

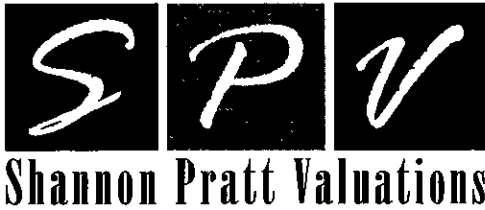
REPORT ON
VALUATION ISSUES IN
SUNWEST MANAGEMENT, INC.
RESTRUCTURING

Answers to Questions Posed by Hamstreet & Associates

Prepared by
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President & COO



July 8, 2009

Clyde Hamstreet
Hamstreet & Associates
One SW Columbia Street
Portland, OR 97258
(503) 223-6222

Dear Sir,

We transmit herewith our report on valuation issues in the restructuring of Sunwest Management, Inc. by Hamstreet & Associates.

The report provides our professional opinion as to three principal valuation issues raised by the restructuring, along with subsidiary and corollary questions, as posed by Hamstreet & Associates to Shannon Pratt Valuations in its letter dated June 30, 2009.

The assignment was performed in accordance with the *Uniform Standards of Professional Appraisal Practice (USPAP)* as promulgated by the Appraisal Standards Board of the Appraisal Foundation, and was done using conventional appraisal procedures.

We appreciate the opportunity to have been of service to you in this matter.

Sincerely,

Shannon P. Pratt
CFA, ARM, ABAR, FASA, MCBA, CM&AA

Alina Niculita
CFA, MBA

**SUNWEST MANAGEMENT, INC.
RESTRUCTURING**

**REPORT ON
VALUATION ISSUES**

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TABLE OF CONTENTS

ISSUE 1	1
INTRODUCTION	
STRATEGIES	
FACTORS CONTRIBUTING TO DIFFERENCES IN VALUE	
ISSUE 2.....	6
PREMIUMS AND DISCOUNTS	
ISSUE 3.....	11
CAPITALIZATION RATE	
 Exhibits 1-16	
 Appendixes	
Appendix A. Statistics on Healthcare REITs as of March 1, 2009	
Appendix B. Assisted Living Facility Stocks and REITs During First Five Months of 2009	
Appendix C. Trends in Capitalization Rates (1994-2008)	
Appendix D. Long-term Care Transactions in January and February of 2009	
Appendix E. Qualifications of Principal Appraisers	
Appendix F. Opinion Certification	
Appendix G. Statement of Contingent and Limiting Conditions	

Shannon Pratt Valuations, Inc. (SPV) was retained by Hamstreet & Associates (Hamstreet) in connection with the restructuring by Hamstreet of Sunwest Management, Inc. to render a professional opinion on three key valuation issues and subsidiary or corollary issues, as set forth in a letter from Hamstreet to SPV dated June 30, 2009.

This report is organized according to the issues and subsidiary or corollary issues presented in Hamstreet's June 30, 2009 letter. Each issue is reproduced as stated in the letter, and SPV's response thereto follows.

Issue 1: Which of the following three strategies for dealing with the restructuring of the company is likely to offer the best overall recovery to investors and creditors, whose claims exceed \$700 million?

1. Orderly liquidation where all properties are sold over the next 6-10 months and net proceeds are returned to investors and other claimants on a pro rata basis.
2. Status quo operation—i.e., one management company managing 150 properties, half of which involve some 2000 TIC ownership interests—and use dividends and future sale rights to construct a large transaction in three years, distributing funds on some basis and adjusting for individual payments received by each TIC or other investor.
3. Combine all the properties into one corporate entity, such as a healthcare REIT, register the shares and have them publicly reported so there is some future liquidity for investors. The REIT would construct a transaction in three to five years that would monetize the investments.

