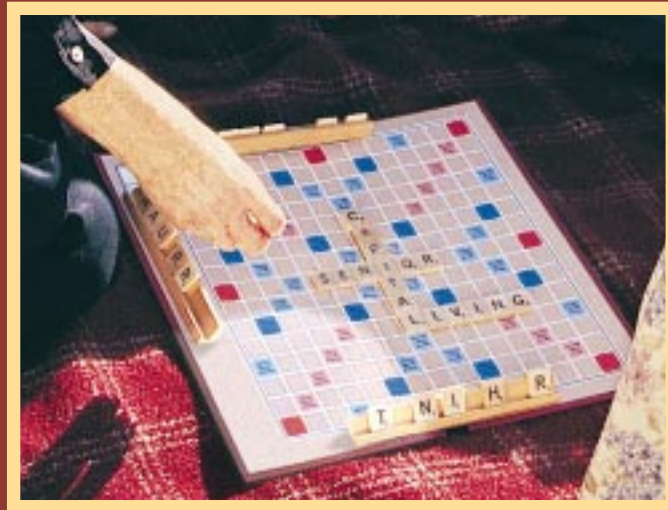


**CAPITAL SENIOR LIVING
CORPORATION**

1998 Annual Report



M ISSION STATEMENT

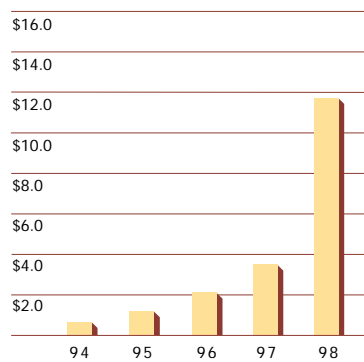
Capital Senior Living Corporation is committed to providing quality housing and services based on the highest standards of excellence in the industry. Our goal is to enrich the daily lives of our senior residents by providing an environment that stimulates them physically, mentally, and emotionally. All of our communities and facilities offer a relaxed atmosphere of warmth and caring that promotes companionship among residents and staff. Every community is staffed by qualified and highly trained employees who possess a personal commitment to serve the senior resident. The on-site staff ensures the highest quality lifestyle possible by providing regular social programs, nutritious meals, housekeeping, transportation, security and appropriate health care. All residents are treated with dignity and respect—just as we ourselves would like to be treated.

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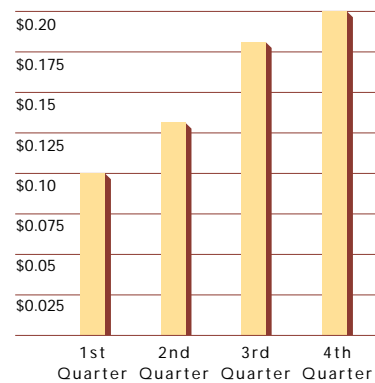
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F INANCIAL HIGHLIGHTS

NET INCOME
\$Millions



EARNINGS PER SHARE
1998



T O OUR FELLOW SHAREHOLDERS:

As a national developer and provider of senior living services, we furnish housing and care for nearly 5,700 residents in 34 communities in 17 states. With our strong balance sheet and deep and experienced management team, we are well-positioned to build on this foundation and meet the rising demand for affordable, quality senior living care. Now, over a year after our initial public offering, we have exceeded even our most optimistic goals.

1998 was an excellent year, even by our standards:

- As of 1998 year-end, we completed our seventh consecutive year of profitability. Our financial results showed significant increases over 1997 and demonstrated our ability to effectively operate while executing on our multiple growth strategies. There was a 140 percent increase in net income for 1998 over pro forma net income for 1997.
- The Company currently has 34 communities under construction or development, which will have a capacity of approximately 5,000 residents, including 27 new Waterford Communities with a capacity of approximately 3,900 residents. This development pipeline is scheduled to be completed throughout 1999 and 2000.
- The Company is expanding 10 existing communities, which are scheduled to be completed during 1999 and 2000, adding approximately 560 additional residents to our total capacity.
- We completed, one year ahead of schedule, the acquisitions of six senior living communities, with a resident capacity of 1,064 and an average occupancy of 96 percent.

Our growth strategy is multifaceted and is based on our strong and experienced management team, our established national platform of operations, our proven track record of profitable expansion, our financial strength and the growing market demand for senior living communities driven by an aging U.S. population. The cornerstones of this growth strategy are:

- Development of new communities;
- Expansion of existing communities;
- Internal growth generating continued profitability and positive rates of return from our communities; and
- Strategic acquisitions that bring geographic or operating leverage to our portfolio.

Our operating philosophy is based on delivering a continuum of care to our residents, which allows them to age in place. Our communities offer differing levels of service to fit this continuum:

- Independent living services for seniors not needing assistance with many activities of daily living (“ADLs”), such as eating, bathing, dressing and medication reminders or dispensing, but who do want a residential community that offers care, meals, recreational activities, transportation, wellness programs, house-keeping and other services;
- Assisted living services that provide personal care, support and supplemental services for residents who need help with ADLs, but who do not require the more acute medical care traditionally given in nursing homes; and



On the left: **JEFFREY L. BECK**, Co-Chairman of the Board
 On the right: **JAMES A. STROUD**, Co-Chairman of the Board

- Home care that expands the range of services offered to bridge the gap between independent and assisted living services.

Our residents benefit from these levels of service because they can maintain as much autonomy and independence as their mental and physical capabilities permit, and their fees are based on the level of service they require. Importantly, as residents' needs change with age and health, they can receive, at many of the Company's communities, the services they require without having to move to a different facility.

This continuum of care also benefits us as a company. We are able to attract residents at an earlier age and provide them with extended services for longer periods of time than many other senior living alternatives. The average length of stay at our continuum of care communities is double the average length of stay at a free standing assisted living community.

With the population of persons aged 75 and older expected to more than double by the year 2030, we believe the demand for our communities and care will continue to increase. Capital's management experience, financial strength and solid foundation position us to translate this demand into quality, affordable living for our senior residents and value for our shareholders.

Thank you for your support,

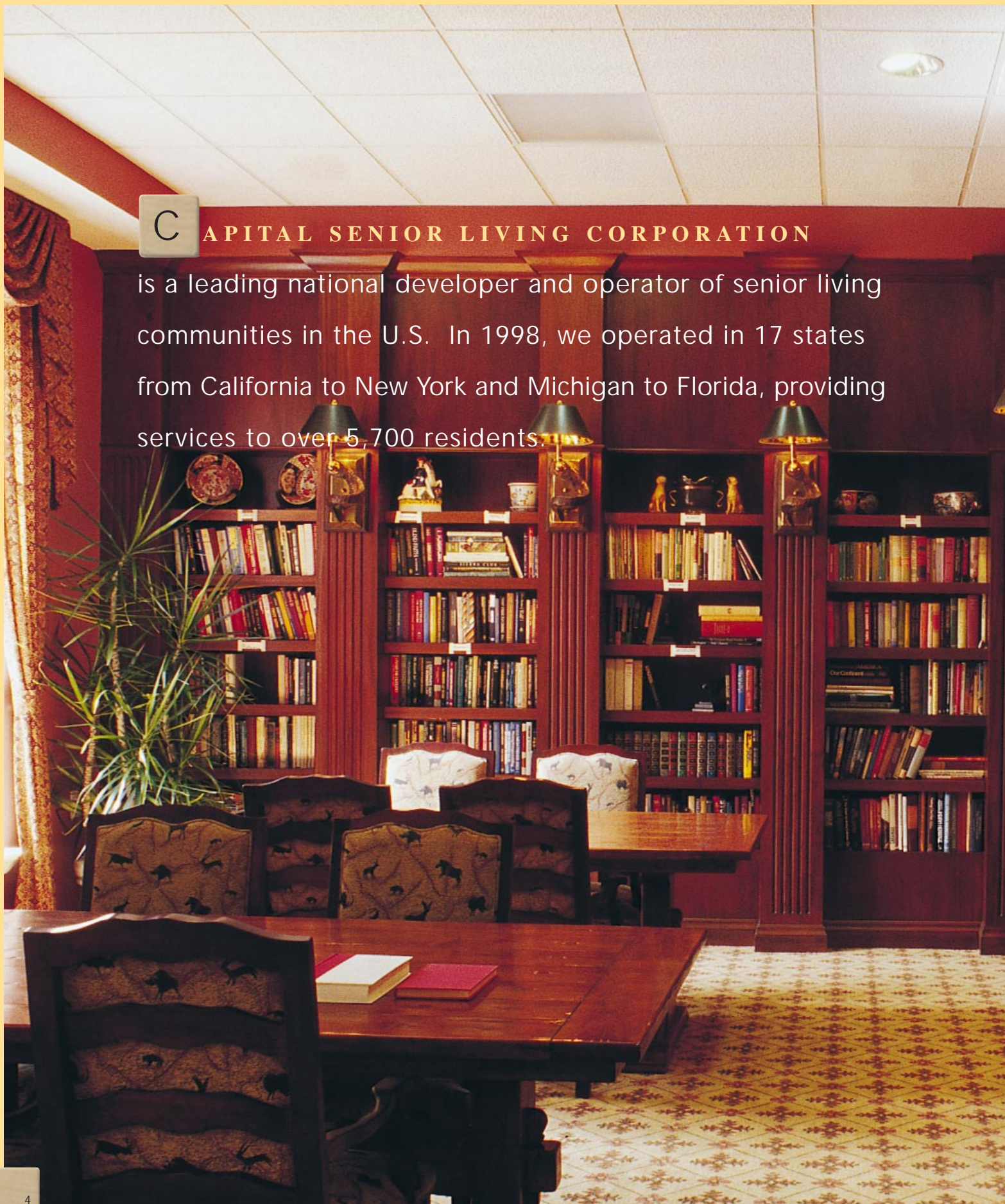
JEFFREY L. BECK, Co-Chairman of the Board

JAMES A. STROUD, Co-Chairman of the Board

March 29, 1999

C APITAL SENIOR LIVING CORPORATION

is a leading national developer and operator of senior living communities in the U.S. In 1998, we operated in 17 states from California to New York and Michigan to Florida, providing services to over 5,700 residents.



Our operating philosophy is to provide affordable, quality living communities and services to senior citizens and deliver a continuum of care for our residents as their needs change over time. This continuum of care, which integrates independent living and assisted living and is bridged by home care, sustains our residents' autonomy and independence based on their physical and mental abilities. As our residents age, in many of the Company's communities, they are able to obtain the additional needed services within the same community, avoiding the disruptive and often traumatic move to a different facility.

Independent living services accounted for about 81 percent of our operations in 1998. Independent living communities are more socially oriented than other health-intensive environments, such as nursing homes, and are ideal for individuals who need or want to make a lifestyle change, rather than one driven by health requirements. This level of service includes daily meals, transportation, social and recreational activities, laundry, housekeeping, security and healthcare monitoring. Additionally, we offer our residents health screenings, dietary and similar programs, exercise and fitness classes, chronic disease management (such as diabetes) and other special services. The monthly fees for independent living range from \$1,250 to \$2,400 per month, depending on the community, the size of the unit and the services and amenities used.

Assisted living services, which provide care and services 24 hours per day, accounted for about 13 percent

of our operations in 1998. Residents needing assisted living services, rather than independent living services, require help with one or more ADLs but do not need skilled or acute nursing care. Certain of our assisted living facilities also provide residents with services for Alzheimer's disease and other forms of dementia. Assisted living services provide a cost-effective alternative to nursing homes for these individuals. Monthly fees for our assisted living residents range from \$1,750 to \$2,400 per month, depending on the size of the unit and the amount of assistance and services required by the resident.

Skilled nursing care services comprise the highest level of care in our continuum and represented about six percent of our operations in 1998. This is traditional, long-term care provided by highly skilled nursing professionals. Through these services, we also offer a comprehensive range of restorative nursing and rehabilitation services, including physical, occupational and speech therapy. Residents pay between \$3,000 and \$3,500 per month, depending on the services they need.





Our continuum of care approach creates the foundation for our operating philosophy.

- First, we provide a broad range of high-quality care that is personalized and tailored to meet each individual resident's needs. We maintain a comprehensive quality assurance program that includes annual surveys of resident satisfaction. This is not only beneficial for our residents, it helps us maintain our occupancy levels and attract new residents to our communities. In 1998, we received a 95 percent resident satisfaction rating.
- We market to middle- and upper-income residents and utilize on-site marketing directors. When evaluating expansion or development plans, we assess whether the demographics of the area support our plans in our targeted age and income group. Partly because of this strategy, 93 percent of our resident revenues were private-pay in 1998.
- We endeavor to maintain and improve our occupancy levels. Our continuum of care results in a lower turnover rate of residents and a longer residence stay than traditional alternative facilities. Average occupancy rates at stabilized

communities were 96 percent and occupancies at all communities (including those in lease-up) averaged 95 percent in 1998. We provide services such as home care and establish professional relationships that lead to referrals. Our high level of resident satisfaction also leads to additional referrals. These factors are complementary to and aided by our active marketing programs.

- We carefully monitor returns from our properties and strive to increase overall operating margins, which averaged 43 percent for 1998. As an example of the success of these efforts, our same-community revenue increased by 6.8 percent over the prior year and net operating income increased from 1997 to 1998 at a rate of 15.5 percent.
- We promote employee training and professional development. Only by focusing on the quality of our hiring, screening, training and supervision of our 1,800 employees can we provide high quality standards of care for our residents.

Several factors have made Capital Senior Living Corporation a success in the senior living industry:

- We have built a senior management team that is one of the most experienced in the industry. Our eight executive officers have an average of 20 years of industry experience and our 14 executive regional and district officers have an average of 15 years experience. At the community level, our executive directors have an average of 13 years of industry experience. Our senior management team has developed over \$400 million in senior living communities.
- We have a large national base and our goal is to cluster new developments creating a strong geographic presence in a particular market. This will provide operating efficiencies, economies of scale and a regional support infrastructure.

