

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2016

Or

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

Commission File Number 000-52566

SUMMIT HEALTHCARE REIT, INC. AND SUBSIDIARIES  
(Exact name of registrant as specified in its charter)

MARYLAND  
(State or other jurisdiction of  
incorporation or organization)

73-1721791  
(I.R.S. Employer  
Identification No.)

2 SOUTH POINTE DRIVE, SUITE 100,  
LAKE FOREST, CA  
(Address of principal executive offices)

92630  
(Zip Code)

800-978-8136  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Sec.232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

|                         |  |                           |                                     |
|-------------------------|--|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/>   | Accelerated filer         | <input type="checkbox"/>            |
| Non-accelerated filer   | <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company | <input checked="" type="checkbox"/> |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).  Yes  No

As of August 10, 2016, we had 23,027,978 shares of common stock of Summit Healthcare REIT, Inc. outstanding.

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FORM 10-Q

SUMMIT HEALTHCARE REIT, INC. AND SUBSIDIARIES  
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**PART I — FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**SUMMIT HEALTHCARE REIT, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)**

|   | <b>June 30,<br/>2016</b> | <b>December 31,<br/>2015</b> |
|---|--------------------------|------------------------------|
| <b>ASSETS</b>   |                          |                              |
| Cash and cash equivalents   | \$ 9,579,000             | \$ 6,603,000                 |
| Restricted cash   | 4,721,000                | 4,822,000                    |
| Real estate properties, net   | 67,632,000               | 77,842,000                   |
| Notes receivable  | 4,817,000                | 4,833,000                    |
| Deferred costs and deposits   | 238,000                  | 140,000                      |
| Tenant and other receivables, net   | 4,264,000                | 3,813,000                    |
| Deferred leasing commissions, net   | 1,616,000                | 1,697,000                    |
| Other assets, net   | 404,000                  | 583,000                      |
| Equity-method investment  | 2,322,000                | 2,178,000                    |
| <b>Total assets</b>   | <b>\$ 95,593,000</b>     | <b>\$ 102,511,000</b>        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                          |                              |
| Accounts payable and accrued liabilities  | \$ 2,906,000             | \$ 2,883,000                 |
| Accrued salaries and benefits   | 267,000                  | 392,000                      |
| Security deposits   | 1,399,000                | 1,627,000                    |
| Loans payable, net of debt discounts  | 58,574,000               | 63,630,000                   |
| <b>Total liabilities</b>  | <b>63,146,000</b>        | <b>68,532,000</b>            |
| Commitments and contingencies   |                          |                              |
| Stockholders' Equity  |                          |                              |
| Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding at June 30, 2016 and December 31, 2015        | —                        | —                            |
| Common stock, \$0.001 par value; 290,000,000 shares authorized; 23,027,978 shares issued and outstanding at June 30, 2016 and December 31, 2015 | 23,000                   | 23,000                       |
| Additional paid-in capital  | 117,230,000              | 117,215,000                  |
| Accumulated deficit   | (85,525,000)             | (83,966,000)                 |
| <b>Total stockholders' equity</b>   | <b>31,728,000</b>        | <b>33,272,000</b>            |
| Noncontrolling interest   | 719,000                  | 707,000                      |
| <b>Total equity</b>   | <b>32,447,000</b>        | <b>33,979,000</b>            |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 95,593,000</b>     | <b>\$ 102,511,000</b>        |

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

**SUMMIT HEALTHCARE REIT, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)**

|   | <b>Three Months Ended June 30,</b> |                   | <b>Six months June 30,</b> |                       |
|---|------------------------------------|-------------------|----------------------------|-----------------------|
|   | <b>2016</b>                        | <b>2015</b>       | <b>2016</b>                | <b>2015</b>           |
| <b>Revenues:</b>  |                                    |                   |                            |                       |
| Rental revenues   | \$ 1,702,000                       | \$ 2,022,000      | \$ 3,544,000               | \$ 4,693,000          |
| Resident services and fee income  | 2,002,000                          | 2,307,000         | 4,145,000                  | 4,550,000             |
| Tenant reimbursements and other income  | 223,000                            | 262,000           | 448,000                    | 574,000               |
| Acquisition and asset management fees   | 78,000                             | 422,000           | 132,000                    | 422,000               |
| Interest income from notes receivable   | 45,000                             | 2,000             | 75,000                     | 4,000                 |
|   | <u>4,050,000</u>                   | <u>5,015,000</u>  | <u>8,344,000</u>           | <u>10,243,000</u>     |
| <b>Expenses:</b>  |                                    |                   |                            |                       |
| Property operating costs  | 443,000                            | 555,000           | 928,000                    | 1,130,000             |
| Resident services costs   | 1,760,000                          | 1,887,000         | 3,517,000                  | 3,624,000             |
| General and administrative  | 1,186,000                          | 1,133,000         | 2,113,000                  | 2,077,000             |
| Depreciation and amortization   | 920,000                            | 1,020,000         | 1,893,000                  | 2,265,000             |
|   | <u>4,309,000</u>                   | <u>4,595,000</u>  | <u>8,451,000</u>           | <u>9,096,000</u>      |
| Operating (loss) income   | (259,000)                          | 420,000           | (107,000)                  | 1,147,000             |
| Income from equity-method investee  | 53,000                             | 17,000            | 99,000                     | 17,000                |
| Other income  | 41,000                             | 8,000             | 72,000                     | 10,000                |
| Interest expense  | (774,000)                          | (856,000)         | (1,589,000)                | (1,939,000)           |
| Gain on disposition of real estate properties   | —                                  | 991,000           | —                          | 991,000               |
| (Loss) income from continuing operations  | (939,000)                          | 580,000           | (1,525,000)                | 226,000               |
| Loss from discontinued operations   | —                                  | —                 | —                          | (1,582,000)           |
| Net (loss) income   | (939,000)                          | 580,000           | (1,525,000)                | (1,356,000)           |
| Noncontrolling interests' share in income (losses)                                    | (17,000)                           | (39,000)          | (34,000)                   | (76,000)              |
| Net (loss) income applicable to common stockholders                                   | <u>\$ (956,000)</u>                | <u>\$ 541,000</u> | <u>\$ (1,559,000)</u>      | <u>\$ (1,432,000)</u> |
| <b>Basic and diluted (loss) income per common share:</b>                              |                                    |                   |                            |                       |
| Continuing operations applicable to common stockholders                               | \$ (0.04)                          | \$ 0.03           | \$ (0.07)                  | \$ 0.01               |
| Discontinued operations   | \$ —                               | \$ —              | \$ —                       | \$ (0.07)             |
| Net (loss) income applicable to common stockholders                                   | <u>\$ (0.04)</u>                   | <u>\$ 0.03</u>    | <u>\$ (0.07)</u>           | <u>\$ (0.06)</u>      |
| Weighted average shares used to calculate basic and diluted net loss per common share | 23,027,978                         | 23,028,014        | 23,027,978                 | 23,028,014            |