In addition to providing your opinion and the reasoning behind it as to which scenario will provide the greatest return to investors, we would like you to address some corollary issues:

- What kind of delta in value are we looking at between the three plans? (Small, moderate, significant—to whatever degree of specificity you feel able to go.)
- What are the factors contributing to the difference in value between the plans, and what role does each play in the accretion or diminution of value? E.g.,
 - Time
 - Risk
 - Liquidity
 - Economies of scale
 - Purchasing
 - Employee benefits
 - Insurance
 - Ability to hire professional management (e.g., specialists such as dietitians, risk managers, quality control, IT systems, and CFO with strong financing and accounting skills and lender contacts)
 - Ability to negotiate favorable loan terms
 - Marketability

- Strategic and other synergies available to one large company vs. 150 separately owned facilities
- Publicly reporting company vs. private ownership.

INTRODUCTION

The country's demographics assure that the demand for assisted living will be explosive in the next three to five years. The average age in assisted living facilities is over 83 years old. The population of Americans over 85 is growing three times as fast as the average population in America. Moreover, the majority of people over 85 have one or more deficiencies in the activities of daily living (ADLs), which assisted living facilities are prepared to address.

While the economy has slowed the growth of people entering assisted living facilities somewhat in 2008, demographics virtually ensure a rapid increase in demand for assisted living in the next three to five years as "baby boomers" live longer and the population in need of assisted living increases rapidly.

80% of people entering an independent living facility come from an owner occupied house. As housing prices fall, independent senior living appears less affordable. This has less of a dampening impact on senior assisted living, since most of the people going to assisted living have need for help with one or more of their ADLs.

STRATEGIES

Liquidation

We believe that the strategy of orderly liquidation over 6 to 10 months is the least desirable. Both the stock market and the real estate market are currently depressed, and we believe that a full recovery will take two to three years. This year is not the time to sell assets to maximize value.

Status quo

The strategy of maintaining the status quo would carry all the current disadvantages and would not enhance value. See third strategy (Consolidation) for discussion of enhanced value.

Consolidation

We believe that consolidation is by far the best strategy to maximize value. Our rationale for this is summarized in the following section on factors contributing to differences in value.

Opinion as to Relative Value of Strategies

It is hard to quantify the economic value differences among the three possible strategies, but our expectation is that consolidation, along with public registration, will yield about five times as much value to the enterprise as liquidation. (There would have to be some constraints on how much stock anyone could sell to prevent flooding the market).

With respect to maintaining the status quo, this leaves some unwieldy problems. First, it impedes the transfer of money from one unit to another so as to greatly limit flexibility. Furthermore, any transaction involving a TIC requires unanimous consent of the members, which is time-consuming if not impossible. Consolidation eliminates these problems.

FACTORS CONTRIBUTING TO DIFFERENCES IN VALUE

Time

The quicker the strategy is determined, the better. Attorney and consultant fees can eat up the estate. Liquidation would take the longest. If maintaining the status quo, there inevitably will be ongoing disputes among the parties. This factor favors consolidation.

Once the proper strategy is in place, time favors holding good properties to give professional management chance to improve occupancy, increase rental rates, and reduce operating cost. Time also favors improved capital and stock markets and increasing demands for product. All this will increase value and recovery.

Risk

Consolidation obviously entails the least risk. In liquidation, the risk is enhanced by the blockage factor; that is, many units on the market at the same time have a depressing effect on the market, especially considering that the market for assisted living companies has been relatively inactive in the early months of 2009. The status quo involves continuing risk due to divisiveness among parties. Consolidation eliminates the risk of divisiveness and also lessens the overall risk because of diversification over a great number of units in various markets.

The following points favor consolidation as it reduces risk:

- A wrongful death or severe injury claim is much harder for an individual unit to absorb than when it is spread over a larger number of properties.
- Less impact from regional downturns or weather events.
- Ability to use cash freely across properties increases liquidity and financial strength, leading to stability and lower cost of capital. Without this ability, every weak property is a risk to the organization, i.e., foreclosures, payroll, etc.

Liquidity, Marketability, Public v. Private Ownership

This is the biggest advantage of consolidation in our opinion, especially if the consolidated company's shares will be registered in a publicly reporting company. Registering shares for public trading enhances value by a substantial amount. (See "Levels of Value," Exhibit 1.).