- We have a strong financial foundation. With the conclusion of 1998, we reported our seventh consecutive profitable year. Our cash balance of nearly \$36 million and a \$20 million credit line (with a commitment to increase the credit line to \$34 million) provide the resources to implement our strategic growth strategy. Additionally, there is \$176 million of off-balance-sheet financing available for the development and long-term financing of our new Waterford communities.
- We have implemented several monitoring and management comprehensive and proprietary information systems to help manage financial and operating data. These systems enable us to identify trends, monitor and control costs and develop pricing strategies. We are well positioned to take advantage of the growing demand for senior living communities. An aging U.S. population will require affordable living and care facilities. According to the U.S. Census Bureau, the population of Americans aged 75 years and up will increase nearly one and a half times from the 1990 level of 13 million to 32 million in 2030. This growing industry provides the backdrop against which we have developed a strong growth plan, based on four key elements.

The first of these is to develop new communities. As of early 1999, we had announced the development of 34 new communities with a capacity of approximately 5,000 residents. Twenty-seven of these new facilities will be Waterford communities, which will be focused toward middle-income residents. The Waterford communities incorporate many amenities normally found in more expensive properties and are based on a flexible model, enabling them to be configured to a particular geographic market, neighborhood or site.

Our second growth strategy is to further expand our existing facilities. We have completed one expansion in 1998 and have 10 communities currently under expansion. When evaluating expansion of our existing properties, we carefully consider expanding not only the number of units but also the scope of services provided. Each level of service, independent living and assisted living, requires different facilities. We are endeavoring to ensure that we have the correct mix of facilities in order to provide a continuum of care for our residents.

The third part of our growth plan is based on internal growth, with the objective of providing an attractive rate of return from our properties. Providing additional levels of care and maintaining high occupancy rates are basic to this success, as is maintaining strict cost controls. Our expansion plans will also contribute to operating efficiencies. As we expand, corporate overhead can be spread over a larger number of units and we are able to utilize greater efficiencies of scale.

The last key element of our growth strategy is acquisitions. Our history provides a proven track record of





successful consolidation and integration. Our industry is highly fragmented, providing opportunities to acquire other communities. During 1998, one year ahead of schedule, we acquired six senior living communities with a resident capacity of 1,064 and an average occupancy of 96 percent.

Since 1996, Capital has managed 13 properties for ILM Senior Living and ILM II Senior Living (the “ILMs”). We recently announced the signing of definitive merger agreements with the ILMs, which upon completion, will increase the number of owned communities by 68 percent from 19 to 32. Capital and the ILMs have a history of working together. We have a proven track record with the ILMs, having increased operating income and occupancies at the ILM communities since we began to manage them in 1996. These results reflect the shared operating strategy of Capital and the ILMs of providing

residents the ability to age in place by integrating independent living with assisted living and personal care. The ILM communities also mirror the type of communities currently owned by Capital, which contain approximately 82 percent independent living and approximately 18 percent assisted living residences.

We are in the senior living business for many reasons, but the main one is that we care. It is extremely rewarding to provide a service that makes such a difference in the caliber of life for so many people. We care that our residents receive the quality, affordable services they require. We care that our employees are well-trained and motivated. We care that our company’s financial health, stability and growth are well-managed. And we care that our shareholders benefit from the growth of our company. We look forward with anticipation to our future.

SELECTED FINANCIAL DATA

The following table sets forth selected financial data of the Company. The selected financial data for the years ended December 31, 1998, 1997, 1996, 1995 and 1994 are derived from the audited consolidated financial statements of the Company.

(in thousands, except per share data)	Year ended December 31,				
	1998	1997	1996	1995	1994
STATEMENTS OF INCOME DATA:					
Revenues:					
Resident and healthcare revenue	\$ 24,790	\$ 21,207	\$ 13,692	\$ 13,238	\$ 12,761
Rental and lease income	4,282	4,276	1,101	1,231	1,235
Unaffiliated management services revenue	2,465	1,920	801	—	—
Affiliated management services revenue	1,327	1,378	2,708	2,778	3,113
Unaffiliated development fees	1,234	804	673	—	—
Affiliated development fees	7,473	173	—	—	—
Other	1,197	952	924	871	800
Total revenues	42,768	30,710	19,899	18,118	17,909
Expenses:					
Operating expenses	17,067	16,701	10,656	10,287	10,142
General and administrative expenses ⁽¹⁾	6,594	7,085	5,635	4,364	4,595
Depreciation and amortization	2,734	2,118	1,481	1,776	1,707
Total expenses	26,395	25,904	17,772	16,427	16,444
Income from operations	16,373	4,806	2,127	1,691	1,465
Other income (expense):					
Interest income	4,939	3,186	432	368	122
Interest expense	(1,922)	(2,022)	(221)	(278)	(261)
Gain on sale of properties	422	—	438	—	—
Equity in earnings on investments	—	—	459	—	—
Other	—	440	42	—	(16)
Income before income taxes and minority interest in consolidated partnerships	19,812	6,410	3,277	1,781	1,310
(Provision) benefit for income taxes ⁽²⁾	(7,476)	(793)	—	(18)	(130)
Income before minority interest in consolidated partnerships	12,336	5,617	3,277	1,763	1,180
Minority interest in consolidated partnerships	(379)	(1,936)	(1,224)	(760)	(634)
Net income	\$ 11,957	\$ 3,681	\$ 2,053	\$ 1,003	\$ 546
Net income per share:					
Basic and Diluted	\$ 0.61	\$ 0.33			
Weighted average shares outstanding	19,717	11,150			
Pro forma net income data (unaudited)⁽³⁾:					
Net income		\$ 3,681	\$ 2,053		
Pro forma income taxes		(965)	(811)		
Pro forma net income		\$ 2,716	\$ 1,242		
BALANCE SHEET DATA:					
Cash and cash equivalents	\$ 35,827	\$ 48,125	\$ 10,819	\$ 10,017	\$ 8,799
Working capital	(8,680) ⁽⁴⁾	44,690	9,567	6,784	5,938
Total assets	205,267	117,371	33,203	29,747	29,913
Long-term debt, excluding current portion	32,671	7,575	201	337	177
Equity	104,516	92,560	17,201	14,447	12,495

(1) General and administrative expenses include officers' salaries of \$670,000, \$3,342,000, \$3,372,000, \$2,976,000 and \$3,443,000 for the years ended December 31, 1998, 1997, 1996, 1995 and 1994, respectively. Prior to November 1997, these amounts were primarily composed of salaries and bonuses paid to the founders and were based in part on federal income tax regulations regarding distributions of closely held corporations and S corporations. Effective with the Offering, these federal income tax regulations no longer applied to the Company. Compensation of the founders since October 1, 1997 has been based on the founders' employment agreements.

(2) A provision for income taxes was recorded by the Company from inception through February 1, 1995. No provision for income taxes has been recorded from February 1, 1995 through completion of the Formation Transactions as the operating companies included in the historical financial statements, prior to the Offering, were S corporations or partnerships and accordingly were not subject to income taxes during the period.

(3) Pro forma income taxes have been calculated based on the assumption that the S corporations and partnerships were subject to income taxes. Pro forma income tax expense has been calculated using statutory federal and state tax rates, estimated at 39.5%.

(4) The Company expects to complete a refinancing of its \$47,700,000 mortgage loan due October 1999 with long term fixed rate mortgage loans during the second quarter of 1999.

OVERVIEW

The following discussion and analysis addresses the Company's results of operations on a historical consolidated basis for the years ended December 31, 1998, 1997 and 1996. The following should be read in conjunction with the Company's historical consolidated financial statements and the selected financial data contained elsewhere in this report.

On September 15, 1997, the Company increased its authorized common shares from 40,000,000 to 65,000,000 shares and authorized 15,000,000 shares of preferred stock. On November 5, 1997, the Company issued 18,037,347 additional shares of common stock (including 1,350,000 shares issued upon exercise of an option granted underwriters to purchase additional common shares in conjunction with the Offering) bringing its total issued and outstanding shares of common stock to 19,717,347 shares. Of the 18,037,347 shares issued, 7,687,347 shares were issued to Messrs. Beck, Stroud and Cohen in the Formation Transactions described herein and 10,350,000 shares were registered with the Securities and Exchange Commission for trading in public markets.

On November 5, 1997, the Company also entered into Formation Transactions (herein so called) with Messrs. Beck and Stroud whereby they contributed all of their owned capital stock of Capital Senior Living, Inc., Capital Senior Management 1, Inc., Capital Senior Management 2, Inc., Capital Senior Development, Inc., and with Mr. Cohen, of Quality Home Care, Inc. (the "Contributed Entities") to the Company in exchange for the issuance of 7,687,347 shares of common stock of the Company and the issuance of separate notes in the aggregate amount of \$18,076,380 to Messrs. Beck, Stroud and Cohen, which were subsequently repaid by the Company from the net proceeds received from the sale of the Company's common stock in the Offering.

As part of the Formation Transactions, the Company simultaneously purchased substantially all of the operating assets of Capital Senior Living Communities, L.P. ("CSLC") [including CSLC's investment in HealthCare Properties, L.P. ("HCP") and NHP Retirement Housing Partners I Limited Partnership ("NHP") and excluding CSLC's cash, U.S. Treasury securities purchased under the Lehman Brothers Holdings, Inc. loan agreement ("LBHI Loan") and working capital items] for an aggregate purchase price of approximately \$76.6 million, comprised of the assumption by the Company of CSLC's outstanding LBHI Loan of approximately \$70.8 million and payment of cash of approximately \$5.8 million to CSLC. On November 7, 1997, the Company repaid the LBHI Loan from the proceeds received from the Offering.

In October 1997, the combined Companies declared and paid dividends of \$457,647 to Messrs. Beck, Stroud and Cohen in preparation for the Formation Transactions that transformed the combined companies from closely held corporations and S corporations to non-closely held C corporations for federal income tax purposes.

Due to all of the entities involved in the Formation Transactions being under the common control of Messrs. Beck and Stroud, the Company's consolidated financial statements reflect the assets and liabilities at their historical values and the accompanying consolidated statements of income, equity, and cash flows reflect the combined results for the periods indicated through the date of the Offering even though they have historically operated as separate entities. The Formation Transactions have been accounted for at historical cost in a manner similar to a pooling of interests to the extent of the percentage ownership by Messrs. Beck and Stroud of the Company. Acquired assets and liabilities of CSLC have been recorded at fair value to the extent of minority interest. CSLC's assets include investments in HCP and NHP.

On September 30, 1998, the Company entered into a mortgage loan agreement with Lehman Brothers Holdings, Inc. ("Lehman Loan"), under which the Company borrowed \$47,700,000. The purpose of the Lehman Loan was to provide financing for the acquisition of four NHP senior living communities, as well as for the Tesson Heights Enterprises ("Tesson") senior living community, all of which have been pledged as collateral. Interest costs are based on 30-day LIBOR and were approximately 6.95% at December 31, 1998. The loan agreement matures October 1, 1999, and the Company expects to complete a refinancing of this mortgage loan with long term fixed rate mortgage loans during the second quarter of 1999.

On September 30, 1998, the Company acquired four senior living communities from NHP for cash consideration of \$40,650,000. The funds for the transaction were provided from working capital of the Company and from the proceeds of the Lehman Loan.

The senior living communities acquired by the Company from NHP are The Atrium of Carmichael in Carmichael, California; Crosswoods Oaks in Citrus Heights, California; The Heatherwood in Southfield, Michigan; and The Veranda Club in Boca Raton, Florida. The Company had operated these communities under a long-term management contract since 1992. The purchase price for the properties was determined by independent appraisal. Personnel working at the property sites and certain home office personnel who performed services for NHP have been employees of the Company. NHP (prior to the acquisitions) reimbursed the Company for the salaries, related benefits, and overhead reimbursements of such personnel. Capital Realty Group Brokerage, Inc., a company wholly owned by Messrs. Beck and Stroud, received a brokerage fee of \$1,219,500 related to this transaction, which was paid by NHP.

The acquisitions were accounted for as a purchase business combination and the Company's operations have included the operations of NHP since September 30, 1998.

On October 28, 1998, the Company acquired two senior living communities from Gramercy Hill Enterprises, a Texas limited partnership ("Gramercy"), and Tesson, for aggregate consideration of approximately \$34,000,000. The funds for the Tesson transaction were provided from working capital of the Company and from \$15,400,000 of proceeds from the Lehman Loan. The funds for the Gramercy transaction were provided from working capital of the Company, the assumption of the \$6,334,660 Washington Mortgage Financial Group, Ltd. ("WMFG") promissory note (assigned to Fannie Mae) and from the proceeds of the \$1,980,000 WMF Washington Mortgage Corp. ("WMFC") loan described below.

On October 28, 1998, the Company entered into a \$6,334,660 Assumption and Release Agreement with Fannie Mae and a \$1,980,000 multifamily note in favor of WMFC. The purpose of the loans was to provide financing for the Gramercy acquisition. The senior living community acquired from Gramercy has been pledged as collateral under these loans. Interest costs are 7.69% and 7.08%, respectively. The Assumption and Release Agreement and WMFC note mature in January 2008 and January 2010, respectively.

The senior living communities acquired by the Company from Gramercy and Tesson are Gramercy Hill in Lincoln, Nebraska and Tesson Heights, in St. Louis, Missouri. The acquisitions were accounted for as purchase business combinations, and the Company's operations have included the operations of Tesson Heights and Gramercy Hill since October 28, 1998.

From 1990 through December 31, 1998, the Company acquired interests in 19 communities and entered into an operating lease with respect to one community, which was terminated effective January 31, 1998. Since 1996, the Company expanded its senior living management services by entering into the management service contracts on 15 communities for four independent third-party owners and commenced providing development and construction management services for new residence properties in addition to adding a home care service agency.