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

**SUMMIT HEALTHCARE REIT, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENT OF EQUITY**  
**For the Six Months Ended June 30, 2016**  
**(Unaudited)**

|  | <u>Common Stock</u>             |   |   | <u>Accumulated<br/>Deficit</u> | <u>Total<br/>Stockholders'<br/>Equity</u> | <u>Noncontrolling<br/>Interests</u> | <u>Total<br/>Equity</u> |
|--|---------------------------------|---|---|--------------------------------|---|-------------------------------------|-------------------------|
|  | <u>Number<br/>of<br/>Shares</u> | <u>Common<br/>Stock<br/>Par<br/>Value</u> | <u>Additional<br/>Paid-In<br/>Capital</u> |                                |   |                                     |                         |
| <b>Balance — January 1, 2016</b>               | <b>23,027,978</b>               | <b>\$ 23,000</b>                          | <b>\$ 117,215,000</b>                     | <b>\$ (83,966,000)</b>         | <b>\$ 33,272,000</b>                      | <b>\$ 707,000</b>                   | <b>\$ 33,979,000</b>    |
| Stock-based compensation                       | —                               | —   | 15,000                                    | —                              | 15,000                                    | —                                   | 15,000                  |
| Distributions paid to noncontrolling interests | —                               | —   | —   | —                              | —   | (22,000)                            | (22,000)                |
| Net (loss) income                              | —                               | —   | —   | (1,559,000)                    | (1,559,000)                               | 34,000                              | (1,525,000)             |
| <b>Balance — June 30, 2016</b>                 | <b>23,027,978</b>               | <b>\$ 23,000</b>                          | <b>\$ 117,230,000</b>                     | <b>\$ (85,525,000)</b>         | <b>\$ 31,728,000</b>                      | <b>\$ 719,000</b>                   | <b>\$ 32,447,000</b>    |

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

**SUMMIT HEALTHCARE REIT, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

|  | <b>Six Months Ended June 30,</b> |                      |
|--|----------------------------------|----------------------|
|  | <b>2016</b>                      | <b>2015</b>          |
| <b>Cash flows from operating activities:</b>   |                                  |                      |
| Net loss   | \$ (1,525,000)                   | \$ (1,356,000)       |
| Adjustments to reconcile net loss to net cash and cash equivalents provided by operating activities: |                                  |                      |
| Amortization of debt discounts   | 69,000                           | 130,000              |
| Depreciation and amortization  | 1,893,000                        | 2,265,000            |
| Straight-line rents  | (329,000)                        | (591,000)            |
| Bad debt expense   | 48,000                           | 110,000              |
| Stock-based compensation expense   | 15,000                           | —                    |
| Gain on disposition of real estate properties  | —                                | (991,000)            |
| Loss on disposition of VIE   | —                                | 1,582,000            |
| Income from equity-method investee   | (99,000)                         | (17,000)             |
| Change in operating assets and liabilities:  |                                  |                      |
| Restricted cash  | (83,000)                         | (126,000)            |
| Tenant and other receivables, net  | 134,000                          | (216,000)            |
| Prepaid and other assets   | (13,000)                         | 144,000              |
| Accounts payable and accrued liabilities   | 511,000                          | 437,000              |
| Accrued salaries and benefits  | (124,000)                        | (125,000)            |
| <b>Net cash and cash equivalents provided by operating activities</b>                                | <b>497,000</b>                   | <b>1,246,000</b>     |
| <b>Cash flows from investing activities</b>  |                                  |                      |
| Restricted cash  | 288,000                          | (156,000)            |
| Deferred costs and deposits  | (98,000)                         | (350,000)            |
| Real estate acquisitions and capitalized costs   | —                                | (14,300,000)         |
| Real estate improvements   | (133,000)                        | (68,000)             |
| Proceeds from contribution of properties, net of cash and restricted cash contributed                | 2,814,000                        | 9,351,000            |
| Investment in equity-method investee   | (62,000)                         | (62,000)             |
| Distributions received from equity-method investee   | 114,000                          | —                    |
| Payments from note receivable  | 16,000                           | 15,000               |
| <b>Net cash and cash equivalents provided by (used in) investing activities</b>                      | <b>2,939,000</b>                 | <b>(5,570,000)</b>   |
| <b>Cash flows from financing activities:</b>   |                                  |                      |
| Proceeds from issuance of loans payable  | —                                | 11,440,000           |
| Payments of loans payable  | (472,000)                        | (1,063,000)          |
| Security deposit   | —                                | 99,000               |
| Distributions paid to non-controlling interests  | (22,000)                         | (63,000)             |
| Financing costs  | 34,000                           | (114,000)            |
| <b>Net cash and cash equivalents (used in) provided by financing activities</b>                      | <b>(460,000)</b>                 | <b>10,299,000</b>    |
| Net increase in cash and cash equivalents  | 2,976,000                        | 5,975,000            |
| Cash and cash equivalents - beginning of period  | 6,603,000                        | 4,405,000            |
| Cash and cash equivalents - end of period  | <u>\$ 9,579,000</u>              | <u>\$ 10,380,000</u> |

**Supplemental disclosure of cash flow information:**

|                        |              |              |
|------------------------|--------------|--------------|
| Cash paid for interest | \$ 1,493,000 | \$ 1,773,000 |
|------------------------|--------------|--------------|

**Supplemental disclosure of non-cash investing and financing activities:**

In January 2015, the Company sold its interests in Sherburne Commons for a note receivable for \$5.0 million due in December 2017 (see Note 6).

