	2,694
Purchase of common stock for treasury	(139,277)

Net cash used in financing activities	(128,877)

Net increase (decrease) in cash and cash equivalents	53,077
Cash and cash equivalents at beginning of period	30,554

Cash and cash equivalents at end of period	\$ 83,631
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See notes to consolidated financial statements.

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MANOR CARE, INC. Notes To Consolidated Financial Statements (Unaudited)

NOTE 1 - ACCOUNTING POLICIES

BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management of Manor Care, Inc. (the Company), the interim data includes all adjustments necessary for a fair statement of the results of the interim periods and all such adjustments are of a normal recurring nature. Operating results for the nine months ended September 30, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003.

The balance sheet at December 31, 2002 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in Manor Care, Inc.'s annual report on Form 10-K for the year ended December 31, 2002.

At September 30, 2003, the Company operated 293 skilled nursing facilities, 70 assisted living facilities, 94 outpatient therapy clinics and 89 home health offices.

COMPREHENSIVE INCOME

Comprehensive income represents the sum of net income plus other comprehensive income (loss). Comprehensive income totaled \$31.5 million and \$80.8 million for the three and nine months ended September 30, 2003, respectively, and \$37.0 million and \$107.2 million for the three and nine months ended September 30, 2002, respectively. The other comprehensive loss in the nine months ended September 30, 2003 represents the reversal of the unrealized gain on investments sold in 2003 partially offset by the unrealized gain on other securities held by the Company. The other comprehensive loss in 2002 primarily relates to the unrealized loss on investments.

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INSURANCE LIABILITIES

At September 30, 2003 and December 31, 2002, the workers' compensation liability consisted of short-term reserves of \$29.5 million and \$26.3 million, respectively, which were included in accrued insurance liabilities, and long-term reserves of \$41.5 million and \$32.5 million, respectively, which were included in other long-term liabilities. The expense for workers' compensation was \$10.2 million and \$34.7 million for the three and nine months ended

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September 30, 2003, respectively, and \$14.9 million and \$40.3 million for the three and nine months ended September 30, 2002, respectively. Although management believes that the Company's liability reserves are adequate, there can be no assurance that these reserves will not require material adjustment in future periods. See Note 7 for discussion of the Company's general and professional liability.

STOCK-BASED COMPENSATION

Stock options are granted for a fixed number of shares to employees with an exercise price equal to the fair market value of the shares at the date of grant. The Company accounts for the stock option grants in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. Accordingly, the Company recognizes no compensation expense for the stock options. During the third quarter of 2003, employees delivered shares to the Company to cover the payment of the option price and related tax withholdings on the option exercises. These shares had a value of \$13.6 million.

The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation for options granted since 1995.

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	Three months ended September 30		Nine months ended September 30	
	2003	2002	2003	2002
	-----	-----	-----	-----
	(In thousands, except earnings per share)			
Net income - as reported	\$ 31,039	\$ 37,063	\$ 81,086	\$ 107,496
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(3,569)	(1,667)	(7,480)	(5,312)
Net income - pro forma	<u>\$ 27,470</u>	<u>\$ 35,396</u>	<u>\$ 73,606</u>	<u>\$ 102,184</u>
Earnings per share - as reported:				
Basic	\$.35	\$.38	\$.90	\$ 1.08
Diluted	\$.35	\$.38	\$.89	\$ 1.07
Earnings per share - pro forma:				
Basic	\$.31	\$.36	\$.82	\$ 1.03
Diluted	\$.31	\$.36	\$.80	\$ 1.02

INTEREST RATE SWAP AGREEMENTS

Interest rate swap agreements are considered to be derivative financial instruments that must be recognized on the balance sheet at fair value. The Company's interest rate swap agreements have been formally designated to hedge certain fixed-rate senior notes and are considered to be effective fair value hedges based on meeting certain hedge criteria. The fair value of the interest

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rate swap agreements affects only the balance sheet and is recorded as a non-current asset or liability with an offsetting adjustment to the underlying senior note. The net interest amounts paid or received and net amounts accrued through the end of the accounting period are included in interest expense.

NEW ACCOUNTING STANDARD

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51" (the Interpretation). The Interpretation requires the consolidation of variable interest entities in which an enterprise absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Currently, entities are generally consolidated by an enterprise that has a controlling financial interest through ownership of a majority voting interest in the entity. The Interpretation provides specific guidance on determining whether an entity is considered a variable interest entity (VIE).

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A subsidiary of the Company leases the Company's corporate headquarters from an unconsolidated entity (the lessor) under an operating lease, which expires in January 2009. The lessor has invested capital at risk exceeding 3 percent of the assets of the transaction with the remainder being financed through a debt obligation. In the Company's March 2003 Form 10-Q, the Company stated that it expected to consolidate its headquarters under this Interpretation. After additional research, the Company determined that it is prohibited from consolidating its headquarters based on the legal entity that owns the building. The building is currently owned by a legal entity that includes other operations of the lessor, and, accordingly is not a VIE. If the lessor had created a separate legal entity to acquire the building, then this entity would be a VIE. Because of the difference in legal form, different accounting may result when the substance of the transaction is similar. As a result, the Company will continue to account for the arrangement as an operating lease. Accordingly, neither the leased corporate headquarters nor the related debt will be reported in the Company's balance sheet.