The Company generates revenue from a variety of sources. For the year ended December 31, 1998, the Company's revenue was derived as follows: 58.0% from the operation of 11 owned communities that were operated by the Company; 10.0% from lease rentals from triple net leases of three skilled nursing facilities and four physical rehabilitation centers; 8.9% from management fees arising from management services provided for four affiliate owned senior living communities from January 1, 1998 through September 30, 1998 and one affiliate owned senior living community from January 1, 1998 through December 31, 1998 and 15 third-party owned senior living communities; and 20.4% from development fees earned for managing the development and construction of new senior living communities for third parties.

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

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

The Company's triple net leases extend through the year 2000 for three of its owned communities and through the year 2001 for four of its owned communities. The payments under these leases are fixed and are not subject to change based upon the operating performance of these communities. Following termination of the lease agreements, the Company may either convert and operate the communities as assisted living and Alzheimer's care facilities, sell the facilities or evaluate other alternatives.

The Company's current management contracts expire on various dates between December 1999 and September 2009 and provide for management fees based generally upon rates that vary by contract from 4% of net revenues to 7% of net revenues. In addition, certain of the contracts provide for supplemental incentive fees that vary by contract based upon the financial performance of the managed community. The Company's development fees are generally based upon a percentage of construction cost and are earned over the period commencing with the initial development activities and ending with the opening of the community. As of December 31, 1998, development fees have been earned for services performed for 39 communities under development or expansions for third parties.

During 1998, 1997, 1996 and 1995, the Company made various purchases of limited partnership interests in HCP. HCP owns and operates a skilled nursing facility and owns and leases to third-party operators (under triple net leases) three skilled nursing facilities and four physical rehabilitation centers. During 1998, 1997, 1996 and 1995, the Company paid approximately \$101,000, \$5,605,000, \$3,201,000 and \$309,000, respectively, for partnership interests in HCP. The Company changed its method of accounting for its investment in HCP from the cost method in 1995 to the equity method in 1996. As a result of additional purchases, the Company's ownership interest in HCP exceeded 50% on June 26, 1997. Accordingly, this partial acquisition has been accounted for by the purchase method of accounting, and the assets, liabilities, minority interest, and the results of operations of HCP have been consolidated in the Company's financial statements since January 1, 1997.

The Company acquired, on November 1, 1997, the Pension Notes of NHP ("NHP Notes") owned by CSLC in the Formation Transactions for \$18,664,128. The NHP Notes bear simple interest at 13% per annum and mature on December 31, 2001. Interest is currently paid quarterly at a rate of 7%, with the remaining 6% interest deferred. Beginning November 1, 1997 through September 30, 1998, the Company has been recording interest income at 10.5% of the purchase price paid, which was determined based on the discounted amount of principal and interest payments to be made following the maturity date (December 31, 2001) of the NHP Notes (using a six-month lag between maturity and full repayment), due to uncertainties regarding the ultimate realization of the accrued interest. On September 30, 1998, the Company purchased four properties from NHP. NHP is in turn redeeming \$7,500,000 of the Company's investment in the NHP Notes and is distributing approximately \$5,300,000 of deferred interest not previously paid on such notes. From October 1, 1998 through December 31, 1998, the Company reevaluated its investment in the NHP Notes, and is recording additional income, after giving consideration to current payment of interest, partial redemption of the NHP Notes with accrued interest and the estimated residual value in NHP. Also, during 1998 and 1996, the Company paid \$344 and \$1,364 for 4% and 3%, respectively, ownership of limited partnership interests in NHP. The Company accounts for its investment in NHP on the cost method with respect to the NHP limited partnership interests and as held-to-maturity securities and reported at amortized cost with respect to the NHP Notes.

The Company will continue to develop and acquire senior living communities. The development of senior living communities typically involves a substantial commitment of capital over a 12- to 14-month construction period during which time no revenues are generated, followed by a 12-month lease-up period. The Company anticipates that newly opened or expanded communities will operate at a loss during a substantial portion of the lease-up period. The Company's growth strategy may also include the acquisition of senior living communities, home care agencies, and other properties or businesses that are complementary to the Company's operations and growth strategy.

RESULTS OF OPERATIONS

The following tables set forth, for the periods indicated, selected historical consolidated statements of income data in thousands of dollars and expressed as a percentage of total revenues.

	Year Ended December 31,					
	1998		1997		1996	
	\$	%	\$	%	\$	%
Revenues:						
Resident and healthcare revenue	\$24,791	58.0%	\$21,207	69.1%	\$13,692	68.8%
Rental and lease income	4,281	10.0	4,276	13.9	1,101	5.5
Unaffiliated management services revenue	2,465	5.8	1,920	6.2	801	4.0
Affiliated management services revenue	1,327	3.1	1,378	4.5	2,708	13.6
Unaffiliated development fees	1,234	2.9	804	2.6	673	3.4
Affiliated development fees	7,473	17.5	173	0.6	—	0.0
Other	1,197	2.7	952	3.1	924	4.7
Total revenues	42,768	100.0	30,710	100.0	19,899	100.0
Expenses:						
Operating expenses	17,067	39.9	16,701	54.4	10,656	53.6
General and administrative expenses	6,594	15.4	7,085	23.1	5,635	28.3
Depreciation and amortization	2,734	6.4	2,118	6.9	1,481	7.4
Total expenses	26,395	61.7	25,904	84.4	17,772	89.3
Income from operations	16,373	38.3	4,806	15.6	2,127	10.7
Other income (expense):						
Interest income	4,939	11.5	3,186	10.4	432	2.2
Interest expense	(1,922)	(4.5)	(2,022)	(6.5)	(221)	(1.1)
Gain on sale of properties	422	1.0	—	—	438	2.2
Equity in earnings on investments	—	—	—	—	459	2.3
Other	—	—	440	1.4	42	0.2
Income before income taxes and minority interest in consolidated partnerships						
	19,812	46.3	6,410	20.9	3,277	16.5
Provision for income taxes	(7,476)	(17.5)	(793)	(2.6)	—	—
Income before minority interest in consolidated partnerships						
	12,336	28.8	5,617	18.3	3,277	16.5
Minority interest in consolidated partnerships	(379)	(0.8)	(1,936)	(6.3)	(1,224)	(6.2)
Net income	\$11,957	28.0%	\$ 3,681	12.0%	\$ 2,053	10.3%

YEAR ENDED DECEMBER 31, 1998 COMPARED TO THE YEAR ENDED DECEMBER 31, 1997

Revenues:

Total revenues were \$42,768,000 in 1998 compared to \$30,710,000 in 1997, representing an increase of \$12,058,000, or 39.3%. Resident and health care revenue increased \$3,584,000, of which \$4,015,000 is a result of purchasing the four NHP properties, Gramercy Hill and Tesson Heights, along with a decrease of \$237,000 relating to the HCP properties. Unaffiliated management services revenue increased \$545,000 due to a significant improvement in the performance at the property level resulting in incentive payments and one additional third-party management contract added in the first quarter of 1998. Unaffiliated development fees increased \$430,000, of which \$894,000 is a result of two additional third-party development contracts and the continuation of four projects that earned fees for seven months in 1998 as compared to two months for 1997 and a decrease of \$464,000 resulting from one development project completed on December 31, 1997 and three development projects terminated by a third party. Affiliated development fees increased \$7,300,000, resulting from fees earned on 29 projects in 1998 compared to one in 1997.

Expenses:

Total expenses were \$26,395,000 in 1998 compared to \$25,904,000 in 1997, representing an increase of \$491,000, or 1.9%. Operating expenses increased \$366,000 due to an increase of \$1,954,000 as a result of acquiring six properties in the fourth quarter of 1998, along with a decrease of \$1,361,000 related to the termination of Maryland Gardens lease and offset by an overall decrease in operating expenses. General and administrative expenses decreased \$491,000 due to a decrease in officers' salaries of \$2,670,000 offset by a \$325,000 increase due to the acquisition of six properties in the fourth quarter of 1998, a \$185,000 increase in development expenses due to the increase in development projects, a \$200,000 increase in professional fees that relate to legal fees, a \$100,000 increase in license and fee expense, a \$320,000 increase in HCP general and administrative expenses, along with an overall increase in general and administrative expenses. Depreciation and amortization increased \$616,000 due to an increase of \$424,000 as a result of the acquisition of the six properties in the fourth quarter of 1998, an \$80,000 increase for the expansion of Cottonwood and an increase of \$37,000 in the amortization of goodwill for twelve months in 1998 as opposed to two months in 1997.

Other income and expenses:

Interest and other income increased \$1,835,000, primarily as a result of a \$1,365,000 increase in income associated with investment of cash reserves, a \$1,600,000 increase in NHP Notes interest due to a partial redemption of the notes and payment of accrued interest, a \$308,000 increase in interest earned from the Triad, Triad II and Triad IV (as hereinafter defined) unsecured credit facilities, which is offset by a \$1,400,000 decrease in interest due to the divestment of an investment from June 1997 through October 1997 by CSLC. Interest expense decreased \$100,000 due to a decrease of \$1,267,000 of interest related to the Lehman debt incurred in the Formation Transactions and a decrease of \$44,000 in HCP interest expense due to refinancing. These decreases are offset by an increase of \$1,201,000 in interest expense due to the acquisition of the six properties. A gain of \$422,000 was recorded on the sale of two properties in the fourth quarter of 1998. In connection with the sale of its investment in HCP to the Company immediately following completion of the offering, CSLC incurred short swing profits, as defined by the Securities and Exchange Commission, and was, accordingly, required to remit such profits to HCP, which recorded the remittance of \$440,000 as other income in 1997.

Minority interest:

Minority interest in limited partnerships decreased \$1,557,000, primarily due to the CSLC minority interest being included in 1997 through October and not included in 1998.

Provision for income taxes:

Provision for income taxes was approximately \$7,476,000 in 1998 compared to \$793,000 in 1997. As a result of the Formation Transactions, the Company and its consolidated subsidiaries were converted from S corporations that are taxed at the shareholder level to C corporations that are subject to corporate income taxes. Accordingly, a provision for federal and state taxes was provided on the earnings for 12 months in 1998 compared to two months in 1997.

Net Income:

As a result of the foregoing factors, net income increased \$8,276,000 to \$11,957,000 for 1998 from \$3,681,000 for 1997.

YEAR ENDED DECEMBER 31, 1997 COMPARED TO THE YEAR ENDED DECEMBER 31, 1996

Revenues:

Total revenues were \$30,710,000 in 1997 compared to \$19,899,000 in 1996, representing an increase of \$10,811,000, or 54.3%. The inclusion of HCP revenues in 1997 from January 1, 1997 contributed \$8,978,000 of the increase, as HCP was not consolidated in 1996. Resident and healthcare revenue increased \$7,515,000, of which \$4,702,000 is a result of the HCP consolidation,

\$1,157,000 was improvement in CSLC's revenues due to realization of additional reimbursements previously limited under the Medicare program for 1994 and 1992 combined with improved CSLC rental rates and occupancies and \$1,543,000 related to the Maryland Gardens facility leased on June 1, 1997. Rental and lease income increased \$3,175,000, of which \$4,276,000 was due to the HCP consolidation, offset by \$1,101,000 due to the sale of CSLC's multi-family properties on November 1, 1996. Unaffiliated management services revenue increased \$1,119,000 due to 15 third-party management contracts added in the third and fourth quarter of 1996 and one additional third-party management contract added in the second quarter of 1997. Affiliated management services revenue decreased by \$1,330,000, of which \$1,177,000 was due to the HCP consolidation. Development fees increased \$304,000 and was due to new development contract management revenue for managing the development and construction of new third-party owned senior living communities.

Expenses:

Total expenses were \$25,904,000 in 1997 compared to \$17,772,000 in 1996, representing an increase of \$8,132,000, or 45.8%. The inclusion of HCP expenses from January 1, 1997 contributed \$6,538,000 of the increase. Operating expenses increased \$6,045,000, of which \$4,251,000 was a result of the HCP consolidation and \$1,561,000 due to Maryland Gardens operating expenses. General and administrative expenses increased \$1,450,000, which was due to the HCP consolidation of \$1,078,000 offset by an overall decrease in general and administrative expenses. Depreciation and amortization increased \$637,000, of which \$1,209,000 was related to the HCP consolidation, offset by a \$572,000 decrease in CSLC's depreciation which was primarily due to the sale of CSLC's multi-family rental properties in November 1996.

Other income and expenses:

Interest income increased \$2,754,000, primarily as a result of CSLC's increase in interest income of \$1,116,754 associated with its investment in U.S. Treasury Bills, \$1,230,000 as a result of the Company's increase in interest income associated with its increased investment in NHP Notes combined with the commencement of accruing a portion of the deferred income on these notes beginning in April 1997, as a result of NHP's improved financial position and performance and increased valuation of the underlying properties, \$288,361 associated with income from temporary investment of net proceeds from the Offering for November and December 1997, and the consolidation of HCP of \$359,000. Interest expense increased \$1,801,000 as a result of higher debt balances including the LBHI Loan borrowings on July 1, 1997 and \$679,000 as a result of the HCP consolidation. Income from equity in earnings on investments decreased \$459,000 as a result of the HCP consolidation on January 1, 1997. In connection with the sale of its investment in HCP to the Company immediately following completion of the Offering, CSLC incurred short swing profits, as defined by the Securities and Exchange Commission, and was, accordingly, required to remit such profits to HCP which recorded the remittance as other income. A gain of \$438,000 was recorded on November 1, 1996, as a result of the sale of multi-family properties with no corresponding gain being realized in 1997.

Minority interest:

Minority interest in limited partnerships increased \$712,000 primarily as a result of the HCP consolidation.

Provision for income taxes:

Provision for income taxes was approximately \$793,000 in 1997 compared to no provision in 1996. As a result of the Formation Transactions, the Company and its consolidated subsidiaries were converted from S corporations that are taxed at the shareholder level to C corporations that are subject to corporate income taxes. Accordingly, a provision for federal and state income taxes is provided on earnings after the Formation Transactions.

Net income:

As a result of the foregoing factors, net income increased \$1,628,000 to \$3,681,000 for 1997 from \$2,053,000 for 1996.