In January 2015, \$207,000 of deferred costs were reclassified to real estate acquisitions.

In April 2015, the Company contributed six properties to its 10%-owned SUL JV (see Note 11). This transaction had the following effect on the Company's 2015 condensed consolidated balance sheet:

|                            |                     |
|----------------------------|---------------------|
| Real estate properties     | \$ (40,391,000)     |
| Other assets               | (832,000)           |
| Loans payable, net         | 30,133,000          |
| Other liabilities          | 1,182,000           |
| <b>Total contribution:</b> | <b>\$ 9,908,000</b> |

During the six months ended June 30, 2016, the Company recorded approximately \$262,000 of distributions receivable from the SUL JV.

In April 2016, the Company contributed one property to its 10%-owned SUL JV (see Note 11). This transaction had the following effect on the Company's 2016 condensed consolidated balance sheet:

|                        |                |
|------------------------|----------------|
| Real estate properties | \$ (8,536,000) |
| Other assets           | (677,000)      |

|                     |                     |
|---------------------|---------------------|
| Loans payable, net  | 4,685,000           |
| Other liabilities   | 601,000             |
| Total contribution: | <u>\$ 3,927,000</u> |

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

**SUMMIT HEALTHCARE REIT, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**JUNE 30, 2016**  
**(Unaudited)**

**1. Organization**

Summit Healthcare REIT, Inc. (“Summit”) is a real estate investment trust that owns 100% of five properties, 95% of six properties and a 10% equity interest in an investment that holds 15 properties. Summit is a Maryland corporation, formed in 2004 under the General Corporation Law of Maryland for the purpose of engaging in the business of investing in and owning real estate. As used in these notes, the “Company”, “we”, “us” and “our” refer to Summit and its consolidated subsidiaries, except where the context otherwise requires.

Generally, we conduct substantially all of our operations through Summit Healthcare Operating Partnership, L.P. (the “Operating Partnership”), which is a Delaware limited partnership. As of June 30, 2016, we own a 99.88% general partner interest in the Operating Partnership, and Cornerstone Realty Advisors, LLC (“CRA”), owns a 0.12% limited partnership interest. Our financial statements and the financial statements of the Operating Partnership are consolidated in the accompanying condensed consolidated financial statements.

***Cornerstone Healthcare Partners LLC***

We own 95% of Cornerstone Healthcare Partners LLC (“CHP LLC”), which was formed in 2012, and the remaining 5% non-controlling interest is owned by Cornerstone Healthcare Real Estate Fund, Inc. (“CHREF”), an affiliate of CRA. CHP LLC is consolidated with our financial statements and owns six properties (the “JV Properties”).

As of June 30, 2016, we own a 95.3% interest in five of the JV Properties, and CHREF owns a 4.7% interest. We continue to own a 95% interest in the sixth JV Property, and CHREF owns a 5% interest.

***Friendswood TRS***

Friendswood TRS (“Friendswood TRS”) is our wholly-owned, taxable REIT subsidiary (“TRS”), which is the licensed operator and tenant of Friendship Haven Healthcare and Rehabilitation Center (“Friendship Haven”) (see Note 3).

***Summit Union Life Holdings, LLC***

On April 29, 2015, through our Operating Partnership, we entered into a limited liability company agreement (as such agreement may be amended from time to time, the “SUL LLC Agreement”) with Best Years, LLC (“Best Years”), an unrelated entity and a U.S.-based affiliate of Union Life Insurance Co, Ltd. (a Chinese corporation), and formed Summit Union Life Holdings, LLC (“SUL JV”). The SUL JV is not consolidated in our condensed consolidated financial statements and is accounted for under the equity-method in the Company’s condensed consolidated financial statements (see Note 5). As of June 30, 2016 and December 31, 2015, we have a 10% interest in the SUL JV. As of June 30, 2016, the SUL JV owned 15 properties and as of December 31, 2015, the SUL JV owned 14 properties.

***Summit Healthcare Asset Management, LLC (TRS)***

Summit Healthcare Asset Management, LLC is our wholly-owned TRS (“SAM TRS”). We serve as the manager (“Manager”) of the SUL JV and provide management services in exchange for fees and reimbursements. All acquisition fees and asset management fees earned by us will be paid to SAM TRS and expenses incurred by us, as the Manager, will be reimbursed from SAM TRS. See Notes 5 and 7 for further information.

## 2. Summary of Significant Accounting Policies

For more information regarding our significant accounting policies and estimates, please refer to “Summary of Significant Accounting Policies” contained in our Annual Report on Form 10-K for the year ended December 31, 2015 filed with the Securities and Exchange Commission (“SEC”) on March 18, 2016. There have been no material changes to our policies since that filing, except as noted below under Recently Adopted Accounting Pronouncements.

The accompanying condensed consolidated balance sheet at December 31, 2015 has been derived from the audited consolidated financial statements at that date. We assume that users of these condensed consolidated financial statements have read or have access to the audited December 31, 2015 consolidated financial statements and Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2015 filed with the SEC on March 18, 2016 and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnotes and other disclosures which would substantially duplicate those contained in our most recent Annual Report on Form 10-K for the year ended December 31, 2015 have been omitted in this report.

### ***Principles of Consolidation and Basis of Presentation***

The accompanying condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries, and CHP LLC (of which the Company owns 95%). All intercompany accounts and transactions have been eliminated in consolidation.

The accompanying financial information reflects all adjustments, which are, in the opinion of management, of a normal recurring nature and necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods. Interim results of operations are not necessarily indicative of the results to be expected for the full year. Operating results for the six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

### ***Recently Adopted Accounting Pronouncements***

On January 1, 2016, the Company adopted the Financial Accounting Standards Board (“FASB”) Accounting Standards Update (“ASU”) No. 2015-03, *Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. The amendments in this ASU require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The Company’s condensed consolidated balance sheet as of December 31, 2015 has been retroactively restated for the effect of adopting this ASU, which resulted in a decrease to total assets of approximately \$1.3 million and a decrease in loans payable, net of debt discounts, and total liabilities of approximately \$1.3 million.