As references to Exhibit 1 and the following exhibits through Exhibit 9 show, there is a substantial difference in value and liquidity between a minority interest in a TIC or a minority interest in an LLC in one facility vs. a share in an REIT with 150 similar properties.

Many studies have been done comparing transactions in minority interest in private companies with transactions in stock of comparable public companies. All such studies show substantial differences, with private company stock discounts from comparable public stocks averaging about 35 to 50 percent. (See Exhibit 2).

Studies of minority interests in real estate indicated similar discounts. (See Exhibit 3).

The restructuring plan calls for a transaction in three to five years that would monetize the investments. Studies show consistently that public companies sell for higher financial metrics (e.g., price/earnings ratios) than do private companies. (See Exhibits 4 and 5).

Investors like "pure play" companies, that is, companies that engage in a single business. Example: conglomerate breakups—after breakup, combined companies sold at about 15% premium over their price as conglomerate. (For example, see Exhibits 6 and 7).

Also, we would tend to favor the REIT form for a public offering. The stock market recently seems inclined to favor REITS. (See Exhibits 8 and 9).

Economies of Scale

Large owner/operators enjoy some economies of scale in administration and purchasing. However, small assisted living facilities can buy into a cooperative purchasing entity, which offsets to some extent the purchasing power of the larger groups of facilities. The small owner/operator attempts to compete based on quality of service. Some of the benefits of the economies of scale that would accrue to a larger owner/operator include:

- Purchasing power.
- Savings in employee benefits.
- Savings and quality of financial, accounting, and management information systems.
- Risk management and insurance cost, particularly ability to self-insure.
- Ability to pay for training and education.
- In-house specialty staff such as dietician, nurse management, risk management, maintenance engineers, etc.

- Ability to institutionalize a system of continuous improvements changes and provide consistency of operations.

Ability to Hire Professional Management

A large, multi-geographic company has great advantages in the ability to attract professional management and specialists. For one thing, they can afford to hire the best because of the ability to spread the cost over many units. Also, a large organization offers talented people opportunities for advancement within the organization. Also, a multi-geographic organization can offer opportunities to transfer locations, for example, if the spouse is required to move to a particular city.

Issue 2: What are the various components of value on a facility basis, what is their proportional share of the facility's enterprise value, and how should this value be allocated to the various claims against the facility? For example, a TIC has an encumbered deed as a tenant in common to a specific piece of real-estate, but the TIC has no claim to the control of the facility, the license to operate, the resident contracts, the FF& E. Meanwhile, other investors have no collateral other than a promise to pay, and some TICs have lost their properties through foreclosure and only hold a securities claim against the company, payable in part through returns from the Harder-Fisher-Gutzler equity position.

In considering Issue 2, please opine on the following components of value, in addition to any others you may find pertinent:

- Control premium
- Minority/TIC discount
- What could the TIC interests be sold for?

PREMIUMS AND DISCOUNTS

Control Premiums

Control premiums and discounts for lack of control are mirror images of each other. This section discusses control premiums and the next section discusses discounts for lack of control.

Control shares are normally more valuable than minority shares because they contain a bundle of rights that minority shares do not enjoy. Following is a partial list of some of the rights that go with control shares that minority shares do not have:

1. Appoint or change operational management.
2. Appoint or change members of the board of directors.
3. Determine management compensation and perquisites.
4. Set operational and strategic policy and change the course of the business.
5. Acquire, lease, or liquidate business assets, including plant, property, and equipment.
6. Select suppliers, vendors, and subcontractors with whom to do business and award contracts.
7. Negotiate and consummate mergers and acquisitions.
8. Liquidate, dissolve, sell out, or recapitalize the company.
9. Sell or acquire treasury shares.
10. Register the company's equity securities for an initial or secondary public offering.
11. Register the company's debt securities for an initial or secondary public offering.
12. Declare and pay cash and/or stock dividends.
13. Change the articles of incorporation or bylaws.