NOTE 2 - REVENUES

Revenues for certain health care services are as follows:

	Three Months Ended September 30 -----		Nine Months Ended September 30 -----	
	2003 ----	2002 ----	2003 ----	2002 ----
	(In thousands)			
Skilled nursing and assisted living services	\$ 648,705	\$ 633,634	\$1,919,189	\$1,919,189
Home health and hospice services	83,168	71,647	239,800	239,800
Rehabilitation services (excludes intercompany revenues)	22,969	21,050	65,467	65,467
Hospital care				
Other services	6,437	6,589	17,929	17,929
	-----	-----	-----	-----
	\$ 761,279	\$ 732,920	\$2,242,385	\$2,242,385
	=====	=====	=====	=====

NOTE 3 - DEBT

Debt consists of the following:

	September 30, 2003	December 31, 2002
	-----	-----
	(In thousands)	
Five Year Agreement		\$ 259,300
7.5% Senior Notes, net of discount (1)	\$ 149,078	149,795
8% Senior Notes (1)	197,780	200,000
6.25% Senior Notes, net of discount	199,401	
2.625% Convertible Senior Notes	100,000	
Mortgages and other notes	12,486	26,325
Capital lease obligations	4,984	5,115
	-----	-----
	663,729	640,535
Less:		
Amounts due within one year	1,921	267,423
	-----	-----
Long-term debt	\$ 661,808	\$ 373,112
	=====	=====

(1) See the interest rate swap agreement discussion on page 8.

In April 2003, the Company refinanced its five-year, \$500 million revolving credit facility that was scheduled to mature September 24, 2003. The financing package included a new three-year \$200 million revolving credit facility, \$200 million of 6.25% Senior Notes due in 2013 and \$100 million of 2.125% Convertible Senior Notes due in 2023. The Company voluntarily increased the interest rate on the Convertible Senior Notes to 2.625% on August 20, 2003 as these investors would not otherwise participate in the common stock dividend paid in August 2003.

Manor Care, Inc.'s three-year \$200 million revolving credit facility was established with a group of banks. As of September 30, 2003, there were no loans outstanding under this agreement and after consideration of usage for letters of credit, there was \$161.4 million available for future borrowing. Loans under the three-year credit facility are guaranteed by substantially all of the Company's subsidiaries. This credit agreement contains various covenants, restrictions and events of default. Among other things, these provisions require the Company to maintain certain financial ratios and impose certain limits on its ability to incur indebtedness, create liens, pay dividends, repurchase stock, dispose of assets and make acquisitions.

Loans under the three-year credit facility bear interest at variable rates that reflect, at the election of the Company, the agent bank's base lending rate or an increment over Eurodollar indices, depending on the quarterly performance of a key ratio. The three-year credit facility also provides for a fee on the total amount of the facility, depending on the performance of the

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same key ratio. In addition to direct borrowings, the three-year credit facility may be used to support the issuance of up to \$100 million of letters of credit.

The Company issued \$200 million principal amount of 6.25% Senior Notes due in 2013, priced at 99.686 percent to yield 6.29 percent. Interest is payable each May 1 and November 1, beginning November 1, 2003. The Company also issued \$100 million principal amount of 2.625% (originally issued at 2.125%) Convertible Senior Notes due in 2023, priced at 100 percent. Interest is payable each April 15 and October 15, beginning October 15, 2003. The Company may not redeem the Convertible Senior Notes before April 15, 2010. Starting with the six-month period beginning April 15, 2010, the Company may be obligated to pay contingent interest to the holders of the Convertible Senior Notes under certain circumstances. The Company's obligation to pay contingent interest is considered to be an embedded derivative and the initial value is not material. The initial conversion price is \$31.12 per share of common stock, equivalent to 32.1337 shares of the Company's common stock per \$1,000 principal amount of notes. The conversion price is subject to adjustment in certain events. The holders of the Convertible Senior Notes may convert their notes into shares of the Company's common stock prior to the stated maturity at their option only under the following circumstances: (1) if the average of the last reported sales price of the Company's common stock for the 20 trading days immediately prior to the conversion date is greater than or equal to 120% of the conversion price per share of common stock on such conversion date; (2) if the notes have been called for redemption; (3) upon the occurrence of specified corporate transactions; and (4) if the credit ratings assigned to the notes decline to certain levels. The holders of the Convertible Senior Notes may require the Company to purchase all or a portion of their notes at any of five specified dates during the life of the notes, with the first such date being April 15, 2005. Except for the initial repurchase date, the Company may elect to satisfy the repurchase in whole or in part with common stock rather than cash.