### ***Recently Issued Accounting Pronouncements***

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* (“ASU 2016-13”). ASU 2016-13 requires that a financial asset (or a group of financial assets) measured at amortized cost basis be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset. The amendments in ASU 2016-13 are an improvement because they eliminate the probable initial recognition threshold in current GAAP and, instead, reflect an entity’s current estimate of all expected credit losses. Previously, when credit losses were measured under GAAP, an entity generally only considered past events and current conditions in measuring the incurred loss. ASU 2016-13 is effective for fiscal years and interim periods within those years beginning after December 15, 2019, with early adoption permitted as of the fiscal years beginning after December 15, 2018. An entity will apply the amendments in this update through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (that is, a modified-retrospective approach). The Company is currently evaluating the impact this guidance will have on its condensed consolidated financial statements when adopted.

The FASB has issued ASU No. 2016-09, *Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. The amendments are intended to improve the accounting for employee share-based payments and affect all organizations that issue share-based payment awards to their employees.

Several aspects of the accounting for share-based payment award transactions are simplified, including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows.

For public companies, the amendments are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for any organization in any interim or annual period. We are currently evaluating the impact of our pending adoption of the new standard on our condensed consolidated financial statements.

The FASB has issued ASU No. 2016-07, *Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*. The amendments affect all entities that have an investment that becomes qualified for the equity method of accounting as a result of an increase in the level of ownership interest or degree of influence.

The amendments eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required.

The amendments require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method.

The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Earlier application is permitted. The Company has evaluated the impact of this new standard and does not expect it to have a significant effect on the condensed consolidated financial statements, when adopted.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*. The new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessors for sales-type, direct financing, and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. We are currently evaluating the impact of our pending adoption of the new standard on our condensed consolidated financial statements.

The FASB has issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*. In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. Public business entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. We are currently evaluating the impact of our pending adoption of ASU 2014-09 on our condensed consolidated financial statements which we will adopt in 2018.

### Reclassifications

Certain amounts in the Company's condensed consolidated financial statements for prior periods have been reclassified to conform to the current period presentation. Based on the intended use of the restricted cash, we have classified changes in restricted cash within the statements of cash flows as operating and investing activities and the prior period presentation has been revised to conform to this classification. These reclassifications had no effect on previously reported results of operations. Additionally, see Recently Adopted Accounting Pronouncements above.

### 3. Investments in Real Estate Properties

As of June 30, 2016 and December 31, 2015, our investments in real estate properties, including those acquired through our subsidiaries and CHP, LLC, but excluding properties contributed to and owned by the SUL JV, were as follows:

|                                 | <b>June 30, 2016</b> | <b>December 31, 2015</b> |
|---------------------------------|----------------------|--------------------------|
| Land                            | \$ 6,502,000         | \$ 6,932,000             |
| Buildings and improvements      | 65,559,000           | 73,181,000               |
| Less: accumulated depreciation  | (6,865,000)          | (5,842,000)              |
| Buildings and improvements, net | 58,694,000           | 67,339,000               |
| Furniture and fixtures          | 6,589,000            | 7,086,000                |
| Less: accumulated depreciation  | (4,153,000)          | (3,515,000)              |
| Furniture and fixtures, net     | 2,436,000            | 3,571,000                |
| Real estate properties, net     | \$ 67,632,000        | \$ 77,842,000            |

During the three months ended June 30, 2016 and 2015, depreciation and amortization expense was approximately \$0.9 million and \$1.0 million, respectively. During the six months ended June 30, 2016 and 2015, depreciation and amortization expense was approximately \$1.8 million and \$2.2 million, respectively.

As of June 30, 2016, our portfolio consisted of 11 properties which were 100% leased to the tenants of the related facilities. The following table provides summary information regarding our properties as of June 30, 2016:

| Property   | Location             | Date Purchased     | Type <sup>(2)</sup> | Purchase Price       | Loans Payable, excluding debt discounts | Number of Beds |
|--|----------------------|--------------------|---------------------|----------------------|---|----------------|
| Sheridan Care Center   | Sheridan, OR         | August 3, 2012     | SNF                 | \$ 4,100,000         | \$ 4,983,000                            | 51             |
| Fernhill Care Center   | Portland, OR         | August 3, 2012     | SNF                 | 4,500,000            | 4,371,000                               | 63             |
| Farmington Square  | Medford, OR          | September 14, 2012 | AL/MC               | 8,500,000            | 6,717,000                               | 71             |
| Friendship Haven Healthcare and Rehabilitation Center <sup>(1)</sup> | Galveston County, TX | September 14, 2012 | SNF                 | 15,000,000           | 7,000,000                               | 150            |
| Pacific Health and Rehabilitation Center                             | Tigard, OR           | December 24, 2012  | SNF                 | 8,140,000            | 7,287,000                               | 73             |
| Danby House  | Winston-Salem, NC    | January 31, 2013   | AL/MC               | 9,700,000            | 7,812,000                               | 100            |
| Brookstone of Aledo  | Aledo, IL            | July 2, 2013       | AL                  | 8,625,000            | 7,380,000                               | 66             |
| The Shelby House   | Shelby, NC           | October 4, 2013    | AL                  | 4,500,000            | 4,833,000                               | 72             |
| The Hamlet House   | Hamlet, NC           | October 4, 2013    | AL                  | 6,500,000            | 4,084,000                               | 60             |
| The Carteret House   | Newport, NC          | October 4, 2013    | AL                  | 4,300,000            | 3,445,000                               | 64             |
| Sundial Assisted Living  | Redding, CA          | December 18, 2013  | AL                  | 3,500,000            | 2,800,000                               | 65             |
| <b>Total:</b>  |                      |                    |                     | <u>\$ 77,365,000</u> | <u>\$ 60,712,000</u>                    | <u>835</u>     |

(1) We terminated the lease with the tenant of this facility on March 16, 2014 and became the licensed operator and tenant of the facility on May 1, 2014 (Friendswood TRS). Upon becoming the licensed operator and tenant of the facility, we entered into a two-year management agreement with an affiliate of Stonegate Senior Living (“Stonegate”), whereby Stonegate will receive a management fee equal to 6% of the adjusted gross revenues as defined, from operations of the facility. In October 2015, we amended the management agreement with Stonegate to increase the term from two years to 12 years (see Note 10).