QUARTERLY RESULTS

The following table presents certain quarterly financial information for the four quarters ended December 31, 1998 and 1997. This information has been prepared on the same basis as the audited Consolidated Financial Statements of the Company appearing elsewhere in this report and include, in the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary to present fairly the quarterly results when read in conjunction with the audited Consolidated Financial Statements of the Company and the related notes thereto.

	1998 Calendar Quarters			
	First	Second	Third	Fourth
	(in thousands, except per share amounts)			
Total revenues	\$ 8,354	\$ 9,234	\$ 10,556	\$ 14,624
Income from operations	2,330	3,397	4,906	5,740
Net income	1,926	2,511	3,506	4,014
Net income per share	\$ 0.10	\$ 0.13	\$ 0.18	\$ 0.20
Weighted average shares outstanding	19,717	19,717	19,717	19,717

	1997 Calendar Quarters			
	First	Second	Third	Fourth
	(in thousands, except per share amounts)			
Total revenues	\$ 7,091	\$ 7,977	\$ 7,652	\$ 7,990
Income from operations	1,124	980	959	1,743
Net income	583	630	797	1,671
Net income per share	\$ 0.06	\$ 0.07	\$ 0.09	\$ 0.10
Weighted average shares outstanding	9,367	9,367	9,367	16,440

LIQUIDITY AND CAPITAL RESOURCES

As described in the notes to the accompanying Consolidated Financial Statements, the Company repaid all of its notes payable to affiliates and the mortgage loan payable to Lehman Brothers Holdings, Inc. with proceeds from the Offering in November 1997, leaving only the mortgage property loans of HCP outstanding thereafter. The Company also secured a three-year revolving line of credit of \$20 million which may be used for acquisition of additional interests in HCP and NHP, expansion of owned communities, acquisition of additional properties and general working capital purposes.

In addition to approximately \$36 million of cash balances on hand as of December 31, 1998, the Company's principal sources of liquidity are expected to be cash flows from operations and amounts available for borrowing under its \$20 million revolving line of credit. Subsequent to December 31, 1998, the Company received a commitment to increase its line of credit to \$34 million. There can be no assurance, however, that the Company will continue to generate cash flows at or above current levels or that the Company will be able to meet its anticipated need for working capital.

The Company derives the benefits and bears the risks attendant to the communities it owns. The cash flows and profitability of owned communities depends on the operating results of such communities and are subject to certain risks of ownership, including the need for capital expenditures, financing and other risks such as those relating to environmental matters.

The cash flows and profitability of the Company's owned communities that are leased to third parties depend on the ability of the lessee to make timely lease payments. At December 31, 1998, HCP was operating one of its properties and had leased seven of its owned properties under triple net leases to third parties until year 2000 or 2001. Four of these properties are leased until year 2001 to HealthSouth Rehabilitation Corp. ("HealthSouth"), which provides acute spinal injury intermediate care at these properties. HealthSouth closed one of these facilities in 1994 and closed another facility in February of 1997 due to low occupancy. HealthSouth has continued to make lease payments on a timely basis for all four properties. Should the operators of the leased properties default on payment of their lease obligations prior to termination of the lease agreements, six of the seven lease contracts contain a continuing guarantee of payment and performance by the parent company of the operators, which the Company intends to pursue in the event of default. Following termination of these leases, the Company will either convert and operate the facilities as assisted living and Alzheimer's care facilities, sell the facilities or evaluate other alternatives. HCP's facility lessees are all current in their lease obligations to HCP. The lessee for one property continues to fund a deficit between the required lease payment and operators' cash flow.

The cash flows and profitability of the Company's third-party management fees are dependent upon the revenues and profitability of the communities managed. While the management contracts are generally terminable only for cause, in certain cases the contracts can be terminated upon the sale of a community, subject to the Company's rights to offer to purchase such community.

The Company plans to continue to develop and acquire senior living communities. The development of senior living communities typically involves a substantial commitment of capital over a 12-month construction period during which time no revenues are generated, followed by a 12- to 14-month lease-up period.

Effective April 1, 1998, Tri Point Communities, L.P. ("Tri Point"), a limited partnership owned by the Company's founders (Messrs. Beck and Stroud) and their affiliates, was reorganized and the interests of Messrs. Beck and Stroud were sold at their cost to Triad Senior Living, Inc. and its affiliates, which are unrelated third parties. Tri Point was renamed Triad Senior Living I, L.P. ("Triad I"). The new general partner of Triad I, owning 1%, is Triad Senior Living, Inc. The limited partners are Blake N. Fail (principal owner of Triad Senior Living, Inc.), owning 80%, and the Company, owning 19%. The development agreements between Triad I and the Company provide for a development fee of 4% to the Company, as well as reimbursement of expenses and overhead not to exceed 4%. Triad I has also entered into management agreements with the Company providing for management fees in an amount equal to the greater of 5% of gross revenues or \$5,000 per month per community, plus overhead reimbursement not to exceed 1% of gross revenues. The Company has an option to purchase the partnership interests of Triad Senior Living, Inc. and Blake N. Fail for an amount equal to the amount such party paid for its interest, plus noncompounded interest of 12% per annum. The management agreements also provide the Company with an option to purchase the communities developed by Triad I upon their completion for an amount equal to the fair market value (based on a third-party appraisal but not less than hard and soft costs and lease-up costs). The Company has made no determination as to whether it will exercise its purchase options. The Company will evaluate the possible exercise of each purchase option based upon the business and financial factors that may exist at the time those options may be exercised.

Triad I has entered into construction loan facilities aggregating approximately \$50,000,000 to fund its development activities and a take-out facility aggregating approximately \$50,000,000.

During 1998, the Company agreed to loan Triad I up to \$10,000,000. The principal is due March 12, 2003. The first draw under this loan facility was made on March 12, 1998. Interest is due quarterly at 8% per annum. This loan may be prepaid without penalty. At December 31, 1998, approximately \$9,636,000 has been advanced to Triad I under this loan facility.

Effective September 24, 1998, the Company and Triad Senior Living II, L.P. ("Triad II"), a limited partnership, entered into a Development and Turnkey Services Agreement in connection with the development and management of the Company's planned new Waterford communities where Triad II would own and finance the construction of the new communities. Triad II was organized on September 23, 1998. The general partner of Triad II, owning 1%, is Triad Partners II, Inc. The limited partners are Triad Partners II, Inc., owning 80%, and the Company, owning 19%.

The Company has an option to purchase the partnership interests of Triad Partners II, Inc. in Triad II for an amount equal to the amount such party paid for its interests, plus noncompounded interest of 12% per annum. The management agreements with Triad II also provide the Company with an option to purchase the communities developed by Triad II upon their completion for an amount equal to the fair market value (based on a third-party appraisal but not less than hard and soft costs and lease-up costs). The Company has made no determination as to whether it will exercise its purchase options. The Company will evaluate the possible exercise of each purchase based upon the business and financial factors which may exist at the time those options may be exercised.

Triad II has entered into construction and mini-perm loan facilities aggregating approximately \$26,000,000 to fund its development activities.

During the third quarter, the Company agreed to loan Triad II up to \$7,000,000. On January 15, 1999, the loan amount was amended to up to \$10,000,000. The principal is due September 25, 2003. The first draw under this loan facility was made on September 25, 1998. Interest is due quarterly at 10.5% per annum. This loan may be prepaid without penalty. At December 31, 1998, approximately \$932,000 has been advanced to Triad II under this loan facility.

On September 30, 1998, the Company acquired four senior living communities from NHP for \$40,683,281 by entering into the \$32,300,000 Lehman Loan, a cash payment of \$8,246,007 and assumption of net assets and liabilities of \$137,274. The Company has mortgaged the four senior living communities as collateral. The acquisition was accounted for as a purchase.

On October 28, 1998, the Company acquired a senior living community from Tesson for \$23,051,786. The Company borrowed \$15,400,000 pursuant to the existing mortgage loan agreement with Lehman and mortgaged the senior living community as collateral. The Company also acquired a senior living community from Gramercy for \$11,036,655. The Company assumed a \$6,334,660 note from Fannie Mae, and borrowed an additional \$1,980,000 from WMFC on a second lien basis and mortgaged

the senior living community as collateral for both loans. The Company paid the remaining purchase prices with a cash payment of \$7,376,632 and \$2,425,798, respectively, and assumption of liabilities of \$275,154 and \$296,197, respectively.

Effective November 10, 1998, the Company and Triad Senior Living III, L.P. ("Triad III"), a limited partnership, entered into a Development and Turnkey Services Agreement in connection with the development and management of the Company's planned new Waterford communities where Triad III would own and finance the construction of the new communities. Triad III was organized on November 10, 1998. The general partner of Triad III, owning 1%, is Triad Partners III, Inc. The limited partners are Triad Partners III, Inc., owning 80%, and the Company, owning 19%.

The Company has an option to purchase the partnership interests of Triad Partners III, Inc. in Triad III for an amount equal to the amount such party paid for its interests, plus noncompounded interest of 12% per annum. The management agreements with Triad III also provide the Company with an option to purchase the communities developed by Triad III upon their completion for an amount equal to the fair market value (based on a third-party appraisal but not less than hard and soft costs and lease-up costs). The Company has made no determination as to whether it will exercise its purchase options. The Company will evaluate the possible exercise of each purchase based upon the business and financial factors which may exist at the time those options may be exercised.

Triad III has entered into construction and mini-perm loan facilities aggregating approximately \$51,000,000 to fund its development activities.

During the fourth quarter, the Company agreed to loan Triad III up to \$10,000,000. The principal is due February 8, 2004. Interest is due quarterly at 10.5% per annum. This loan may be prepaid without penalty. At December 31, 1998, no monies have been advanced to Triad III under this loan facility.

Effective December 30, 1998, the Company and Triad Senior Living IV, L.P. ("Triad IV"), a limited partnership, entered into a Development and Turnkey Services Agreement in connection with the development and management of the Company's planned new Waterford communities where Triad IV would own and finance the construction of the new communities. Triad IV was organized on December 22, 1998. The general partner of Triad IV, owning 1%, is Triad Partners IV, Inc. The limited partners are Triad Partners IV, Inc., owning 80%, and the Company, owning 19%.

The Company has an option to purchase the partnership interests of Triad Partners IV, Inc. in Triad IV for an amount equal to the amount such party paid for its interests, plus noncompounded interest of 12% per annum. The management agreements with Triad IV also provide the Company with an option to purchase the communities developed by Triad IV upon their completion for an amount equal to the fair market value (based on a third-party appraisal but not less than hard and soft costs and lease-up costs). The Company has made no determination as to whether it will exercise its purchase options. The Company will evaluate the possible exercise of each purchase based upon the business and financial factors which may exist at the time those options may be exercised.

Triad IV is negotiating commitments for loan facilities aggregating up to \$50,000,000 to fund its development activities.

During the fourth quarter, the Company agreed to loan Triad IV up to \$10,000,000. The principal is due December 30, 2003. The first draw under this loan facility was made on December 30, 1998. Interest is due quarterly at 10.5% per annum. This loan may be prepaid without penalty. At December 31, 1998, approximately \$1,160,000 has been advanced to Triad IV under this loan facility.

Net cash provided by operating activities, of \$6,689,000 for the year ended December 31, 1998, decreased \$2,994,000, or 31%, over that of the comparable year ended December 31, 1997, which was composed of increased cash flow created by improved earnings of \$7,215,000 (after noncash adjustments) combined with \$10,209,000 of cash derived from working capital.

Net cash used in investing activities of \$25,094,000 for the year ended December 31, 1998 decreased \$56,408,000 over that of the comparable year ended December 31, 1997. This decrease was composed of increased capital expenditures of \$3,586,000 primarily related to the Cottonwood expansion, the lack of comparable proceeds from sale of properties in 1997 compared to 1998's proceeds of \$676,000, a decrease in investments in 1998 in limited partnerships (CSLC, HCP and NHP Notes) of \$13,915,000, the \$64,203,000 investment by the Company in restricted cash securities from the proceeds obtained from the LBHI Loan and the difference in 1997 for cash paid for the September 1998 purchase of assets acquired from NHP, and the October 1998 purchase of assets acquired from Tesson and Gramercy, offset by the November 1997 purchase of assets from CSLC and offset by HCP's beginning cash balance of \$8,995,000 as a result of the consolidation of HCP at January 1, 1997 in the amount of \$9,805,000.

Net cash provided by financing activities, of \$6,106,000 for the year ended December 31, 1998, decreased \$103,019,000 over that of the comparable year ended December 31, 1997. This decrease was due to \$110,331,000 of net proceeds received by the Company in November 1997 from the Offering.

YEAR 2000 ISSUE

The Year 2000 Issue is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's computer programs or hardware that have date-sensitive software or embedded chips may recognize the year 2000 as a date other than the year 2000. This could result in a system failure or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities.

Based on ongoing assessments, the Company has developed a program to modify or replace significant portions of its software and certain hardware, which are generally PC-based systems, so that those systems will properly recognize and utilize dates beyond December 31, 1999. The Company has substantially completed software reprogramming and software and hardware replacement as of December 31, 1998, with 100% completion targeted for September 30, 1999. The Company presently believes that these modifications and replacements of existing software and certain hardware will mitigate the Year 2000 Issue. However, if such modifications and replacements are not completed timely, the Year 2000 Issue could have a material impact on the operations of the Company. The costs of Year 2000 remediation are not expected to be material based on the Company's operations.

The Company has assessed its exposure to operating equipment, and such exposure is not significant due to the nature of the Company's business.

The Company is not aware of any external agent with a Year 2000 Issue that would materially impact the Company's results of operations, liquidity, or capital resources. However, the Company has no means of determining whether or ensuring that external agents will be Year 2000-ready. The inability of external agents to complete their Year 2000 resolution process in a timely fashion could materially impact the Company.