14. Set one's own compensation (and perquisites) and the compensation (and perquisites) of related-party employees.
15. Select joint venturers and enter into joint venture and partnership agreements.
16. Decide what products and/or services to offer and how to price those products/services.
17. Decide what markets and locations to serve, to enter into, and to discontinue serving.
18. Decide which customer categories to market to and which not to market to.
19. Enter into inbound and outbound license or sharing agreements regarding intellectual properties.
20. Block any or all of the above actions.

The empirical evidence to quantify the control premium, or, conversely, the minority discount, is derived from the public market. There are several hundred public companies that are taken over each year, with most (about 85 percent) takeovers occurring at prices that represent a premium over the previous public trading price. There are two sources of control premium data, the *Mergerstat Review* and *Mergerstat/Shannon Pratt's Control Premium Study*. Both sets of control premium data relate acquisition prices of controlling interests in public companies to their previous public trading prices. The control premium is based on the "Mergerstat unaffected trading price," which may vary from the actual price the day before the close of the deal.

The *Mergerstat/Shannon Pratt's Control Premium Study* is an online database consisting of all takeovers of public companies resulting in over 50 percent ownership since 1998. As of July 1, 2009, it contained 6,939 transactions and is updated quarterly. The transactions are all completed deals and are presented as of the closing date rather than the announcement date.

Exhibit 10 presents the mean and median percentage premium paid in acquisitions of a controlling interest in public companies by year since 1998. We include in this exhibit all companies in the study in all industries. Sometimes, the acquisition price premium data presented in *Mergerstat Review* and the *Control Premium Study* report control event merger and acquisition transactions that have been consummated at a below-market price. These negative premiums are labeled as "negatives" in the database and in the exhibits in this report. We prefer to include these negative premiums in the data set, and also prefer to use medians over means, because means tend to be distorted by outliers. As a result, from Exhibit 10, we can see that the median control premium including negatives for all companies in all industries over the years 1998-2008 was 24 percent.

In Exhibit 11, we repeat the exercise of searching the Mergerstat database, but this time we limit our search to companies in industries related to Sunwest's operations. Specifically, we searched the database for companies in the following SIC and NAICS codes:

SIC 8051 Skilled Nursing Care Facilities
SIC 8052 Intermediate Care Facilities
SIC 8059 Nursing and Personal Care Facilities, Not Elsewhere Classified
SIC 8361 Residential Care

NAICS 623110 Nursing Care Facilities
NAICS 623220 Residential Mental Health and Substance Abuse Facilities
NAICS 623311 Continuing Care Retirement Communities
NAICS 623312 Homes for the Elderly

Our search resulted in 18 transactions over the last 11 years, and of the 18, only two took place at a negative premium in 1998. From Exhibit 11, we can see that the median control premium, including negatives for all companies in all above industries over the years 1998-2008, was 45.8 percent.

One note about the control premiums as reported in *Mergerstat Review* and *Mergerstat/Shannon Pratt's Control Premium Study* is that it is difficult, if not impossible, to sort out how much of this premium is for elements of control, and how much is for synergies between the seller and the buyer.

Discounts for Lack of Control

Discounts for lack of control account for the fact that a noncontrolling interest in a business does not have the prerogatives of control enumerated in the previous section on control premiums. As noted in the previous section, minority discounts are the mirror image of control premiums. Thus, much of the evidence to quantify control premiums can be used in reverse to quantify discounts for lack of control.

The formula for converting a control premium to an implied minority discount is:

$$\text{Lack of Control Discount} = 1 - [1/(1 + \text{Control Premium})]$$

Exhibit 12 is an expanded version of Exhibit 10, with four additional columns showing the implied minority discount for the control premium selected for each year. This exhibit shows that the implied minority discount for the last 11 years, using the median control premium including negatives of 24 percent is 19.2 percent and it includes all companies in all industries available in the study.

Exhibit 13 is an expanded version of Exhibit 11, where we show additional columns for the implied minority discount for the 18 companies identified in industries related to Sunwest. This exhibit shows that the implied minority discount for the last 11 years, using the median control premium including negatives of 45.8 percent, is 28.8 percent.