(2) SNF is an abbreviation for skilled nursing facility.  
AL is an abbreviation for assisted living facility.  
MC is an abbreviation for memory care facility.

#### **Future Minimum Lease Payments**

The future minimum lease payments to be received under existing operating leases for properties owned as of June 30, 2016 are as follows <sup>(1)</sup>:

| <b>Years ending December 31,</b>  |                      |
|-----------------------------------|----------------------|
| July 1, 2016 to December 31, 2016 | \$ 2,985,000         |
| 2017                              | 6,073,000            |
| 2018                              | 6,208,000            |
| 2019                              | 6,346,000            |
| 2020                              | 6,487,000            |
| Thereafter                        | 46,453,000           |
|                                   | <u>\$ 74,552,000</u> |

(1) This schedule does not reflect future rental revenues from the potential renewal or replacement of existing and future leases, tenant reimbursements, and the rental revenues for the tenant (Friendswood TRS) of Friendship Haven.

## *Acquisitions - 2015*

### **Front Royal, Virginia**

On January 23, 2015, we acquired an 84-bed assisted living facility in Front Royal, Virginia (“Loving Arms”) for a total purchase price of \$14.3 million, which was funded through cash on hand plus a collateralized loan. Loving Arms is leased under a 15-year triple net lease.

Loving Arms was contributed to SUL JV in April 2015 (see Notes 5 and 11 under JV 2 Properties).

### **Wisconsin Properties**

On November 3, 2015, through wholly-owned subsidiaries, we acquired four separate assisted living facilities in Wisconsin (“Cottage Properties”) for an aggregate purchase price of \$18.4 million, which was funded through cash on hand plus the proceeds from a collateralized loan. The Cottage Properties are leased under 12-year triple net leases.

The Cottage Properties were contributed to SUL JV in December 2015 (see Notes 5 and 11).

### **Littleton, New Hampshire**

On November 17, 2015, through a wholly-owned subsidiary, we acquired Riverglen House, a 59-bed assisted living facility located in Littleton, New Hampshire, (“Riverglen”) for a purchase price of \$8.5 million, which was funded through cash on hand plus the proceeds from the loan assumed and described in Note 4 under Housing and Healthcare Finance, LLC (“HHF”). Riverglen is leased pursuant to a 15-year triple net lease.

On February 29, 2016, we received an executed commitment from Best Years, our SUL JV partner, of its intent to participate in the contribution of Riverglen to the SUL JV. On April 28, 2016, we completed the process of executing a modified transfer of physical assets (“TPA”) agreement for the loan agreement with HHF (see Note 4), a U.S. Department of Housing and Urban Development (“HUD”) insured loan. We legally could not complete the contribution of Riverglen to the SUL JV until we received approval from HUD and then the TPA process was completed.

As of April 29, 2016, Riverglen is no longer consolidated in our condensed consolidated financial statements (see Note 11).

### ***Leasing Commissions***

Leasing commissions paid to CRA prior to termination of our advisory agreement with CRA on April 1, 2014 are capitalized at cost and amortized on a straight-line basis over the related lease term. As of June 30, 2016 and December 31, 2015, total costs incurred were \$2.2 million and the unamortized balance of capitalized leasing commissions was approximately \$1.6 million. Amortization expense for the three months ended June 30, 2016 and 2015 was \$41,000 and \$41,000, respectively. Amortization expense for the six months ended June 30, 2016 and 2015 was \$81,000 and \$81,000, respectively.

## **4. Loans Payable**

In April 2015, we formed the SUL JV with Best Years and contributed six properties (“JV 2 Properties”) to the SUL JV. As part of the contribution of the JV 2 Properties, approximately \$30.4 million of loans payable were transferred to the SUL JV upon disposition of the JV 2 Properties (approximately \$10.6 million from GE Capital Corporation and \$19.8 million from The PrivateBank and Trust Company). In April 2016, we contributed Riverglen, including the related loan payable of approximately \$4.7 million, to the SUL JV. See Notes 5 and 11 for further information regarding the contribution and disposition of real estate properties.

As of June 30, 2016 and December 31, 2015, loans payable consisted of the following:

|  | <u>June 30, 2016</u> | <u>December 31, 2015</u> |
|--|----------------------|--------------------------|
| Loan payable to Healthcare Financial Solutions, LLC (formerly GE Capital) in monthly installments of approximately \$11,000, including interest at LIBOR (floor of 0.50%) plus 4.0% (4.6% and 4.5% at June 30, 2016 and December 31, 2015, respectively), due in October 2018, and as of June 30, 2016 and December 31, 2015, collateralized by Sundial Assisted Living.               | \$ 2,800,000         | \$ 2,800,000             |
| Loan payable to Oxford Finance, LLC in monthly installments of approximately \$42,000, including interest at LIBOR (floor of 0.75%) plus 6.50% (7.25% as of June 30, 2016 and December 31, 2015) due in October 2019, collateralized by Friendship Haven.  | 7,000,000            | 7,000,000                |
| Loan payable to HHF (insured by HUD) in monthly installments of approximately \$21,000, including interest, at fixed interest rate of 4.25% due in April 2054, collateralized by Riverglen.  | -                    | \$ 4,728,000             |
| Loans payable to Lancaster Pollard (insured by HUD) in monthly installments of approximately \$238,000, including interest, ranging from a fixed rate of 3.70% to 3.78%, due in September 2039 through January 2051, and as of June 30, 2016 and December 31, 2015 collateralized by Sheridan, Fernhill, Pacific Health, Farmington Square, Shelby, Hamlet, Carteret, Aledo and Danby. | 50,912,000           | 51,372,000               |
|  | <b>60,712,000</b>    | <b>65,900,000</b>        |
|  | <b>(2,138,000)</b>   | <b>(2,270,000)</b>       |
| <b>Less debt discounts</b>   |                      |                          |
| <b>Total loans payable</b>   | <b>\$ 58,574,000</b> | <b>\$ 63,630,000</b>     |

We have total debt obligations of approximately \$60.7 million that will mature between 2018 and 2051. See Note 3 for loans payable balance for each property.