The net proceeds of approximately \$292.1 million from the closing of the three-year credit facility, Senior Notes and Convertible Senior Notes were used to repay borrowings outstanding under the Company's five-year revolving credit facility and to purchase \$25.0 million of the Company's common stock concurrent with the refinancing transactions. In the third quarter, the Company registered identical Senior Notes and Convertible Senior Notes with the Securities and Exchange Commission, which were exchanged for the Senior Notes issued in April. The Senior Notes and Convertible Senior Notes are guaranteed by substantially all of the Company's subsidiaries.

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NOTE 4 - INTEREST RATE SWAP AGREEMENTS

In May 2003 the Company entered into interest rate swap agreements on a notional amount of \$200 million in order to provide a better balance of fixed and variable rate debt. These fair value hedge agreements effectively convert the interest rate on \$100 million each of the Company's 7.5% and 8% Senior Notes to variable rates equal to six-month LIBOR plus a spread. The fair value of these agreements was a \$3.0 million liability at September 30, 2003. Interest expense was reduced by \$0.9 million related to these agreements in 2003.

NOTE 5 - STOCK REPURCHASE

In April 2003, the Company's board of directors authorized management to spend an additional \$100 million to purchase common stock through December 31, 2004.

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The Company purchased 6,765,647 shares in the first nine months of 2003 for \$139.3 million, including the \$25 million repurchased concurrently with the Convertible Senior Notes offering. At September 30, 2003, the Company had remaining unused repurchase authority of \$98.7 million.

NOTE 6 - EARNINGS PER SHARE

The calculation of earnings per share (EPS) is as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2003	2002	2003	2002
(In thousands, except earnings per share)				
Numerator:				
Income before cumulative effect	\$ 31,039	\$ 37,063	\$ 81,086	\$108,810
	=====	=====	=====	=====
Denominator:				
Denominator for basic EPS - weighted-average shares	88,060	97,239	90,272	99,133
Effect of dilutive securities:				
Stock options	1,253	895	910	941
Non-vested restricted stock	407	295	350	291
	-----	-----	-----	-----
Denominator for diluted EPS - adjusted for weighted-average shares and assumed conversions	89,720	98,429	91,532	100,365
	=====	=====	=====	=====
EPS - Income before cumulative effect:				
Basic	\$.35	\$.38	\$.90	\$ 1.10
Diluted	\$.35	\$.38	\$.89	\$ 1.08

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Options to purchase shares of the Company's common stock that were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common shares were: 3.0 million shares with an average exercise price of \$28 for the nine months of 2003 and 2.1 million shares with an average exercise price of \$32 for the nine months of 2002.

NOTE 7 - CONTINGENCIES

One or more subsidiaries or affiliates of Manor Care of America, Inc. (MCA) have been identified as potentially responsible parties (PRPs) in a variety of actions (the Actions) relating to waste disposal sites which allegedly are subject to remedial action under the Comprehensive Environmental Response Compensation Liability Act, as amended, 42 U.S.C. Sections 9601 et seq. (CERCLA) and similar state laws. CERCLA imposes retroactive, strict joint and several liability on PRPs for the costs of hazardous waste clean-up. The Actions arise out of the alleged activities of Cenco, Incorporated and its subsidiary and affiliated companies (Cenco). Cenco was acquired in 1981 by a wholly owned subsidiary of MCA. The Actions allege that Cenco transported and/or generated

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hazardous substances that came to be located at the sites in question. Environmental proceedings such as the Actions may involve owners and/or operators of the hazardous waste site, multiple waste generators and multiple waste transportation disposal companies. Such proceedings involve efforts by governmental entities and/or private parties to allocate or recover site investigation and clean-up costs, which costs may be substantial. The potential liability exposure for currently pending environmental claims and litigation, without regard to insurance coverage, cannot be quantified with precision because of the inherent uncertainties of litigation in the Actions and the fact that the ultimate cost of the remedial actions for some of the waste disposal sites where MCA is alleged to be a potentially responsible party has not yet been quantified. At September 30, 2003, the Company had \$4.5 million accrued based upon the current assessment of the likely outcome of the Actions by its outside advisors.

The Company is party to various other legal matters arising in the ordinary course of business including patient care-related claims and litigation. At September 30, 2003 and December 31, 2002, the general and professional liability consisted of short-term reserves of \$60.5 million and \$50.3 million, respectively, which were included in accrued insurance liabilities, and long-term reserves of \$117.5 million, which were included in other long-term liabilities. The expense for general and professional liability claims, premiums and administrative fees was \$25.0 million and \$67.7 million for the three and nine months ended September 30, 2003, respectively, and \$20.5 million and \$61.8 million for the three and nine months ended September 30, 2002, respectively, which was included in operating expenses. Although management believes that the Company's liability reserves are adequate, there can be no assurance that such provision and liability will not require material adjustment in future periods.