Management of the Company believes it has an effective program in place to resolve the Year 2000 Issue in a timely manner. As noted above, the Company has completed most but not all necessary phases of its Year 2000 program. In the event that the Company does not complete the current program or any additional phases, the Company could incur disruptions to its operations. In addition, disruptions in the economy generally resulting from Year 2000 Issues could also materially adversely affect the Company. The Company could be subject to litigation for computer systems failure. The amount of potential liability and lost revenue cannot be reasonably estimated at this time.

The Company currently has no contingency plans in place in the event it does not complete all phases of its Year 2000 program. The Company plans to evaluate the status of completion in mid-1999 and determine whether such a plan is necessary.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's primary market risk exposure is interest rate risk. At December 31, 1998, the Company had \$66,674,186 million of variable rate debt tied to LIBOR, consisting of one \$18,974,186 revolving credit facility that matures on December 10, 2000 (the "Bank One Facility") and one \$47,700,000 credit facility that matures on October 1, 1999 (the "Lehman Facility"). The Company expects to complete a refinancing of the Lehman Facility with long term fixed rate mortgage loans during the second quarter of 1999. Interest on the Bank One Facility is based on LIBOR plus 1.7%. Interest on the Lehman Facility is based on LIBOR plus 1.875%. At December 31, 1998, the LIBOR rate was 5.08%. An increase in interest rates will increase the amount of interest expense incurred by the Company. Other notes payable of \$14,415,847 consists of fixed rate mortgage loans. Notes receivable of \$11,728,162 are also fixed rate financial instruments.

The Company is also exposed to market risks from fluctuations in interest rates and the effects of those fluctuations on the market values of its cash equivalent short-term investments. The cash equivalent short-term investments consist primarily of overnight investments that are not significantly exposed to interest rate risk, except to the extent that changes in interest rates will ultimately affect the amount of interest income earned on these investments.

IMPACT OF INFLATION

To date, inflation has not had a significant impact on the Company. Inflation could, however, affect the Company's future revenues and results of operations because of, among other things, the Company's dependence on senior residents, many of whom rely primarily on fixed incomes to pay for the Company's services. As a result, during inflationary periods, the Company may not be able to increase resident service fees to account fully for increased operating expenses. In structuring its fees, the Company attempts to anticipate inflation levels, but there can be no assurance that the Company will be able to anticipate fully or otherwise respond to any future inflationary pressures.

FORWARD-LOOKING STATEMENTS

Certain information contained in this report constitutes "Forward-Looking Statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which can be identified by the use of forward-looking terminology such as "may," "will," "expect," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. The Company cautions readers that forward-looking statements, including, without limitation, those relating to the Company's future business prospects, revenues, working capital, liquidity, capital needs, interest costs, and income, are subject to certain risks and uncertainties that could cause actual results to differ materially from those indicated in the forward-looking statements, due to several important factors herein identified, among others, and other risks and factors identified from time to time in the Company's reports filed with the Securities and Exchange Commission.

MARKET FOR CAPITAL SENIOR LIVING CORPORATION'S STOCK

During the period of January 1, 1998 through December 31, 1998, the high and low sales prices were 15 1/2 and 5 1/8 respectively.

At December 31, 1998, there were approximately 3,900 shareholders of record of the Company's common stock.

It is the policy of the Company's Board of Directors to retain all future earnings to finance the operation and expansion of the Company's business. Accordingly, the Company has not and does not anticipate declaring or paying cash dividends on the common stock in the foreseeable future. The payment of cash dividends in the future will be at the sole discretion of the Company's Board of Directors and will depend on, among other things, the Company's earnings, operations, capital requirements, financial condition, restrictions in then existing financing agreements, and other factors deemed relevant by the Board of Directors.

The Company's shares of common stock are listed for trading on the New York Stock Exchange ("NYSE") under the symbol "CSU".

THE SHAREHOLDERS

CAPITAL SENIOR LIVING CORPORATION

We have audited the accompanying consolidated balance sheets of Capital Senior Living Corporation as of December 31, 1998 and 1997, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the consolidated financial statements of HealthCare Properties, L.P. and subsidiaries, a 57% owned subsidiary, which statements reflect total assets of \$32,758,958 and \$32,801,853 as of December 31, 1998 and 1997, respectively, and total revenues of \$8,787,575 and \$8,977,628 for the years ended December 31, 1998 and 1997, respectively. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to data included for HealthCare Properties, L.P., is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Capital Senior Living Corporation as of December 31, 1998 and 1997, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.

Ernst + Young LLP

Dallas, Texas

February 5, 1999,

except for Notes 20 and 12, as to which the dates are
February 7, 1999 and February 12, 1999, respectively

CONSOLIDATED BALANCE SHEETS

	December 31,	
	1998	1997
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 35,827,270	\$ 48,125,225
Accounts receivable, net	2,955,507	1,966,357
Accounts receivable from affiliates	7,217,127	26,696
Interest receivable	535,857	229,749
Deferred taxes	287,040	8,280
Prepaid expenses and other	448,790	251,400
Total current assets	47,271,591	50,607,707
Property and equipment, net	118,943,953	41,120,448
Deferred taxes	10,108,715	10,090,997
Deferred interest	853,075	173,456
Notes receivable from affiliates	11,728,162	—
Investments in limited partnerships	13,337,522	13,741,940
Management contract rights, net	195,631	243,559
Goodwill, net	1,213,876	1,257,595
Deferred financing charges, net	530,531	108,435
Other assets	1,083,679	26,773
Total assets	\$ 205,266,735	\$ 117,370,910
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 2,780,513	\$ 2,566,392
Accrued expenses	2,231,895	1,259,410
Current portion of notes payable	48,419,050	932,664
Customer deposits	851,375	277,413
Federal and state income taxes payable	1,668,602	831,682
Due to affiliates	—	50,064
Total current liabilities	55,951,435	5,917,625
Deferred income from affiliates	792,240	—
Deferred income	115,062	231,256
Notes payable, net of current portion	13,696,797	5,744,767
Line of credit	18,974,186	1,830,130
Minority interest in consolidated partnerships	11,220,836	11,087,512
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$.01 par value:		
Authorized shares – 15,000,000; no shares issued or outstanding	—	—
Common stock, \$.01 par value:		
Authorized shares – 65,000,000		
Issued and outstanding shares – 19,717,347 in 1998 and 1997	197,173	197,173
Additional paid-in capital	91,740,251	91,740,251
Retained earnings	12,578,755	622,196
Total shareholders' equity	104,516,179	92,559,620
Total liabilities and shareholders' equity	\$ 205,266,735	\$ 117,370,910

See accompanying notes.

CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	1998	1997	1996
Revenues:			
Resident and healthcare revenue	\$24,790,516	\$ 21,206,865	\$13,691,984
Rental and lease income	4,281,603	4,275,611	1,101,317
Unaffiliated management services revenue	2,464,677	1,919,618	800,961
Affiliated management services revenue	1,327,019	1,378,444	2,708,077
Unaffiliated development fees	1,234,050	803,767	673,587
Affiliated development fees	7,472,501	172,927	—
Other	1,197,260	952,650	923,700
Total revenues	42,767,626	30,709,882	19,899,626
Expenses:			
Operating expenses	17,067,451	16,701,127	10,656,431
General and administrative expenses	6,593,810	7,084,986	5,634,873
Depreciation and amortization	2,733,658	2,117,288	1,481,056
Total expenses	26,394,919	25,903,401	17,772,360
Income from operations	16,372,707	4,806,481	2,127,266
Other income (expense):			
Interest income	4,938,989	3,185,815	432,342
Interest expense	(1,921,897)	(2,022,494)	(221,521)
Gain on sale of properties	421,718	—	437,819
Equity in earnings on investments	—	—	458,992
Other	—	440,007	42,042
Income before income taxes and minority interest in consolidated partnerships	19,811,517	6,409,809	3,276,940
Provision for income taxes	(7,475,771)	(792,524)	—
Income before minority interest in consolidated partnerships	12,335,746	5,617,285	3,276,940
Minority interest in consolidated partnerships	(379,187)	(1,936,122)	(1,223,997)
Net income	\$11,956,559	\$ 3,681,163	\$ 2,052,943
Net income per share:			
Basic and diluted	\$ 0.61	\$ 0.33	
Weighted average shares outstanding	19,717,347	11,150,087	
Pro forma net income (unaudited):			
Net income		\$ 3,681,163	\$ 2,052,943
Pro forma income taxes		(964,776)	(810,912)
Pro forma net income		\$ 2,716,387	\$ 1,242,031

See accompanying notes.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Partners' Capital	Common Stock		Additional Paid-In Capital	Retained Earnings (Deficit)	Total
		Shares	Amount			
Balance at January 1, 1996	\$ 14,655,669	1,680,000	\$ 16,800	\$ (13,242)	\$ (211,849)	\$ 14,447,378
Issuance of common stock	—	—	—	16,800	—	16,800
Capital contributions	—	—	—	23,000	—	23,000
Purchase of Beneficial Unit						
Certificates of CSLC	660,403	—	—	—	—	660,403
Net income	1,941,706	—	—	—	111,237	2,052,943
Balance at December 31, 1996	17,257,778	1,680,000	16,800	26,558	(100,612)	17,200,524
Purchase of Beneficial Unit						
Certificates of CSLC	374,867	—	—	—	—	374,867
Distributions prior to Offering	—	—	—	—	(457,647)	(457,647)
Issuance of stock resulting						
from the Formation	—	7,687,347	76,873	(76,873)	—	—
Issuance of stock in Offering, net	—	10,350,000	103,500	110,227,415	—	110,330,915
Equity not retained						
in Asset Purchase	(20,133,353)	—	—	(18,436,849)	—	(38,570,202)
Net income	2,500,708	—	—	—	1,180,455	3,681,163
Balance at December 31, 1997	—	19,717,347	197,173	91,740,251	622,196	92,559,620
Net income	—	—	—	—	11,956,559	11,956,559
Balance at December 31, 1998	\$ —	19,717,347	\$197,173	\$91,740,251	\$12,578,755	\$104,516,179

See accompanying notes.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	1998	1997	1996
OPERATING ACTIVITIES			
Net income	\$ 11,956,559	\$ 3,681,163	\$ 2,052,943
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	2,639,883	1,894,665	1,397,258
Amortization	93,775	222,623	83,798
Amortization of deferred financing charges	163,708	—	—
Minority interest in consolidated partnerships	379,187	1,936,122	1,223,997
Deferred interest	(679,619)	(173,456)	—
Deferred income from affiliates	792,240	—	—
Deferred income	(116,194)	231,256	—
Deferred income taxes	(296,478)	(39,158)	—
Equity in earnings on investments	—	—	(458,992)
Gain on sale of land	(421,718)	—	(437,819)
Provision for bad debts	500,000	43,254	22,312
Changes in operating assets and liabilities, net of acquisitions:			
Cash, restricted	—	186,416	(2,588)
Accounts receivable	(1,481,883)	(1,556,965)	(219,854)
Accounts receivable from affiliates	(7,190,431)	90,955	58,811
Interest receivable	(306,108)	—	—
Prepaid expenses and other	4,110	(373,006)	23,359
Other assets	(1,059,034)	(11,454)	(14,940)
Accounts payable	361,798	2,698,550	85,328
Accrued expenses	525,944	23,529	(5,402)
Federal and state income taxes payable	836,920	831,682	—
Customer deposits	36,812	28,955	32,295
Due to affiliates	(50,064)	(31,392)	61,310
Net cash provided by operating activities	6,689,407	9,683,739	3,901,816
INVESTING ACTIVITIES			
Capital expenditures	(6,027,361)	(2,441,106)	(851,732)
Cash paid for acquisition of NHP facilities	(40,546,007)	—	—
Cash paid for acquisition of Gramercy facility	(4,405,798)	—	—
Cash paid for acquisition of Tesson facility	(22,776,633)	—	—
Proceeds from sale of land	676,036	—	2,549,352
Advances to affiliates	(11,728,162)	—	—
Cash acquired upon acquisition of HCP	—	8,995,455	—
Investment in restricted cash equivalents	—	(64,202,763)	—
Cash paid for Asset Purchase and cash not retained	—	(8,244,077)	—
Investments in limited partnerships	(1,693,934)	(15,609,034)	(3,401,207)
Net cash used in investing activities	(86,501,859)	(81,501,525)	(1,703,587)

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	1998	1997	1996
FINANCING ACTIVITIES			
Proceeds from notes payable and line of credit	67,039,026	78,663,883	—
Repayments of notes payable and line of credit	(791,214)	(77,363,736)	(145,319)
Repayments of notes payable to affiliates	—	(1,166,481)	(455,592)
Proceeds from notes payable to affiliates	—	500,000	470,000
Distributions to minority partners	—	(224,795)	—
Distributions prior to Offering	—	(457,647)	—
Issuance of common stock, net	—	110,330,915	16,800
Capital contribution	—	—	23,000
Cash received for redemption of NHP limited partnership interest	1,997,280	—	—
Repurchase of HCP limited partnership interests by HCP	(144,791)	—	—
Repurchase of Beneficial Unit Certificates of CSLC	—	(960,752)	(1,262,355)
Deferred loan charges paid	(585,804)	(196,888)	(42,953)
Net cash provided by (used in) financing activities	67,514,497	109,124,499	(1,396,419)
(Decrease) increase in cash and cash equivalents	(12,297,955)	37,306,713	801,810
Cash and cash equivalents at beginning of year	48,125,225	10,818,512	10,016,702
Cash and cash equivalents at end of year	\$ 35,827,270	\$ 48,125,225	\$10,818,512
SUPPLEMENTAL DISCLOSURES			
Cash paid during the year for:			
Interest	\$ 1,956,812	\$ 2,041,366	\$ 188,510
Income taxes	\$ 6,935,330	\$ —	\$ —

See accompanying notes.