Discounts for Direct Undivided Ownership Interests in Real Estate¹

See Exhibit 3 for references to empirical data on discounts for fractional interests in real estate.

¹ *Valuing a Business*, 5th Edition, Shannon Pratt with Alina Niculita.

Real estate undivided ownership interest discounts tend to be considerably smaller than lack of control discounts for stocks or partnership interests. This probably is explained in large part by differences in the respective rights of the ownership interests. An owner of an individual ownership interest in real estate may sue for partition—that is, to have the property divided and to give each owner his or her pro rata share. If the court finds that the property is not divisible, then it may order the property to be sold. Owners of noncontrolling stock and partnership ownership interests have no such rights. It is interesting to note that the U.S. Tax Court has distinguished between (1) lack of control (i.e., minority interest) and (2) lack of marketability discounts for an undivided interest in real estate. The court has stated:

“A minority interest discount for an interest in real property may be allowed on account of the lack of control which accompanies co-ownership.” The minority interest discount should consider “the cost, uncertainty, and delays attendant upon partition proceedings. The marketability discount, by contrast, measures the diminution in value attributable to the lack of a ready market for the property.”²

Lack of Control and Marketability of TIC Interests

When a tenant in common (TIC) investor entered into an investment with Sunwest, the rights and restrictions associated with the TIC Interest were governed principally by three different agreements, as follows: the Master Lease Agreement, the Purchase Option Agreement, and the Tenancy in Common Agreement. Additionally, there is the Management and Consulting Agreement, which establishes Sunwest as the manager of the assisted living facilities.

The TIC interests suffer from lack of control, because the TIC investors in Sunwest deals gave up their right to control the use of the property to a Master Tenant under the long-term Master Lease Agreement. Additionally, Sunwest has control over the operations of the assisted living facilities according to the Management and Consulting Agreement.

The TIC interests suffer from lack of marketability, because the TIC investors gave up the right to sell, rent, mortgage, or transfer ownership in the property they own under the Master Lease Agreement for a long time (40 to 50 years). Additionally, the TIC investors also give up the absolute right to sell their interest by entering into Purchase Option Agreement, under which they give a Sunwest controlled entity an absolute purchase option to purchase the TIC investor's property, exercisable anytime 18 months after the TIC investors purchased their property interest.

Transfers in TIC interests are subject to a right of first refusal from the other TIC investors, who have 10 days to make an offer. If the seller does not accept any of the offers, he or she has 90 days in which to complete a sale for cash for a price higher than the offers received from the TICs.

The TIC investors have a right to a partition action, but before commencing such an action, they have to offer their interest for sale at a price equal to the fair market value of the interest to the other TIC investors. The fair market value of the TIC Interest is defined as: “The fair

² *Samuel J. LeFrak v. Commissioner*, 66 T.C.M. 1297 (1993).

market value of the property...multiplied by a percentage equal to the percentage ownership in the property represented by the fee interest.”

The TIC investors are entitled to cash in the form of rents, as owners of fractional interests in real estate during the term of the Master Lease term. In the case of the sale of the property, the sale proceeds first satisfy the mortgage loan on the property in proportion to each TIC member's interest, with the remainder being distributed to the TIC in proportion to their interest.

The above factors considerably exacerbate the discounts for lack of control and lack of marketability that would be applied in a valuation of the TIC interests.

Discounts from Net Asset Value for Limited Partnerships³

A limited partnership interest in a public real estate limited partnership is an investment in an entity that itself has an interest in an operating real estate project (e.g., office buildings, industrial/warehouse facilities, research and development facilities, business parks, apartments and retirement centers, shopping centers, outlet malls and other retail-use space, manufactured housing communities, mobile home parks, hotels and other lodging facilities, restaurants, and mini-warehouses/self-storage facilities).