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NOTE 8 - SEGMENT INFORMATION

The Company provides a range of health care services. The Company now has two reportable operating segments, long-term care, which includes the operation of skilled nursing and assisted living facilities, and home health and hospice. The home health and hospice segment met the 10 percent disclosure threshold requirement in the second quarter of 2003 and the Company restated its 2002 corresponding information. The "Other" category includes the non-reportable segments and corporate items. The revenues in the "Other" category include services for rehabilitation, hospital care and other services. The Company's hospital was sold on April 30, 2002. Asset information, including capital expenditures, is not reported by segment by the Company. Operating performance represents revenues less operating expenses and does not include general and administrative expense, depreciation and amortization, asset impairment, other income and expense items, income taxes and cumulative effect. The other category is not comparative as the Company sold its hospital on April 30, 2002 and recorded \$8.4 million of operating expenses in the second quarter of 2003 related to a proposed settlement of a review of certain Medicare cost reports filed by facilities of the former Manor Care, Inc. for the period 1992-1998. See Management's Discussion and Analysis for additional discussion of this expense.

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Long-Term Care	Home Health and Hospice	Other	Total
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	-----	-----	-----	-----
	(In thousands)			
Three months ended September 30, 2003				
Revenues from external customers	\$ 648,705	\$ 83,168	\$ 29,406	\$ 761,279
Intercompany revenues			14,392	14,392
Depreciation and amortization	30,116	988	954	32,058
Operating margin	102,996	14,869	5,179	123,044
Three months ended September 30, 2002				
Revenues from external customers	633,634	71,647	27,639	732,920
Intercompany revenues			15,469	15,469
Depreciation and amortization	28,550	914	1,362	30,826
Operating margin	113,386	11,273	5,236	129,895
Nine months ended September 30, 2003				
Revenues from external customers	1,919,189	239,800	83,396	2,242,385
Intercompany revenues			44,112	44,112
Depreciation and amortization	89,347	2,941	3,307	95,595
Operating margin	313,967	43,820	1,852	359,639
Nine months ended September 30, 2002				
Revenues from external customers	1,867,752	211,271	98,319	2,177,342
Intercompany revenues			43,203	43,203
Depreciation and amortization	86,933	2,255	4,994	94,182
Operating margin	345,156	34,398	966	380,520

NOTE 9 - SUBSEQUENT EVENT

On October 24, 2003, the Company announced that it will pay a quarterly cash dividend of 12.5 cents per share of common stock. The dividend is payable November 20, 2003 to shareholders of record on November 7, 2003. The Company currently intends to declare and pay regular quarterly cash dividends; however, there can be no assurance that any dividends will be declared or paid in the future.

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

RESULTS OF OPERATIONS - OVERVIEW

Federal Medicare Payment Legislation. The Centers for Medicare & Medicaid Services, or CMS, made several announcements during the second quarter that should increase Medicare reimbursement. CMS indicated that it would not implement case-mix refinements at least until fiscal 2005 and recommended a 3.0 percent market basket adjustment increase in Medicare payment rates for fiscal 2004. In June, CMS announced a proposal to correct prior period market basket forecast errors which increased nursing center Medicare reimbursement by an additional 3.26 percent beginning October 1, 2003. With the annual market basket adjustment and the correction proposed by CMS, we expect our fourth quarter Medicare revenues to increase by approximately \$20 per patient day. In addition, beginning October 1 our hospice business received a 3.4 percent market basket adjustment and our home health business received a 3.3 percent increase.

CRITICAL ACCOUNTING POLICIES

General and Professional Liability. Our general and professional

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reserves include amounts for patient care-related claims and incurred but not reported claims. We evaluated the adequacy of our general and professional liability reserves with our independent actuary during the second quarter of 2003 for all policy periods through May 31, 2003. The amount of our reserves is determined based on an estimation process that uses information obtained from both company-specific and industry data. The estimation process requires us to continuously monitor and evaluate the life cycle of the claims. Using data obtained from this monitoring and our assumptions about emerging trends, we along with our independent actuary develop information about the size of ultimate claims based on our historical experience and other available industry information. The most significant assumptions used in the estimation process include determining the trend in costs, the expected cost of claims incurred but not reported and the expected costs to settle unpaid claims. Our assumptions take into consideration our internal efforts to contain our costs by reviewing our risk management programs, our operational and clinical initiatives, and other industry changes affecting the long-term care market. The number of new claims in the first nine months of 2003 is similar to the same period in 2002, despite some acceleration around the tort legislative activity in Texas and to some degree Florida. We expect the average settlement costs per claim for the year 2003 to approximate 2002. Although we believe our reserves are adequate, we can give you no assurance that this liability will not require material adjustment in future periods.

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RESULTS OF OPERATIONS -

QUARTER AND YEAR-TO-DATE SEPTEMBER 30, 2003 COMPARED WITH SEPTEMBER 30, 2002

Revenues. Our revenues increased \$28.4 million, or 4 percent, from the third quarter of 2002 to 2003. Revenues from our long-term care segment (skilled nursing and assisted living facilities) increased \$15.1 million, or 2 percent, due to increases in rates/patient mix--\$13.5 million and occupancy--\$10.0 million that were partially offset by a decrease in capacity--\$8.4 million. Our revenues from the home health and hospice segment increased \$11.5 million, or 16 percent, primarily because of an increase in hospice patient days.