NOTE 1. ORGANIZATION, FORMATION AND INITIAL PUBLIC OFFERING

Capital Senior Living Corporation, a Delaware corporation, was incorporated on October 25, 1996. The accompanying financial statements include the consolidated financial statements of Capital Senior Living Corporation (“Corporation”); Capital Senior Living Properties, Inc. including HealthCare Properties, L.P. (“HCP”) (as of January 1, 1997); Capital Senior Living, Inc. (“Living”); Quality Home Care, Inc. (“Quality”); Capital Senior Development, Inc. (“Development”); Capital Senior Management 1, Inc. (“Management 1”); Capital Senior Management 2, Inc. (“Management 2”); Capital Senior Living Properties 2, Inc. (“Properties 2”), which includes Capital Senior Living Properties 2-Gramercy, Inc. (“Gramercy”) and Capital Senior Living Properties 2-NHPCT, Inc. (“NHPCT”) (collectively referred to with Capital Senior Living Corporation as the “Company”). The accompanying financial statements are presented on a combined basis prior to November 5, 1997, and include Capital Senior Living Communities, L.P. (“CSLC”) through that date. CSLC included the accounts of CSLC and HCP. All material intercompany balances and transactions have been eliminated in consolidation.

The Company is a provider of senior living services. The Company owns, operates, develops and manages senior living communities throughout the United States.

The Company completed the registration of its common stock in an initial public offering (“Offering”) on November 5, 1997. Simultaneously with the closing of the Offering, Corporation acquired Living, Quality, Development, Management 1, and Management 2 (“Formation”) in exchange for 7,687,347 shares of common stock and a note payable for \$18,076,380 (“Formation Note”) to Jeffrey L. Beck and James A. Stroud or a related trust (collectively, the “Stockholders”) and Lawrence A. Cohen, all officers of the Company. Additionally, Corporation purchased substantially all of the assets, other than working capital items, of CSLC (the “Asset Purchase”) for the assumption of a \$70,833,752 note payable and a cash payment of \$5,782,927. The Stockholders owned 46% of the common stock of the Company after the Offering.

Due to all of these entities being under the common control of the Stockholders for all periods presented prior to the Offering, these consolidated financial statements reflect the assets and liabilities at their historical values and the accompanying consolidated statements of income, equity, and cash flows reflect the consolidated results for the periods indicated even though they have historically operated as separate entities prior to the Formation. The Formation was accounted for at historical cost in a manner similar to a pooling of interests to the extent of the percentage ownership by the Stockholders. The Asset Purchase was recorded at fair value to the extent of the minority interest. A step-up in basis of \$9,282,202 was recorded for property and equipment and \$2,692,669 for the investment in NHP Notes. Additionally, a deferred tax asset of \$10,060,119 and goodwill of \$1,264,881 was recorded. Assets that were not acquired from CSLC in the Asset Purchase that were combined in the financial statements until such date were charged to paid-in capital. CSLC’s assets included investments in HCP and NHP Retirement Housing Partners I, L.P. (“NHP”) which were acquired in the Asset Purchase. NHP owned a portfolio of five independent senior living communities. On September 30, 1998, the Company purchased four of the five independent senior living communities from NHP (See Note 4).

In the accompanying consolidated financial statements, HCP is consolidated as though the Company had acquired a controlling financial interest in HCP at January 1, 1997. At December 31, 1998, 1997 and 1996, the Company owned approximately 57%, 56% and 31% of HCP’s limited partner units, respectively. Preacquisition earnings for 1997 applicable to HCP are included in minority interest.

HCP is a Delaware limited partnership established for the purpose of acquiring, leasing and operating existing or newly constructed long-term healthcare properties. One property is operated by HCP and seven properties are leased to qualified operators who provide specialized healthcare services. Capital Realty Group Senior Housing, Inc. (“Housing”), an entity controlled by the Stockholders until June 10, 1998, is the general partner. On June 10, 1998, Housing’s parent corporation, Capital Realty Group Corporation, sold 100% of its stock in Housing to an unrelated third party. The Company continues to consolidate HCP at December 31, 1998, since it still maintains a controlling financial interest.

HCP and NHP are subject to the reporting obligations of the Securities and Exchange Commission.

N OTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Cash and cash equivalents:

Investments with original maturities of three months or less are considered to be cash equivalents. The Company has deposits in banks that exceed Federal Deposit Insurance Corporation insurance limits. Management believes that credit risk related to these deposits is minimal.

Long-lived assets:

Property and equipment are stated at cost and depreciated on a straight-line basis over the estimated useful lives of the assets. The estimated useful lives are 30 to 40 years for buildings, 20 years for land improvements and 5 to 10 years for furniture, equipment and automobiles.

Management contract rights are stated at cost and amortized on a straight-line basis over their respective contract lives. Accumulated amortization for management contract rights at December 31, 1998 and 1997, was \$320,532 and \$272,604, respectively. Goodwill is the excess purchase price over the fair value of the assets acquired in the Asset Purchase to the extent of the minority interest and is amortized over 30 years on a straight-line basis. Accumulated amortization for goodwill at December 31, 1998 and 1997, was \$51,005 and \$7,286, respectively.

At each balance sheet date, the Company reviews the carrying value of its management contract rights, goodwill, and property and equipment to determine if facts and circumstances suggest that they may be impaired or that the amortization or depreciation period may need to be changed. The Company considers external factors relating to each asset, including contract changes, local market developments, and other publicly available information. If these external factors indicate the intangible assets or property and equipment will not be recoverable, the carrying value of the intangible assets or property and equipment will be analyzed and adjusted accordingly. During 1996, management contract rights of \$44,755 were written off due to the termination of a certain contract that has been reflected as additional amortization expense. The Company does not believe there are any indicators that would require an adjustment to the carrying value of the management contract rights, goodwill or property and equipment or their remaining useful lives as of December 31, 1998.

Income taxes:

The Company accounts for income taxes under the liability method. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

CSLC and HCP are partnerships and, consequently, are not subject to income taxes. Taxable income or loss is directly allocated to the individual partners.

Prior to the Formation, Living, Quality, Development, Management 1 and Management 2 were S corporations and consequently, were not subject to income taxes. Thus, taxable income or loss is directly allocated to the individual stockholders. Upon Formation, these corporations converted from S corporations to C corporations. A deferred tax benefit of \$41,085 was recorded in the consolidated statements of income upon conversion.

Revenue recognition:

Resident and healthcare revenue is recognized at estimated net realizable amounts due from residents in the period to which the rental and other services are provided.

Revenues from the Medicare and Medicaid programs accounted for 16% and 22% in 1998 and 1997, respectively, and less than 10% in 1996 of the Company's net revenues. One community is a provider of services under the Indiana Medicaid program. Accordingly, the community is entitled to reimbursement under the foregoing program at established rates that are lower than private pay rates. Patient service revenue for Medicaid patients is recorded at the reimbursement rates as the rates are set prospectively by the state upon the filing of an annual cost report. Two communities are providers of services under the Medicare program and are entitled to reimbursement under the foregoing programs in amounts determined based on the filing of an annual cost report prepared in accordance with federal regulations, which reports are subject to audit and retroactive adjustments in future periods. Revenue from the Medicare program is recorded at established rates and adjusted for differences between such rates and estimated amounts reimbursable from the program. Any differences between estimated and actual reimbursements are included in operations in the year of settlement, which have not been material. Under federal regulations, Medicare reimbursements to these facilities are limited to routine cost limits determined on a geographical region. The Company has filed exception reports

to request reimbursement in excess of its routine cost limits for the years 1992 through 1997, as of December 31, 1998, and recorded revenue of approximately \$43,000 in 1998, as a result of being granted exception requests for 1997 and approximately \$346,000 in 1997, as a result of being granted exception requests for 1992 and 1994. There can be no assurance that an exception to a facility's routine cost limits will be granted. CSLC retained cost report exposure for cost years prior to the Offering.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Company believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

Management services revenue, resident and healthcare revenue and development fees are recognized when earned. Management services revenue relates to providing certain management and administrative support services under management contracts, which have terms expiring through 2002. Management services revenue is shown net of reimbursed expenses. The reimbursed expenses from affiliates were \$11,031,136, \$3,892,526 and \$6,477,199, for the years ended December 31, 1998, 1997 and 1996, respectively. Reimbursed expenses from unaffiliated parties were \$14,689,953, \$8,941,343 and \$2,600,529, for the years ended December 31, 1998, 1997 and 1996, respectively.

Credit risk:

The Company's resident receivables are generally due within 30 days and development fee receivables are due at completion of construction, which is generally one year. The Company does not require collateral. Credit losses have been within management's expectations, and management believes that the allowance for doubtful accounts adequately provides for any expected losses.

Advertising:

Advertising expenses are expensed as incurred. Advertising expenses for the years ended December 31, 1998, 1997 and 1996 were \$243,720, \$336,738 and \$210,028, respectively.

Net income per share:

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

Net income per share for periods prior to 1997 are not comparable to subsequent period amounts due to the Company's Formation and Offering in October 1997 and, consequently, are not included.

Stock-based compensation:

The Company has elected to follow the intrinsic value method in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations in accounting for its employee stock options. In accordance with APB 25, since the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. The Company has adopted the disclosure-only provisions for the fair value method of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("FASB 123").

Segment information:

Effective January 1, 1998, the Company adopted the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("Statement 131"). Statement 131 superseded FASB Statement No. 14, "Financial Reporting for Segments of a Business Enterprise". Statement 131 establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports. Statement 131 also establishes standards for related disclosures about products and services, geographic areas and major customers. The adoption of Statement 131 did not affect results of operations or financial position, but did affect the disclosure of enterprise-wide information.

The Company evaluates the performance and allocates resources of its senior living facilities based on current operations and market assessments on a property-by-property basis. The Company does not have a concentration of operations geographically or by product or service as its management functions are integrated at the property level.

Affiliated development fees in the accompanying statements of income represents development fees earned from the Triad partnerships.

Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications:

Certain prior year amounts have been reclassified to conform to 1998 presentation.

NOTE 3. TRANSACTIONS WITH AFFILIATES

Effective April 1, 1998, the Company obtained a 19% limited partnership interest in Triad Senior Living I, L.P. ("Triad I") for \$330,243 in cash. The Company is accounting for this investment under the equity method of accounting based on the provisions of the Triad I partnership agreement. The Company is developing senior living communities for Triad I. Additionally, the Company loaned money to Triad I pursuant to an unsecured loan facility not to exceed \$10,000,000. The principal is due March 12, 2003. The first draw under this loan facility was made on March 12, 1998. Interest is due quarterly at 8% per annum. This loan may be prepaid without penalty. At December 31, 1998, \$9,635,799 has been advanced to Triad I under this loan facility. The Company has deferred interest income and development fees from Triad I of \$67,253 and \$222,550, respectively, as of December 31, 1998.

Effective September 23, 1998, the Company obtained a 19% limited partnership interest in Triad Senior Living II, L.P. ("Triad II") for \$74,100 in cash. The Company is accounting for this investment under the equity method of accounting based on the provisions of the Triad II partnership agreement. The Company is developing senior living communities for Triad II. Additionally, the Company loaned money to Triad II pursuant to an unsecured loan facility not to exceed \$7,000,000, which was increased to \$10,000,000 on January 15, 1999. The principal is due September 25, 2003. The first draw under this loan facility was made on September 25, 1998. Interest is due quarterly at 10.5% per annum. This loan may be prepaid without penalty. At December 31, 1998, \$932,201 has been advanced to Triad II under this loan facility. The Company has deferred interest income and development fees from Triad II of \$3,149 and \$94,913 respectively, as of December 31, 1998.

Effective November 10, 1998, the Company obtained a 19% limited partnership interest in Triad Senior Living III, L.P. ("Triad III") for \$142,500 in cash. The Company is accounting for this investment under the equity method of accounting based on the provisions of the Triad III partnership agreement. The Company is developing senior living communities for Triad III. Additionally, the Company loaned money to Triad III pursuant to an unsecured loan facility not to exceed \$10,000,000. The principal is due February 8, 2004. The first draw under this loan facility will be made, subsequent to December 31, 1998, on February 8, 1999. Interest is due quarterly at 10.5% per annum. This loan may be prepaid without penalty. At December 31, 1998, no monies have been advanced to Triad III under this loan facility. The Company has deferred development fees from Triad III of \$162,532 as of December 31, 1998.

Effective December 22, 1998, the Company obtained a 19% limited partnership interest in Triad Senior Living IV, L.P. ("Triad IV") for \$142,500 in cash. The Company is accounting for this investment under the equity method of accounting based on the provisions of the Triad IV partnership agreement. The Company is developing senior living communities for Triad IV. Additionally, the Company loaned money to Triad IV pursuant to an unsecured loan facility not to exceed \$10,000,000. The principal is due December 30, 2003. The first draw under this loan facility was made on December 30, 1998. Interest is due quarterly at 10.5% per annum. This loan may be prepaid without penalty. At December 31, 1998, \$1,160,162 has been advanced to Triad IV under this loan facility. The Company has deferred interest income and development fees from Triad IV of \$129 and \$237,558, respectively as of December 31, 1998.

The Company has options to purchase properties from the above Triad partnerships at fair value. The Company also can purchase the partnership interests of the non-Company partners for an amount equal to the amount such party paid for its interest, plus noncompounded interest of 12% per annum. The Company provides a guarantee of its subsidiaries' completion of construction guarantee and operating deficit agreement. The Company has no commitments or obligations to acquire any properties or additional partnership interests. Also, the Company has no commitments relating to any of the secured loan facilities of any of the above Triad partnerships.

NOTE 4. ACQUISITIONS

On September 30, 1998, the Company acquired four senior living communities from NHP for \$40,683,281 by entering into a \$32,300,000 mortgage loan agreement with Lehman Brothers Holdings, Inc. (“Lehman”), a cash payment of \$8,246,007 and assuming net liabilities of \$137,274. The acquisition was accounted for as a purchase. The Company’s preliminary purchase price allocation was based on independent valuations from third-party valuation firms.