In connection with our loans payable, we incurred debt issuance costs. The unamortized balance of the debt discounts totals \$2.1 million and \$2.3 million, as of June 30, 2016 and December 31, 2015 (retrospectively reclassified as of January 1, 2016 – see Note 2), respectively. These debt discounts are being amortized over the life of their respective financing agreements using the straight-line basis which approximates the effective interest rate method. For the three months ended June 30, 2016 and 2015, \$34,000 and \$56,000, respectively, of debt discounts were amortized and included in interest expense in our condensed consolidated statements of operations. For the six months ended June 30, 2016 and 2015, \$69,000 and \$130,000, respectively, of debt discounts were amortized and included in interest expense in our condensed consolidated statements of operations.

During the three months ended June 30, 2016 and 2015, we incurred approximately \$0.8 million and \$0.9 million, respectively, of interest expense related to our loans payable. During the six months ended June 30, 2016 and 2015, we incurred approximately \$1.6 million and \$1.9 million, respectively, of interest expense related to our loans payable.

The principal payments due on the loans payable (excluding debt discounts) for the period from July 1, 2016 to December 31, 2016 and for each of the four following years and thereafter ending December 31 are as follows:

| <b>Year</b>                       | <b>Principal Amount</b> |
|-----------------------------------|-------------------------|
| July 1, 2016 to December 31, 2016 | \$ 495,000              |
| 2017                              | 1,132,000               |
| 2018                              | 3,879,000               |
| 2019                              | 7,846,000               |
| 2020                              | 1,104,000               |
| Thereafter                        | 46,256,000              |
|                                   | <b>\$ 60,712,000</b>    |

### **Healthcare Financial Solutions, LLC (formerly known as GE Capital Corporation (“GE”))**

On October 6, 2015, we refinanced our existing GE loan for the Friendship Haven facility with a secured term loan agreement with Oxford Finance, LLC (“Oxford”) (see below for further information – Oxford Finance, LLC) and the funds received were used to pay off the outstanding principal balance for this property.

On October 6, 2015, we refinanced our existing GE loan for the Brookstone of Aledo facility with Lancaster Pollard (see below for further information – Lancaster Pollard) and the funds received were used to pay off the outstanding principal balance for this property.

On October 30, 2015, the GE loan agreement for the Sundial Assisted Living property located in Redding was amended and restated. The amended loan is with Healthcare Financial Solutions, LLC (“HFS (formerly GE). The loan is interest only through January 2017 and then the loan payments increase to approximately \$15,000 a month, including interest.

### **The PrivateBank and Trust Company (“PrivateBank”)**

On December 21, 2015, we refinanced our existing loan for the Danby House facility with Lancaster Pollard (see below for further information – Lancaster Pollard) and the funds received were used to pay off the outstanding principal balance for this property.

As of December 31, 2015, we had no borrowings under the PrivateBank loans.

### **Lancaster Pollard Mortgage Company, LLC**

In 2015 and 2014, we refinanced certain properties with HUD insured loans from the Lancaster Pollard Mortgage Company, LLC (“Lancaster Pollard”). See table above for further information. HUD requires that our lender hold certain reserves for property tax, insurance, and capital expenditures. These reserves are included in restricted cash on our condensed consolidated balance sheets.

### **Oxford Finance, LLC**

On October 6, 2015, we refinanced our existing GE loan for the Friendship Haven facility with a secured term loan agreement with Oxford. The loan is interest only through October 2016 and then the loan payments increase to approximately \$51,000 a month, including interest.

### **Housing and Healthcare Finance, LLC (“HHF”)**

On November 17, 2015, in conjunction with the purchase of Riverglen (see Note 3), we entered into a Modification, Release, and Assumption Agreement with HHF and assumed the outstanding HUD insured loan. On April 29, 2016, Riverglen was contributed to the SUL JV (see Notes 3, 5 and 11).

## **5. Equity-Method Investment**

In April 2015, we formed the SUL JV, which is owned 10% by the Operating Partnership and 90% by Best Years. The SUL JV will continue until an event of dissolution occurs, as defined in the SUL LLC Agreement. We account for our investment using the equity-method.

In conjunction with the formation of the SUL JV, the Operating Partnership contributed to the SUL JV all of the JV 2 Properties (see Note 11). This contribution increased our equity-method investment by approximately \$1.0 million.

The Operating Partnership recorded a receivable for approximately \$362,000 for distributions that could not be paid prior to the contribution of the JV 2 Properties due to cash restrictions related to the loans payable for the contributed JV 2 Properties. As of June 30, 2016 and December 31, 2015, the receivable of \$362,000 and due from the JV 2 Properties, is included in tenant and other receivables on our condensed consolidated balance sheets.

In October 2015, the SUL JV acquired four additional properties located in Texas which increased our equity-method investment by approximately \$0.8 million.

On December 24, 2015, we contributed the Cottage Properties, which we had acquired in November 2015, to the SUL JV (see Notes 3, 4 and 11). This contribution increased our equity-method investment by approximately \$0.5 million.

On April 29, 2016, we contributed Riverglen located in Littleton, New Hampshire (see Note 3) to the SUL JV. This contribution resulted in the SUL JV owning Riverglen and, therefore, Riverglen is no longer consolidated in our condensed consolidated financial statements as of April 29, 2016. The aggregate net value of Riverglen at the date of the contribution was approximately \$3.9 million, which approximated the Operating Partnership's carrying value on the date of contribution (total assets were approximately \$9.2 million less liabilities of approximately \$5.3 million, which included approximately \$4.7 million in a HUD insured loan payable (see Note 4)). Concurrent with the contribution of Riverglen, Best Years contributed cash to the SUL JV in the amount of approximately \$3.4 million and the Operating Partnership received cash of approximately \$3.4 million from the SUL JV, not including approximately \$0.2 million we had received in 2015 for reimbursed acquisition costs related to Riverglen. This contribution increased our equity-method investment by approximately \$0.3 million.