Our revenues in the first nine months of 2003 increased \$65.0 million, or 3 percent, compared with the first nine months of 2002. Excluding the results of our hospital that we sold in April 2002, our revenues increased \$86.4 million, or 4 percent. Revenues from our long-term care segment increased \$51.4 million, or 3 percent, due to increases in rates/patient mix--\$43.2 million and occupancy--\$25.2 million that were partially offset by a decrease in capacity--\$17.0 million. Our revenues from the home health care and hospice segment increased \$28.5 million, or 14 percent, primarily because of an increase in hospice patient days.

Our average rates per day for the long-term care segment were as follows:

	Third Quarter			First Nine Months	
	2003	2002	Increase (Decrease)	2003	2002
Medicaid	\$131.04	\$125.93	4%	\$130.21	\$123.48
Private and other (skilled only)	\$190.34	\$182.16	4%	\$189.30	\$181.05
Medicare	\$311.98	\$335.42	(7)%	\$311.17	\$334.27

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The increase in overall rates was also a result of a shift in the mix of our patients to a higher percentage of Medicare patients, even though the Medicare rate decreased. The rate decreased because certain of the increases in Medicare reimbursement for skilled nursing facilities provided for under the Medicare, Medicaid and SCHIP Balanced Budget Refinement Act of 1999, or BBRA 99, and the Medicare, Medicaid, and SCHIP Benefits Improvement and Protection Act of 2000, or BIPA 2000, expired on September 30, 2002, the so-called Medicare Cliff.

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Our occupancy levels were as follows:

	Third Quarter		First Nine Months	
	-----		-----	
	2003	2002	2003	2002
	----	----	----	----
Total	88%	87%	88%	87%
Excluding start-up facilities	89%	88%	88%	88%
Skilled nursing facilities	89%	89%	89%	88%

The quality mix of revenues from Medicare, private pay and insured patients that related to skilled nursing and assisted living facilities and rehabilitation operations was 67 percent for the third quarter and first nine months of 2003 compared to 67 percent for the third quarter and 68 percent for the first nine months of 2002.

Our bed capacity declined between the third quarter and first nine months of 2002 and 2003 primarily because we sold three skilled nursing facilities in May 2003 with 374 beds and closed or sold three skilled nursing facilities in 2002 with 498 beds, which was partially offset by opening three assisted living facilities in 2002 with 188 beds.

Operating Expenses. Our operating expenses in the third quarter of 2003 increased \$35.2 million, or 6 percent, compared with the third quarter of 2002.

Operating expenses from our long-term care segment increased \$25.5 million, or 5 percent between the third quarters of 2002 and 2003. We attribute the largest portion (\$7.6 million) of the long-term care operating expense increase to wages, temporary staffing and payroll overhead. Our other operating expense increase for this segment included ancillary costs, excluding internal labor, of \$4.4 million. Ancillary costs, which include various types of therapies, medical supplies and prescription drugs, increased as a result of our more medically complex patients. Our general and professional liability expense increased \$4.2 million as a result of an increase in the claims accrual and insurance premiums. The expense related to our stock appreciation rights for operating participants increased \$2.6 million because of the 20 percent increase in our stock price this quarter. See general and administrative expenses for additional discussion of the increase in costs related to stock appreciation rights.

Our operating expenses from our home health and hospice segment increased \$7.9 million, or 13 percent between the third quarters of 2002 and 2003. The increase related to labor costs of \$3.6 million, ancillary costs including pharmaceuticals of \$1.5 million and other direct nursing care costs, including medical equipment and supplies, of \$1.1 million.

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Our operating expenses in the first nine months of 2003 increased \$85.9 million, or 5 percent, compared with the first nine months of 2002. Excluding the results of our hospital that was sold on April 30, 2002, operating expenses increased \$105.8 million, or 6 percent. During the second quarter of 2003, we recorded an expense of \$8.4 million for a proposed settlement of a

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review of certain Medicare cost reports filed by facilities of the former Manor Care, Inc. prior to the implementation of the prospective payment system. This review, which was conducted by the Department of Justice and the Office of Inspector General of the Department of Health and Human Services, focused primarily on nursing cost allocations made in reliance upon instructions from the facilities' Medicare fiscal intermediary for the period 1992-1998. We believe the former Manor Care facilities were fully entitled to the reimbursement they received for these allocations. The agreement in principle, if ultimately approved and executed by all parties, will resolve any uncertainty over potential liability to the Medicare program. We have fully cooperated with the Department of Justice throughout the review. No complaint has been filed, nor has any subpoena been issued to the Company related to this matter. This agreement in principle is subject to final approvals within the Department of Justice and to negotiation of a definitive settlement agreement. We expect the settlement to be completed in the near future.