On October 28, 1998, the Company acquired a senior living community from Tesson Heights Enterprises, a Texas limited partnership, for \$23,051,786, by borrowing \$15,400,000 pursuant to the existing mortgage loan agreement with Lehman and \$7,376,632 under an existing line of credit and assuming \$275,154 of net liabilities. The Company also acquired a senior living community from Gramercy Hill Enterprises, a Texas limited partnership, for \$11,036,655, by assuming a \$6,334,660 note, along with borrowing \$1,980,000 from WMF Washington Mortgage Corp. (“WMF”) on a second lien basis and \$2,425,798 under an existing line of credit and assuming net liabilities of \$296,197. The acquisitions were accounted for as a purchase. The Company’s preliminary purchase price allocations were based on independent valuations from third-party valuation firms.

The results of operations for the above acquisitions are included in the Company’s statement of income from the date of acquisition.

Pro forma results of operations as if the NHP, Tesson Heights and Gramercy Hill acquisitions had occurred on January 1, 1997 are as follows:

	Year Ended December 31,	
	1998	1997
Total revenues	\$ 56,559,920	\$ 47,082,786
Net income	11,518,250	946,143
Net income per share	\$ 0.58	\$ 0.08
Shares used in computing pro forma net income per share	19,717,347	11,150,087

The unaudited pro forma consolidated amounts are presented for informational purposes only and do not necessarily reflect the financial position or results of operations of the Company which would have actually resulted had the acquisitions occurred on January 1, 1997.

NOTE 5. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	December 31,	
	1998	1997
Land	\$ 10,641,671	\$ 2,777,087
Land improvements	6,400	3,906
Buildings and building improvements	119,759,970	47,562,214
Furniture and equipment	4,685,174	2,387,485
Automobiles	73,890	—
Construction in process	71,611	2,049,574
	135,238,716	54,780,266
Less accumulated depreciation	16,294,763	13,659,818
Property and equipment, net	\$118,943,953	\$ 41,120,448

On November 24, 1998, the Company sold land on one of its properties for \$738,385. This sale resulted in a \$415,847 gain and net cash proceeds of \$664,984. On December 7, 1998, the Company sold land on another one of its properties for \$12,662. This sale resulted in the recognition of a \$8,545 gain and net cash proceeds of \$11,052.

The Company capitalized \$348,626 of interest as part of building and building improvements during 1998.

NOTE 6. ACCRUED EXPENSES

Accrued expenses consists of the following:

	December 31,	
	1998	1997
Accrued salaries, bonuses and related expenses	\$ 847,722	\$ 432,249
Accrued property taxes	538,697	493,796
Other	845,476	333,365
	<u>\$2,231,895</u>	<u>\$1,259,410</u>

NOTE 7. NOTES PAYABLE AND LINE OF CREDIT

Notes payable consists of the following:

	December 31,	
	1998	1997
Lehman \$60 million mortgage loan, bearing interest at prime or LIBOR plus 1.875% (6.95% at December 31, 1998); payable in monthly installments of interest only, maturing on October 1, 1999, secured by the certain properties of NHPCT	\$47,700,000	\$ —
WMF mortgage loan, bearing interest at 7.69%; payable in monthly installments of principal and interest of \$48,089, maturing on January 2008 secured by a certain property of Gramercy	6,312,032	—
WMF second mortgage loan, bearing interest at 7.08%; payable in monthly installments of principal and interest of \$14,095, maturing on January 2010 secured by a certain property of Gramercy	1,975,159	—
HCP mortgage loans, bearing interest ranging from 6.2% to 10.75%; payable in monthly installments of \$99,212 including interest, maturing from 2001 to 2012 secured by certain properties of HCP	6,128,656	6,677,431
	<u>62,115,847</u>	<u>6,677,431</u>
Less current portion	48,419,050	932,664
	<u>\$13,696,797</u>	<u>\$ 5,744,767</u>

The aggregate maturities of notes payable at December 31, 1998, are as follows:

1999	\$48,419,050
2000	675,909
2001	561,856
2002	414,654
2003	455,512
Thereafter	11,588,866
	<u>\$62,115,847</u>

In connection with obtaining the Lehman and other 1998 mortgage loans, the Company incurred \$569,896 in deferred financing charges, which are amortized over the life of the loans using the straight-line method. Accumulated amortization was \$123,727 at December 31, 1998.

On December 10, 1997, the Company entered into a \$20 million revolving line of credit with a bank that expires December 10, 2000. Subsequent to December 31, 1998, the Company received a commitment to increase its line of credit to \$34 million. Borrowings under the line of credit are secured by three senior living communities and bear interest at the prime rate or LIBOR

plus 1.7% (7.33% and 7.42% at December 31, 1998 and 1997, respectively). The line of credit may be used for acquisition of additional interests in HCP and NHP, acquisition of additional properties, development of expansions to existing properties and general working capital purposes. Amounts outstanding under the line of credit at December 31, 1998 and 1997, were \$18,974,186 and \$1,830,130, respectively. In connection with obtaining the line of credit, the Company incurred \$6,847 and \$111,533 in 1998 and 1997, respectively, in deferred financing charges, which are amortized over the life of the line of credit. Accumulated amortization was \$41,066 and \$3,098 at December 31, 1998 and 1997, respectively.

Under the line of credit, the Company must maintain certain levels of tangible net worth and comply with other restrictive covenants.

On June 30, 1997, CSLC entered into a \$77,000,000 mortgage loan agreement with Lehman Brothers Holdings, Inc., and pledged four senior living communities and its investments in HCP and NHP as collateral. Subsequent to June 30, 1997, \$70,800,000 was advanced under this loan agreement; \$5,500,000 was used to repay a mortgage loan and \$64,500,000 was used to fund the liquidity requirement under the loan agreement through the purchase of three-month U.S. Treasury Securities. The U.S. Treasury Securities were sold under a repurchase agreement with a term equal to their maturity. The repurchase agreement was cancelled and the outstanding debt was assumed and repaid by the Corporation from the proceeds of the Offering. The U.S. Treasury Securities reverted to CSLC for use or disposition as determined by CSLC, and the Company has no interest in such securities.

HCP leases four of its properties under a master lease. The rentals under the master lease provide additional security for two notes payable used to finance two of the master lease properties. These notes are due December 1, 2001.

NOTE 8. EQUITY

The Company is authorized to issue preferred stock in series and to fix and state the voting powers and such designations, preferences and relative participating, optional or other special rights of the shares of each such series and the qualifications, limitations and restrictions, thereof. Such action may be taken by the Board without stockholder approval.

On November 5, 1997, the Company issued 10,350,000 shares of \$.01 par value common stock for cash of \$110,330,915, net of issuance costs of \$11,317,705 and payment of the Formation Note of \$18,076,380, in connection with the Offering. Additionally, the Company issued 7,687,347 shares of \$.01 par value common stock in connection with the Formation. For financial reporting purposes, the shares issued in connection with the Formation are presented as outstanding as of January 1, 1997.

During 1996, the Company issued 1,680,000 shares of \$.01 par value common stock for \$16,800 in cash. For financial reporting purposes, as the combined entities were under common control, the Company's common stock is presented as outstanding as of January 1, 1996.

Common stock reserved for future issuance is 1,565,000 for stock options. The rights, preferences and privileges of holders of common stock are subject to the rights of the holders of Preferred Stock.

Purchases of Beneficial Unit Certificates ("BUCs") of CSLC during 1997 and 1996 represent additional purchases by the Stockholders and are accounted for at the book value of the BUCs and as an addition to partners' capital and a reduction in minority interest. CSLC purchased 55,316 BUCs for \$960,762 during 1997, at an average cost of \$17.37 per unit. CSLC purchased 91,854 BUCs for \$1,262,355 during 1996, at an average cost of \$13.74 per unit.

Net income (loss) of HCP is generally allocated 98% to the limited partners and 2% to the general partner. The net income of HCP from the disposition of a property is allocated: (i) to partners with deficit capital accounts on a pro rata basis; (ii) to limited partners until they have been paid an amount equal to the amount of their adjusted investment (as defined); (iii) to the limited partners until they have been allocated income equal to their 12% Liquidation Preference; and (iv) thereafter, 80% to the limited partners and 20% to the general partner. The net loss of HCP from the disposition of a property is allocated: (i) to partners with positive capital accounts on a pro rata basis and (ii) thereafter, 98% to the limited partners and 2% to the general partner. Distributions of available cash flow are generally distributed 98% to the limited partners and 2% to the general partner, until the limited partners have received an annual preferential distribution, as defined. Thereafter, available cash flow is distributed 90% to the limited partners and 10% to the general partner. During 1998, HCP repurchased \$144,791 of its limited partnership interests. HCP made a \$224,795 distribution in 1997 to minority partners.

NOTE 9. STOCK OPTIONS

The Company adopted a stock option plan during 1997, providing for the grant of incentive and nonqualified stock options to employees and directors. This plan provides for the grant of options to purchase up to 1,565,000 shares. The option exercise price and vesting provisions of such options are fixed when the option is granted. The options expire ten years from the date of grant and vest from zero to five years. The option exercise price is the fair market value of a share of common stock on the date the option is granted.

A summary of the Company's stock option activity, and related information for the years ended December 31, 1998 and 1997, is presented below:

	Shares	Weighted Average Exercise Price
Outstanding at January 1, 1997	—	—
Granted	776,250	\$13.50
Exercised	—	—
Forfeited	—	—
Expired	—	—
Outstanding at December 31, 1997	776,250	\$13.50
Granted	—	—
Exercised	—	—
Forfeited	76,750	13.50
Expired	—	—
Outstanding at December 31, 1998	699,500	\$13.50
Exercisable at December 31, 1998	258,010	\$13.50
Exercisable at December 31, 1997	121,500	\$13.50

The weighted average remaining contractual life of the options at December 31, 1998 and 1997, is approximately 8.8 years and 9.8 years, respectively. Unoptioned shares available for the granting of options at December 31, 1998 and 1997 was 865,500 and 788,750, respectively.

The average daily price of the stock during 1998 and 1997 subsequent to the Offering was \$11.73 and \$13.04, respectively, per share, and therefore, the options are considered anti-dilutive for the calculation of diluted net income per share.

Pro forma information regarding net income per share has been determined as if the Company had accounted for its employee stock options under the fair value method of that statement. The fair value for these options was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: risk-free interest rate of 5.7 percent; dividend yield of zero percent; expected lives of seven years; and volatility of 70.1 percent. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting periods.

	1998	1997
Net income		
As reported	\$ 11,957,000	\$ 3,681,000
Pro forma	10,848,000	2,787,000
Net income per share		
As reported	\$ 0.61	\$ 0.33
Pro forma	0.55	0.25

NOTE 10. INCOME TAXES

The provision for income taxes consists of the following:

	Year Ended December 31,		
	1998	1997	1996
Current:			
Federal	\$ 6,308,319	\$ 730,184	\$ —
State	1,463,930	101,498	—
Deferred:			
Federal	(240,635)	(39,404)	—
State	(55,843)	246	—
	<u>\$ 7,475,771</u>	<u>\$ 792,524</u>	<u>\$ —</u>

The provision for income taxes differed from the amounts computed by applying the U.S. federal income tax rate to income before provision for income taxes as a result of the following:

	Year Ended December 31,		
	1998	1997	1996
Tax expense at federal statutory rates	\$ 6,606,992	\$ 1,521,053	\$ —
Tax expense at federal statutory rates on income earned prior to Formation and Asset Purchase	—	(831,026)	—
State income tax expense	1,420,503	101,744	—
Conversion of S corporations to C corporation status	—	(41,085)	—
Other	(551,724)	41,838	—
	<u>\$ 7,475,771</u>	<u>\$ 792,524</u>	<u>\$ —</u>

A summary of the Company's deferred tax assets and liabilities, are as follows:

	December 31,	
	1998	1997
Deferred tax assets:		
Tax basis in excess of book basis arising from the Asset Purchase	\$ 9,644,505	\$ 10,060,119
Other	1,113,530	128,000
Total deferred tax assets	10,758,035	10,188,119
Deferred tax liabilities	362,280	88,842
Total deferred tax assets, net	<u>\$ 10,395,755</u>	<u>\$ 10,099,277</u>

NOTE 11. RELATED PARTY TRANSACTIONS

Certain administrative and occupancy costs were incurred by an affiliate on behalf of the Company. Total costs allocated to the Company were \$0, \$679,423 and \$552,586 for the years ended December 31, 1998, 1997 and 1996, respectively.

Prior to the Offering, the Company paid premiums to a related party for employee medical coverage. The related party insured the Company for any claims exceeding the premiums paid. Accordingly, no amounts have been accrued at December 31, 1997, for claims incurred prior to the Offering but unpaid.

The Company manages properties for a third party, in which an officer of the Company was also a director of the third-party companies until July 1, 1998. Management fees received for the period ended June 30, 1998 and for the years ended December 31, 1997 and 1996 were \$987,840, \$1,589,703 and \$657,260, respectively.

Upon sale of the four NHP properties on September 30, 1998, an affiliate received a \$1,219,500 brokerage fee.

Upon sale of the four CSLC properties in November 1997, an affiliate received a \$4,597,080 brokerage fee.

In October 1997, HCP paid an affiliate a refinancing fee of \$13,245.

Upon sale of certain multi-family properties in November 1996, an affiliate received a \$79,883 brokerage fee.

An officer of the Company is chairman of the board of a bank where the Company holds the majority of its operating cash accounts.

NOTE 12. CONTINGENCIES

On August 11, 1998, the Company executed a settlement agreement with Angeles Housing Concepts, Inc. (“AHC”) and ILM I Lease Corporation and ILM II Lease Corporation (collectively, “ILM Lease”) resolving all claims among the parties relating to a lawsuit filed by AHC against the Company alleging interference with AHC’s management agreements with ILM (the “Settlement Agreement”) and calling for a dismissal with prejudice of this lawsuit. The Settlement Agreement did not involve any payment of damages to AHC or any other party by the Company.