Under the SUL LLC Agreement, as amended, net operating cash flow of the SUL JV will be distributed monthly, first to the Operating Partnership and Best Years *pari passu* up to a 9% to 10% annual return, as defined, and thereafter to Best Years 75% and the Operating Partnership 25%. All capital proceeds from the sale of the properties held by the SUL JV, a refinancing or another capital event) will be paid first to the Operating Partnership and Best Years *pari passu* until each has received an amount equal to its accrued but unpaid 9% to 10% return plus its total contribution, and thereafter to Best Years 75% and the Operating Partnership 25%.

As of June 30, 2016 and December 31, 2015, the Operating Partnership has recorded distributions receivable from the SUL JV of approximately \$262,000 and \$179,000, respectively. This is included in tenant and other receivables on our condensed consolidated balance sheets. For the six months ended June 30, 2016, we received approximately \$213,000 in cash distributions, of which \$99,000 is included in our cash flows from operating activities in tenant and other receivables and \$114,000 is included in our cash flows from investing activities.

We serve as the manager of the SUL JV and provide management services in exchange for fees and reimbursements (see Note 7). Total acquisition and asset management fees earned in connection with the SUL JV were approximately \$78,000 and \$0.4 million for the three months ended June 30, 2016 and 2015, respectively, and are included in acquisition and asset management fees in the condensed consolidated statements of operations. Total acquisition and asset management fees earned in connection with the SUL JV were approximately \$0.1 million and \$0.4 million for the six months ended June 30, 2016 and 2015, respectively, and are included in acquisition and asset management fees in the condensed consolidated statements of operations.

As of June 30, 2016 and December 31, 2015, the balance of our equity-method investment was approximately \$2.3 million and \$2.2 million, respectively.

## **6. Receivables**

### **Notes Receivable**

#### ***Fernhill Note***

In September 2014, we loaned approximately \$140,000 to the operator of the Fernhill facility for certain property improvements at a fixed rate of interest of 6% payable in monthly installments through January 2019. As of June 30, 2016 and December 31, 2015, the balance on the note was approximately \$0.1 million.

## Nantucket Note - Sale of VIE

On January 7, 2015, through our Operating Partnership, we sold Sherburne Commons to an unaffiliated third party buyer to The Residences at Sherburne Commons, Inc. ("Sherburne Buyer"), an unaffiliated Massachusetts non-profit corporation, in exchange for \$5.0 million, as evidenced by a purchase money note from Sherburne Buyer to us as the lender. During January 2015, we recorded a loss on disposition of approximately \$1.7 million related to this previously consolidated VIE, which is included in loss on discontinued operations on the condensed consolidated statements of operations.

The \$5.0 million purchase money note is collateralized by the Sherburne Commons property, bears an annual interest rate of 3.5% and matures on December 31, 2017. Interest payments on the note are due monthly and are recorded as payments are received. Outstanding and unpaid principal due shall be paid from the net proceeds payable to Sherburne Buyer from the sale of the residential cottages in Sherburne Commons. We may also participate in additional interest of up to \$1 million from 50% of the net proceeds of cottage sales through December 31, 2018.

As of June 30, 2016, we have not collected any funds related to the principal on the note and the balance on the note receivable was \$4.7 million. For the three months ended June 30, 2016 and 2015, we received interest payments from the note of approximately \$42,000 and \$0, which is recorded as interest income from notes receivable in our condensed consolidated statements of operations. For the six months ended June 30, 2016 and 2015, we received interest payments from the note of approximately \$72,000 and \$0, which is recorded as interest income from notes receivable in our condensed consolidated statements of operations.

### Tenant and Other Receivables, net

Tenant and other receivables, net consists of:

|   | June 30,<br>2016    | December 31,<br>2015 |
|---|---------------------|----------------------|
| Accounts receivable from resident services, net of allowance for doubtful accounts of \$314,000 and \$309,000, respectively | \$ 958,000          | \$ 1,002,000         |
| Straight-line rent receivables  | 2,412,000           | 2,143,000            |
| Distribution receivables  | 624,000             | 581,000              |
| Other receivables   | 270,000             | 87,000               |
| Total   | <u>\$ 4,264,000</u> | <u>\$ 3,813,000</u>  |

## 7. Related Party Transactions

### CRA

Prior to the termination of our advisory agreement on April 1, 2014 with CRA (our former advisor, a related party), we incurred costs related to fees paid and costs reimbursed for services rendered to us by CRA through March 31, 2014. Some of the fees we had paid to CRA were considered to be in excess of allowed amounts and, therefore, CRA was required to reimburse us for the amount of the excess costs we paid to them. The fees and expense reimbursements payable to CRA under our advisory agreement are described in more detail in our Annual Report filed on Form 10-K for the year ended December 31, 2015 filed with the SEC on March 18, 2016. As of June 30, 2016 and December 31, 2015, the receivables from CRA are fully reserved due to the uncertainty of collectability and are included in tenant and other receivables in our condensed consolidated balance sheets.

As of June 30, 2016 and December 31, 2015, we had the following receivables and reserves:

|  | Receivables         | Reserves              | Balance     |
|--|---------------------|-----------------------|-------------|
| Organizational and offering costs        | \$ 738,000          | \$ (738,000)          | \$ -        |
| Asset management fees and expenses       | 32,000              | (32,000)              | -           |
| Operating expenses (direct and indirect) | 189,000             | (189,000)             | -           |
| Operating expenses (2%/25% Test)         | 1,717,000           | (1,717,000)           | -           |
| Total Real Estate Properties             | <u>\$ 2,676,000</u> | <u>\$ (2,676,000)</u> | <u>\$ -</u> |

See Note 5 for further discussion of distributions and acquisition and asset management fees related to the SUL JV.

### **8. Concentration of Risk**

Our cash is generally invested in investment-grade short-term instruments. As of June 30, 2016, we had cash and cash equivalent accounts in excess of FDIC-insured limits. However, we do not believe the risk associated with this excess is significant.