Operating expenses from our long-term care segment increased \$82.6 million, or 5 percent, between the first nine months of 2002 and 2003. The largest portion of the long-term care operating expense increase of \$43.7 million related to wages, temporary staffing and payroll overhead. Our other operating expense increase for this segment included ancillary costs, excluding internal labor, of \$9.4 million and general and professional liability expense of \$6.5 million. Excluding the \$4.9 million charge recorded in the second quarter of 2002 due to a court-ordered liquidation of one of our insurers, our general and professional liability expense increased \$11.4 million because of an increase in the claims accrual and insurance premiums. The expense related to our stock appreciation rights increased \$4.0 million because of a 20 percent increase in our stock price this quarter that was in addition to the 30 percent increase in the second quarter.

Our operating expenses from our home health and hospice segment increased \$19.1 million, or 11 percent. The increase related to labor costs of \$9.9 million, ancillary costs including pharmaceuticals of \$4.2 million and other direct nursing care costs, including medical equipment and supplies, of \$3.8 million.

General and Administrative Expenses. Our general and administrative expenses increased \$7.4 million and \$24.4 million from the third quarters and first nine months of 2002 to 2003, respectively. An increase of \$6.2 million in the second quarter of 2003 related to restructuring split-dollar life insurance policies for officers and key employees as a result of the Sarbanes-Oxley Act of 2002 which prohibits employee loans in the form of prepaid premiums and recent tax law changes that make the internal buildup of cash surrender value taxable. The restructuring requires transferring a portion of the Company's share of the split-dollar life insurance policies to the employees. The other significant expense for the third quarter and first nine months of 2003 related to the increase in costs associated with our stock appreciation rights and deferred compensation plans. The increase in these costs included in general and administrative expenses was \$5.7 million from the third quarters of 2002 to 2003 and \$13.8

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million from the first nine months of 2002 to 2003, primarily from the increase in our stock price in the second and third quarters. The increase in costs related to stock appreciation rights and deferred compensation plans were recorded in both general and administrative expenses and operating expenses. The total increase for these expenses was \$9.2 million for the quarter and \$19.3 million for the first nine months when compared to the prior year period.

Asset Impairment. During our quarterly reviews of long-lived assets in 2002, management determined that certain assets were impaired by \$27.6 million for the first nine months of 2002. The impairment consisted of \$22.2 million for certain long-lived assets and \$5.4 million of our vision business' intangible assets. Refer to our Form 10-Q for the quarter ended September 30, 2002 for additional discussion.

Interest Expense. Interest expense increased from the third quarters and first nine months of 2002 to 2003 because of the higher interest rates associated with our fixed-rate senior notes issued in April 2003 compared with our variable-rate credit agreement debt that was paid off. The increase in interest expense also related to additional amortization of finance fees from the new senior notes. We expected our interest expense to increase by approximately \$1.0 million per month as a result of the refinancing. See Note 3 to the consolidated financial statements for discussion of our debt refinancing.

We entered into interest rate swap agreements in May 2003 on a notional amount of \$200 million to hedge certain fixed-rate senior notes. These agreements effectively converted the interest rates of these notes to variable rates in order to provide a better balance of fixed and variable rate debt. These agreements reduced interest expense by \$0.7 million for the third quarter of 2003. See Note 4 to the consolidated financial statements for discussion of our interest rate swap agreements.

Gain on Sale of Assets. Our gain on sale of assets in the first nine months of 2003 primarily resulted from the sale of non-strategic land parcels and sale of securities. Our gain on sale of assets in the first nine months of 2002 primarily related to the gain of \$31.1 million recognized on the sale of our hospital on April 30, 2002.

Equity in Earnings of Affiliated Companies. Our equity earnings increased in the third quarter and first nine months of 2003 compared with 2002 primarily because of our ownership interests in two hospitals acquired on April 30, 2002.

Income Taxes. Our effective tax rate decreased to 34.8 percent in the third quarter of 2003 compared with 38.0 percent for the year 2002 primarily as a result of a decrease in our deferred tax rate in the third quarter of 2003. We expect our annualized effective tax rate to be approximately 37.5%.

Cumulative Effect of Change in Accounting Principle. In July 2001, the Financial Accounting Standards Board issued Statement No. 142, "Goodwill and Other Intangible Assets," that we adopted January 1, 2002. Under this Statement, goodwill and indefinite-lived intangible assets are no longer amortized but are reviewed annually for impairment, or more frequently if impairment indicators arise. We completed our initial impairment test in the second quarter of 2002 and determined that \$1.3 million of our goodwill related to our vision business was impaired. The impairment loss, with no tax effect, was recorded retroactive

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to January 1, 2002 as a cumulative effect of a change in accounting principle.

FINANCIAL CONDITION - SEPTEMBER 30, 2003 AND DECEMBER 31, 2002

Property and equipment decreased \$15.0 million primarily due to depreciation of \$89.5 million and disposal of assets of \$11.5 million. These decreases were partially offset by \$74.1 million in new construction and renovations to existing facilities and a \$10.1 million cash payment to exercise a purchase option on a leased facility.

Accrued insurance liabilities decreased \$3.6 million primarily due to an \$18.6 million payment of an environmental liability partially offset by increases in our other insurance accruals. We also received insurance proceeds of \$9.5 million in January 2003 which reduced our receivables and offset half of the environmental payment.