On or about October 23, 1998, Robert Lewis filed a putative class action complaint on behalf of certain holders of Assignee Interests in NHP in the Delaware Court of Chancery against NHP, the Company, Capital Senior Living Properties 2-NHPCT, Inc. and Capital Realty Group Senior Housing, Inc. (collectively, the “Defendants”). Mr. Lewis purchased 90 Assignee Interests in February 1993 for \$180. The complaint alleges, among other things, that the Defendants breached, or aided and abetted a breach of, the express and implied terms of NHP Partnership Agreement in connection with the sale of four properties by NHP to Capital Senior Living Properties 2-NHPCT, Inc. The complaint seeks, among other relief, rescission of the sale of these properties and unspecified damages. The Company believes the complaint is without merit and intends to vigorously defend itself in this action.

On February 12, 1999 a competitor of the Company, Holiday Retirement Corporation (“Holiday”), as well as Colson & Colson Construction Company and their architects, Curry Brandaw Architects, filed suit against the Company in U.S. District Court in Dallas. The complaint alleges, among other claims, that the Company infringed the copyrighted architectural plans and trade dress of Holiday on at least three of the Company’s communities. The communities using this Waterford prototype design are owned by Triad I, in which the Company is a 19% limited partner and provides development services under a third-party development agreement. The plaintiffs are additionally seeking a preliminary and permanent injunction to bar further use of their allegedly copyrighted architectural plans and trade dress as well as damages, including punitive damages. The defense of this suit has been turned over to the Company’s insurer for handling. The Company vigorously denies the allegations mentioned in the lawsuit and has filed an answer and counterclaim.

The Company has pending claims incurred in the normal course of business that, in the opinion of management, based on the advice of legal counsel, will not have a material effect on the financial statements of the Company.

NOTE 13. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts and fair values of financial instruments at December 31, 1998 and 1997 are as follows:

	1998		1997	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$35,827,270	\$35,827,270	\$48,125,225	\$48,125,225
Line of credit	18,974,186	18,974,186	1,830,130	1,830,130
Notes payable	62,115,845	62,115,845	6,677,431	6,611,128

The following methods and assumptions were used in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents: The carrying amounts reported in the balance sheet for cash and cash equivalents approximate fair value.

Line of credit and notes payable: The fair value of notes payable is estimated using discounted cash flow analysis, based on current incremental borrowing rates for similar types of borrowing arrangements.

NOTE 14. INVESTMENTS IN LIMITED PARTNERSHIPS

The investments in limited partnerships balance consists of the following:

	December 31,	
	1998	1997
NHP pension notes	\$12,646,471	\$13,740,576
NHP limited partnership interests	1,708	1,364
Triad I limited partner interest	330,243	—
Triad II limited partner interest	74,100	—
Triad III limited partner interest	142,500	—
Triad IV limited partner interest	142,500	—
	\$13,337,522	\$13,741,940

HCP:

During 1998, 1997 and 1996, the Company paid \$101,072, \$5,604,944 and \$3,200,686, respectively, for partnership interests in HCP and, as of December 31, 1998 and 1997, the Company owned a 57% and 56% ownership in HCP, respectively.

The Company changed its method of accounting for its investment in HCP from the equity method to the consolidation of HCP in its financial statements in 1997. Had HCP been consolidated in 1996, using its weighted average ownership interest of 23%, the results of operations on a pro forma basis for the year ended December 31, 1996 would have been:

Revenue	\$26,504,461
Income before extraordinary item and minority interest	1,166,289
Net income	2,118,981

Pro forma net income, assuming a tax rate of 39.5%, is \$1,281,984.

In the second quarter of 1996, CSLC purchased a 9.36% limited partnership interest in HCP from an affiliate. CSLC paid \$1,269,077 to the affiliate, who recognized a gain of \$878,592 on the transaction. As a result of this purchase, the Company exceeded a 20% ownership in HCP and changed its method of accounting from the cost method to the equity method. The change resulted in recognizing \$3,519,315 of deferred income for the difference between cost and the underlying equity in HCP, which was

being amortized over 20 years. At the Offering date, the unamortized deferred income was eliminated as a result of applying the purchase method of accounting for CSLC's acquisition of HCP limited partnership units. At the Offering date, the allocation of purchase price to the assets and liabilities of HCP was based on independent valuation information from third-party valuation firms.

Summary financial information regarding the results of operations of HCP for fiscal 1996 is as follows:

Net revenue	\$7,560,104
Net income	1,637,343

NHP:

The Company acquired, on November 1, 1997, the Pension Notes of NHP ("NHP Notes") owned by CSLC in the Formation Transactions for \$18,664,128. The NHP Notes bear simple interest at 13% per annum and mature on December 31, 2001. Interest is currently paid quarterly at a rate of 7%, with the remaining 6% interest deferred. Beginning November 1, 1997 through September 30, 1998, the Company has been recording interest income at 10.5% of the purchase price paid, which was determined based on the discounted amount of principal and interest payments to be made following the maturity date (December 31, 2001) of the NHP Notes (using a six-month lag between maturity and full repayment), due to uncertainties regarding the ultimate realization of the accrued interest. On September 30, 1998, the Company purchased four properties from NHP. NHP is in turn redeeming \$7,500,000 of the Company's investment in the NHP Notes and is distributing approximately \$5,300,000 of deferred interest not previously paid on such notes. From October 1, 1998 through December 31, 1998, the Company reevaluated its investment in the NHP Notes, and is recording additional income, after giving consideration to current payment of interest, partial redemption of the NHP Notes with accrued interest and the estimated residual value in NHP. This change in estimate resulted in \$579,278 of additional income in 1998 (\$0.03 net income per share impact), and is expected to increase income by approximately \$3,000,000, \$2,400,000 and \$2,300,000 in 1999, 2000 and 2001 (NHP Notes redemption is December 31, 2001), respectively.

During 1998 and 1996, the Company paid \$344 and \$1,364, respectively, increasing the ownership of limited partnership units in NHP to 3.9% from 3.1%. Subsequent to year-end and through February 5, 1999, the Company disbursed \$13,500 for an additional investment in NHP Notes and \$378 for an additional investment in NHP units. These purchases bring the Company's ownership of NHP Notes to 33.1% and the ownership of NHP units to 4.8%. The Company classifies its investment in NHP Notes as held to maturity.

Summary financial information regarding the financial position and results of operations of NHP as of December 31 and for the years then ended is as follows:

	December 31,	
	1998	1997
Cash	\$ 5,821,300	\$ 4,495,733
Property and equipment, net	18,849,354	49,490,473
Other assets	592,146	1,599,634
Total assets	\$25,262,800	\$55,585,840
Pension notes	\$20,157,826	\$42,672,000
Interest payable	13,142,864	23,730,407
Other liabilities	633,817	1,203,421
Partnership deficit	(8,671,707)	(12,019,988)
Total liabilities and partnership deficit	\$25,262,800	\$55,585,840

	Year ended December 31,		
	1998	1997	1996
Net revenue	\$13,746,088	\$15,548,138	\$14,488,099
Net income (loss)	3,409,569	(3,522,917)	(3,574,668)

NOTE 15. ALLOWANCE FOR DOUBTFUL ACCOUNTS

The components of the allowance for doubtful accounts are as follows:

	December 31,		
	1998	1997	1996
Balance at beginning of year	\$ 301,042	\$ 164,822	\$ 141,452
Provision for bad debts	500,000	43,254	22,312
Write-offs and other	—	(17,474)	1,058
Allowances not assumed in asset purchase	—	(145,602)	—
Allowance arising from consolidation of HCP	—	256,042	—
Balance at end of year	\$ 801,042	\$ 301,042	\$ 164,822

NOTE 16. LEASES

The Company leases its corporate headquarters under an operating lease expiring in 2002. Additionally, the senior living communities have entered into various contracts for services for duration of 5 years or less and are on a fee basis as services are rendered. Rent expense under these leases was \$266,590 and \$188,986 for 1998 and 1997, respectively. Future commitments are as follows:

1999	\$ 293,023
2000	296,959
2001	303,207
2002	185,931
	<u>\$ 1,079,120</u>

HCP leases its property and equipment to tenants under noncancelable operating leases. The lease terms range from 9 to 12 years with options to renew for additional five-year terms and options to purchase the leased property at the current fair market value at the end of the initial lease term. The leases generally provide for contingent rentals based on the performance of the property. Contingent rentals aggregated \$310,275 and \$271,340 in 1998 and 1997, respectively.

Minimum rentals for the next two years for the HCP leases are \$3,971,328 per year, subject to change based on changes in interest rates. Minimum rentals are \$3,761,262 and \$2,858,619 for the years 2000 and 2001. There are no minimum rentals thereafter. Property and improvements less accumulated depreciation attributable to such rentals amounted to \$18,329,061 and \$19,339,886 at December 31, 1998 and 1997, respectively.

Four of HCP's senior living communities are subject to a master lease with a single operator, Rebound, Inc., a subsidiary of HealthSouth Corporation ("HealthSouth"). This master lease, as amended, contains a nine-year renewal option and provides for contingent rentals equal to 4% of the revenue differential, as defined, effective January 30, 1997. As of December 31, 1998 and 1997, no contingent rentals have been accrued on the master lease. Prior to February 28, 1997, HealthSouth closed two of the four communities under the master lease. Despite these closures, HealthSouth has continued making its full lease payments under the terms of the master lease.

NOTE 17. OFFICERS' SALARIES AND BONUS

General and administrative expense includes officers' salaries and bonuses of \$670,000, \$3,342,360 and \$3,371,887 for the years ended December 31, 1998, 1997 and 1996, respectively. Compensation of the Stockholders and Cohen, all officers of the Company, are based on their respective employment agreements since October 1, 1997.

NOTE 18. PRO FORMA INCOME TAXES (UNAUDITED)

The income taxes on earnings of the S corporations and partnerships for fiscal 1996 and for the period from January 1, 1997 through October 31, 1997, are the responsibility of the Stockholders and partners. The pro forma adjustments reflected on the statements of income assume these S corporations and partnerships were subject to income taxes. Pro forma income tax expense has been calculated using statutory federal and state tax rates, estimated at 39.5%.

NOTE 19. PRO FORMA RESULTS OF OPERATIONS (UNAUDITED)

Shown below are unaudited pro forma consolidated amounts for the year ended December 31, 1997 and 1996, respectively, representing the results of operations of the Company for such periods after giving effect to the adjustments relating to the Offering and the Formation, as if the transactions had occurred as of January 1, 1996. The unaudited pro forma consolidated amounts are presented for informational purposes only and do not necessarily reflect the financial position or results of operations of the Company which would have actually resulted had the Offering and the Formation occurred as of January 1, 1996, or the future results of operations of the Company.

	Year Ended December 31,	
	1997	1996
Total revenues	\$30,709,882	\$26,504,461
Net income	4,991,288	3,396,742
Net income per share	\$ 0.25	\$ 0.17
Shares used in computing pro forma net income per share	19,717,347	19,717,347

NOTE 20. SUBSEQUENT EVENT

On February 7, 1999, the Company entered into definitive Agreements and Plans of Merger with ILM Senior Living, Inc. and ILM II Senior Living, Inc. for a combined transaction value of approximately \$174 million, which includes approximately \$4 million of net liabilities. The primary assets of ILM Senior Living, Inc. and ILM II Senior Living, Inc. collectively are 13 senior living communities that have been managed by the Company under management agreements since 1996. Under the two merger agreements, both ILM Senior Living, Inc. and ILM II Senior Living, Inc. would separately merge with and into a wholly owned direct subsidiary of the Company, with the aggregate issued and outstanding shares of ILM Senior Living, Inc. and ILM II Senior Living, Inc. common stock eligible to receive 65% of the merger consideration in cash (approximately \$110.5 million) and 35% in 8% convertible trust preferred securities (with a liquidation value of approximately \$59.5 million). Both mergers have been approved by the boards of directors of each company and each transaction requires the approval of the applicable shareholders of either ILM Senior Living, Inc. or ILM II Senior Living, Inc. The mergers also are subject to certain other customary conditions, including regulatory approvals, and are expected to be completed during the second half of 1999.



STOCKHOLDERS INFORMATION

EXECUTIVE OFFICERS:

JEFFREY L. BECK¹

Co-Chairman of the Board

JAMES A. STROUD¹

Co-Chairman of the Board,
Chairman and Chief Operating Officer

LAWRENCE A. COHEN¹

Vice-Chairman of the Board,
acting Chief Executive Officer
and Chief Financial Officer

KEITH N. JOHANNESSEN

President

ROB L. GOODPASTER

Vice President, National Marketing Director

DAVID W. BEATHARD

Vice President, Director of Operations

DAVID G. SUAREZ

Vice President, Director of Development

DAVID R. BRICKMAN

Vice President, General Counsel

KATHLEEN L. GRANZBERG

Corporate Controller

ROBERT F. HOLLISTER

Property Controller

DIRECTORS:

JEFFREY L. BECK¹

JAMES A. STROUD¹

LAWRENCE A. COHEN¹

DR. GORDON L. GOLDSTEIN^{2,3}

Chairman of Dallas Anesthesiology Associates

J. FRANK MILLER, III³

President and Chief Executive Officer of JPI

JAMES A. MOORE^{2,3}

President of Moore Diversified Services, Inc.

DR. VICTOR W. NEE²

Professor in the Department of Aerospace and
Mechanical Engineering, University of Notre Dame

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STOCK LISTING

Capital Senior Living Corporation Common

Stock is listed on the New York Stock Exchange
and trades under the symbol "CSU"

AUDITORS

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Dallas, Texas 75201

TRANSFER AGENT AND REGISTRAR

ChaseMellon Shareholder Services, L.L.C.

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Ridgefield, New Jersey 07660

800-635-9270

ANNUAL MEETING

May 20, 1999 at 9:00 a.m.

at The Waldorf-Astoria

301 Park Avenue

New York, NY 10022

FORM 10-K

A copy of Capital Senior Living Corporation's
annual report to the Securities and Exchange
Commission on Form 10-K for fiscal year 1998
is available, without charge, upon written request
to Investor Relations at the corporate office.

¹ Member of the Executive Committee of the Company

² Member of the Compensation Committee of the Company

³ Member of the Audit Committee of the Company



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