Most market transactions in limited partnership interests in recent years have been at substantial price discounts from underlying net asset values. Unlike stocks, most limited partnerships sold in public offerings never develop a secondary public trading market. A few limited partnerships are exchanged in a limited market made by a few brokerage houses. Their number has been decreasing in recent years due to liquidation and lack of new public limited partnership offerings. Those that are still outstanding with some trading are tracked by an organization called Partnership Profiles, which publishes trading prices relative to estimates of underlying asset values. Therefore, unlike most stocks, where one body of empirical data helps to quantify lack of control discounts and another discount for lack of marketability, the discounts from net asset value for limited partnership transactions encompass aspects of both (1) the lack of control discount and (2) the lack of marketability discount. Shannon Pratt Valuations believes that most of the discount is due to lack of control.

The results shown in Exhibit 14 are from the 2004 issue of *The Partnership Re-Sale Discount Study* (the last one published under that format), from the highest distributions down through the lowest. The average discount from the pro-rata share of the net asset values ranged from 14 to 38 percent.

³ *Valuing a Business*, 5th Edition, Shannon Pratt with Alina Niculita.

Issue 3: Finally, if this is an area in which you have expertise, we would like your professional opinion about the following market factors:

- Cap rate on March 1, 2009, for assisted living facilities
- Interest rates over next 36 to 60 months
- Inflation over next 36 to 60 months
- Value of REITS, particularly healthcare REITS.

Capitalization Rate for Assisted Living Facilities

In order to estimate a capitalization rate (cap rate) for assisted living facilities as of March 1, 2009, we reviewed several sources of information for investors in senior living and healthcare entities. Specifically, we reviewed recent issues of two publications, *The Senior Care Investor* and *The Health Care M&A Monthly*, both of which report details on acquisitions in the industry. Additionally, we conducted discussions and obtained data from certain market participants in the healthcare merger and acquisition activity, specifically assisted living facilities. Exhibit 15 presents transaction data for several transactions in assisted living facilities at the end of 2008 and in 2009, before the valuation date of March 1, 2009. The notes below the exhibit include some comments about the fact that the earnings are sometimes estimated by the publishers of the publications based on current earnings, occupancy rates, and potential growth rates. Data necessary to compute the cap rate for the assisted living facilities is not available for all the transactions, but we show averages for the cap rate for all the available transactions, and for the transactions in 2009 separately. The averages for the cap rates in 2009 are slightly higher than the cap rates for the all the transactions. The median cap rate for 2009 transactions is in the low 9 percent range.

In addition to the publications above, we consulted with lenders involved in the healthcare industry, and obtained cap rates for different types of senior living facilities as of the last three quarters in 2008. These rates are presented in Exhibit 16. Additional data on the trend in capitalization rates are presented in Appendix C. For 2008, the average cap rate was 8.9 percent, while the median was 9 percent.

Also, we interviewed a buyer of senior living facilities about the level of the cap rates for such properties, and his response was that that the low 9 percent range is an aggressive rate, and that he typically sees rates in the double digits now, with most being the low 11 percent range.

Interest Rates

We believe that interest rates will go up moderately over the next 36 to 60 months. There are many conflicting sources of predictions on this issue, and we can document several sources if it would be useful to you.

Inflation

The Federal Open Market Committee (FOMC) in January issued the following predictions of inflation:

<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Long-term</u>
0.3% to 1.0%	1% to 1.5%	.9% to 1.7%	1.7% to 2.0%

The 10-year inflation forecast of the Federal Reserve Bank of Philadelphia, known as the *Livingston Survey*, was 2.5% as of December 9, 2008 (the latest issued).

We tend to think the *Livingston Survey* is closer to the mark.

Value of Healthcare REITs

See Exhibit 8.

Also see statistics we compiled on Healthcare REITs in Appendix A.

ADDITIONAL INFORMATION

We compiled some additional information which we thought you might find useful/interesting on the performance of assisted living facility stocks and REITs in the first five months of 2009, which we attach as Appendix B. The trend in cap rates for 1994 through 2008 is presented in Appendix C. Transactions completed in January and February of 2009 are presented in Appendix D.