Income tax payable decreased \$11.7 million primarily due to state tax payments and tax benefits related to the exercise of stock options.

Our debt classification between current and long-term changed during the first nine months of 2003 as a result of the new financing package completed in April 2003. We issued \$300.0 million of senior notes. With the proceeds, we paid off our expiring revolving credit facility that had a balance of \$259.3 million at December 31, 2002 and was classified as a current liability. See Note 3 to the consolidated financial statements for additional discussion of the financing package.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows. During the first nine months of 2003, we satisfied our cash requirements with cash generated from operating activities. We used the cash principally for capital expenditures, acquisitions, to purchase our common stock, to pay dividends and in the first quarter to pay down debt. Cash flows from operating activities were \$254.5 million for the first nine months of 2003, an increase of \$36.0 million from the first nine months of 2002. It has not been necessary to pay any estimated federal tax payments in 2003 compared with \$53.5 million in the first nine months of 2002 due to changes in tax laws and tax accounting methods for return purposes.

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Investing Activities. Our expenditures for property and equipment of \$74.1 million in the first nine months of 2003 included \$14.6 million to construct new facilities and expand existing facilities. In the first quarter of 2003, we exercised a purchase option for \$10.1 million on a facility that was previously leased.

Debt Agreement. During April 2003, we refinanced our five-year, \$500 million revolving credit agreement that was scheduled to mature September 24, 2003. The financing package included a new three-year \$200 million revolving credit facility, \$200 million of 6.25% Senior Notes due in 2013 and \$100 million of 2.625% (originally issued at 2.125%) Convertible Senior Notes due in 2023. The net proceeds of approximately \$292.1 million from the closing of these transactions were used to repay borrowings outstanding under our five-year revolving credit facility and to purchase \$25.0 million of our common stock concurrent with the refinancing transactions. As of September 30, 2003, there were no loans outstanding under the new three-year revolving credit facility and after consideration of usage for letters of credit, there was \$161.4 million available for future borrowing.

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Stock Purchase. During 2001 and 2002, our board of directors authorized us to spend up to \$300 million to purchase our common stock with \$200 million of the authorization expiring on December 31, 2003 and the remaining \$100 million on December 31, 2004. In April 2003, our board authorized an additional \$100 million through December 31, 2004. With these authorizations, we purchased 6,765,647 shares in the first nine months of 2003 for \$139.3 million, which includes the \$25.0 million repurchased concurrently with the Convertible Senior Notes offering. We have \$98.7 million remaining authority to repurchase our shares as of September 30. We may use the shares for internal stock option and 401(k) match programs and for other uses, such as possible future acquisitions.

Cash Dividend. The Company paid its first quarterly dividend of 12.5 cents per common share, or \$11.2 million, in the third quarter of 2003. On October 24, 2003, the Company announced that it will pay a quarterly cash dividend of 12.5 cents per share of common stock to shareholders of record on November 7, 2003. This dividend payment will approximate \$11.0 million payable on November 20, 2003. We intend to declare and pay regular quarterly cash dividends; however, there can be no assurance that any dividends will be declared or paid in the future.

We believe that our cash flow from operations will be sufficient to cover operating needs, future capital expenditure requirements, scheduled debt payments of miscellaneous small borrowing arrangements and capitalized leases, cash dividends and some share repurchase. Because of our significant annual cash flow, we believe that we will be able to refinance the major pieces of our debt as they mature. It is likely that we will pursue growth from acquisitions, partnerships and other ventures that we would fund from excess cash from operations, credit available under our

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bank credit agreement and other financing arrangements that are normally available in the marketplace.

CAUTIONARY STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS

This report may include forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events. We identify forward-looking statements in this report by using words or phrases such as "anticipate," "believe," "estimate," "expect," "intend," "may be," "objective," "plan," "predict," "project," and "will be" and similar words or phrases, or the negative thereof.

These forward-looking statements are subject to numerous assumptions, risks and uncertainties. Factors which may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by us in those statements include, among others: changes in the health care industry because of political and economic influences; changes in Medicare, Medicaid and certain private payors' reimbursement levels; existing government regulations, including applicable health care, tax and health and safety regulations, and changes in, or the failure to comply with, governmental regulations or the interpretations thereof; legislative proposals for health care reform; competition and general economic and business conditions; the ability to attract and retain qualified personnel; changes in current trends in the cost and volume of patient-care related claims and workers' compensation claims and in insurance costs related to such claims; other litigation and our ability to complete the settlement with the Department of Justice.

Although we believe the expectations reflected in our forward-looking statements

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are based upon reasonable assumptions, we can give no assurance that we will attain these expectations or that any deviations will not be material. Except as otherwise required by the federal securities laws, we disclaim any obligations or undertaking to publicly release any updates or revisions to any forward-looking statement contained in this report to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Changes in U.S. interest rates expose us to market risks inherent with derivatives and other financial instruments. Our interest expense is most sensitive to changes in the general level of U.S. interest rates applicable to our U.S. dollar indebtedness. In the second quarter of 2003, we refinanced our five-year credit agreement prior to its scheduled maturity in September 2003 with a new three-year \$200 million credit facility, \$200 million of 6.25% Senior Notes due in 2013 and \$100 million of 2.125% Convertible Senior Notes due in 2023. The Company voluntarily increased the interest rate on the Convertible Senior Notes to 2.625% effective August 20, 2003. There are no loans outstanding under our new credit facility at September 30, 2003.

We entered into interest rate swap agreements on a notional amount of \$200 million in May 2003 in order to provide a better balance of fixed and variable rate debt. The agreements effectively convert the interest rate on \$100 million each of our 7.5% and 8% Senior Notes to variable rates equal to six-month LIBOR plus a spread.

The tables below provide information about our derivative financial instruments that are sensitive to changes in interest rates, including interest rate swaps and debt obligations. For debt obligations, the tables present principal cash flows and weighted-average interest rates by expected maturity dates. For interest rate swaps, the table presents notional amounts by expected (contractual) maturity date. Notional amounts are used to calculate the contractual payments to be exchanged under the contract.

The following table provides information about our significant interest rate risk at September 30, 2003:

	Expected Maturity Dates						
	2004	2005	2006	2007	2008	Thereafter	T
	----	----	----	----	----	-----	---
	(Dollars in thousands)						
Long-term debt:							
Fixed rate debt			\$150,000		\$200,000	\$ 300,000	\$6
Average interest rate			7.5%		8.0%	5.0%	
Interest rate swaps -							
fixed to variable:							
Notional amount			\$100,000		\$100,000		\$2
Pay variable rate			L+ 5.1%		L+ 5.0%		
Receive fixed rate			7.5%		8.0%		

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L= six-month LIBOR

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The following table provides information about our significant interest rate risk at December 31, 2002:

	Expected Maturity Dates						
	2003	2004	2005	2006	2007	Thereafter	
	----	----	----	----	----	-----	
	(Dollars in thousands)						
Long-term debt:							
Variable rate debt	\$259,300						\$2
Floating index rate	(1)						
Fixed rate debt				\$150,000		\$ 200,000	\$3
Average interest rate				7.5%		8.0%	

(1) Eurodollar-based rate plus .4%

Item 4. Controls and Procedures

An evaluation was performed under the supervision and with the participation of our management, including the chief executive officer, or CEO, and chief financial officer, or CFO, of the effectiveness of the design and operation of our disclosure procedures. Based on that evaluation, our management, including the CEO and CFO, concluded that our disclosure controls and procedures were effective as of September 30, 2003. There have been no significant changes in our internal control over financial reporting in the third quarter of 2003 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

See Note 7 - Contingencies in the notes to the consolidated financial statements for a discussion of litigation related to environmental matters and patient-care related claims.

Item 2. Changes in Securities and Use of Proceeds.

None

Item 3. Defaults Upon Senior Securities.

None

Item 4. Submission of Matters to a Vote of Security Holders.

None

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Item 5. Other Information.

None

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits

S-K Item

601 No.

- 4.1 Indenture for 6.25% Senior Notes due 2013, dated as of April 15, 2003, among Manor Care, Inc., the subsidiary guarantors as named therein and National City Bank, as trustee (filed as Exhibit 4.1 to Manor Care, Inc.'s Registration Statement on Form S-4, File No. 333-107399 and incorporated herein by reference)
- 4.2 Indenture for 2.125% Convertible Senior Notes due 2023, dated as of April 15, 2003, among Manor Care, Inc., the subsidiary guarantors as named therein and National City Bank, as trustee (filed as Exhibit 4.1 to Manor Care, Inc.'s Registration Statement on Form S-3, File No. 333-107481 and incorporated herein by reference)
- 4.3 Amendment to Indenture for 2.125% Convertible Senior Notes due 2023, dated as of August 7, 2003, among Manor Care, Inc., the subsidiary guarantors as named therein and National City Bank, as trustee (filed as Exhibit 4.4 to Manor Care, Inc.'s Registration Statement for Amendment No. 1 to Form S-3, File No. 333-107481 and incorporated herein by reference)
- 31.1 Chief Executive Officer Certification
- 31.2 Chief Financial Officer Certification
- 32.1 Chief Executive Officer Certification Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 Of The Sarbanes-Oxley Act Of 2002
- 32.2 Chief Financial Officer Certification Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 Of The Sarbanes-Oxley Act Of 2002

(b) Reports on Form 8-K

On July 25, 2003, Manor Care, Inc. filed a Form 8-K and under Item 5 filed the July 25, 2003 press release reporting the Company's financial results for the second quarter of 2003.

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SIGNATURES

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

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Manor Care, Inc.
(Registrant)

Date October 31, 2003

By /s/ Geoffrey G. Meyers

Geoffrey G. Meyers, Executive Vice
President and Chief Financial Officer

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EXHIBIT INDEX

Exhibit

- | | |
|------|--|
| 31.1 | Chief Executive Officer Certification |
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