As of June 30, 2016, we owned one property in California, four properties in Oregon, four properties in North Carolina, one property in Texas, and one property in Illinois. Accordingly, there is a geographic concentration of risk subject to economic conditions in certain states.

Additionally, for the three months ended June 30, 2016, we leased our 11 healthcare properties to five different tenants under long-term triple net leases, two of which comprise 49% and 29% percent of our tenant rental revenue. For the three months ended June 30, 2015, we leased our 11 healthcare properties to seven different tenants under long-term triple net leases, two of which comprise 29% and 23% of our tenant rental revenue. For the six months ended June 30, 2016, we leased our 11 healthcare properties to five different tenants under long-term triple net leases, two of which comprise 47% and 27% percent of our tenant rental revenue. For the six months ended June 30, 2015, we leased our 11 healthcare properties to seven different tenants under long-term triple net leases, two of which comprise 29% and 23% of our tenant rental revenue.

As of June 30, 2016 and December 31, 2015, we have one tenant that constitutes a significant asset concentration, as the net assets of the tenant exceeds 20% of our total assets as of December 31, 2015.

### **9. Fair Value Measurements of Financial Instruments**

Our condensed consolidated balance sheets include the following financial instruments: cash and cash equivalents, restricted cash, notes receivable (except as noted below), deferred costs and deposits, tenant and other receivables, deferred leasing commissions, certain other assets, accounts payable and accrued liabilities, accrued salaries and benefits, security deposits and loans payable. With the exception of the Nantucket note receivable (see Note 6) and loans payable discussed below, we consider the carrying values to approximate fair value for such financial instruments because of the short period of time between origination of the instruments and their expected payment.

As of June 30, 2016 and December 31, 2015, the fair value of the Nantucket note receivable (see Note 6) was \$4.9 million compared to the carrying value of \$4.7 million. The fair value of the note receivable was estimated based on cash flow analysis at an assumed market rate of interest. As the inputs to our valuation estimate are neither observable in nor supported by market activity, our notes receivable are classified as Level 3 assets within the fair value hierarchy.

As of June 30, 2016 and December 31, 2015, the fair value of loans payable was \$61.7 million and \$67.3 million compared to the carrying value of \$60.7 million and \$65.9 million, respectively. The fair value of loans payable is estimated using lending rates available to us for financial instruments with similar terms and maturities. To estimate fair value as of June 30, 2016, we utilized a discount rate ranging from 4.4% to 7.3% and a weighted-average discount rate of 4.7%. As the inputs to our valuation estimate are neither observable in nor supported by market activity, our loans payable are classified as Level 3 assets within the fair value hierarchy.

As a result of our ongoing analysis for potential impairment of our investments in real estate, we may be required to adjust the carrying value of certain assets to their estimated fair values, or estimated fair value less selling costs, under certain circumstances. No impairments were recorded during the three and six months ended June 30, 2016 and 2015.

At June 30, 2016 and December 31, 2015, we do not have any financial assets or financial liabilities that are measured at fair value on a recurring basis in our condensed consolidated financial statements.

## **10. Commitments and Contingencies**

We inspect our properties for the presence of hazardous or toxic substances. While there can be no assurance that a material environmental liability does not exist, we are not currently aware of any environmental liability with respect to the properties that would have a material effect on our consolidated financial condition, results of operations and cash flows. Further, we are not aware of any environmental liability or any unasserted claim or assessment with respect to an environmental liability that we believe would require additional disclosure or the recording of a loss contingency.

Our commitments and contingencies include the usual obligations of real estate owners and licensed operators in the normal course of business. In the opinion of management, these matters are not expected to have a material impact on our consolidated financial condition, results of operations and cash flows. We are also subject to contingent losses resulting from litigation against the Company.

On April 1, 2014, CRA and Cornerstone Ventures, Inc. filed a complaint in the Superior Court of California for the County of Orange-Central Justice Center, Case No. 30-2014-00714004-CU-BT-CJC, naming the Company, its directors and two of its officers as defendants, seeking declaratory and injunctive relief and compensatory and punitive damages. On April 17, 2014, Judge Nakamura denied in its entirety plaintiffs' ex parte application for a temporary restraining order to show cause why a preliminary injunction against the defendants should not issue. On May 19, 2014, the Company filed a counter claim against plaintiffs and certain individuals affiliated with CRA and affiliated entities. The Company continues to believe that all of plaintiffs' claims are without merit and will continue to vigorously defend itself. Plaintiffs and defendants are conducting discovery.

A bankruptcy petition was filed against Healthcare Real Estate Partners, LLC ("HCRE") by the investors in Healthcare Real Estate Fund, LLC or Healthcare Real Estate Qualified Purchasers Fund, LLC. Following the dismissal of the involuntary bankruptcy petition filed against it, in the United States Bankruptcy Court of the District of Delaware HCRE filed a motion for attorneys' fees and damages and a separate complaint for violation of the automatic stay against the petitioning creditors and the Company. At a status hearing, the Bankruptcy Court expressed concern about HCRE commencing this litigation and urged the parties to mediate the issues. A mediation schedule has not yet been set. The Company believes that all of HCRE's claims are without merit and will vigorously defend itself.

### ***Friendship Haven and Stonegate Management Agreement***

In October 2015, as part of the amended Stonegate management agreement (see Note 3) the lease is cancellable by either party with written notice, as defined in the agreement. However, if we terminate the agreement before October 6, 2016, we could be obligated to pay a termination fee up to three times the highest monthly management fee paid to Stonegate prior to the termination. As of June 30, 2016, the termination fee could be up to approximately \$144,000.

### ***Medford Purchase Option***

Our property, Farmington Square in Medford, Oregon, which has a book value of approximately \$7.4 million as of June 30, 2016, is subject to a purchase option that became exercisable on September 14, 2014. The option provides the option holder with the right to purchase the property at increasing exercise price intervals based on elapsed time, starting at \$10.8 million through October 2016, then increasing to \$11.0 million from November 2016 through July 2017 and then to \$11.3 million until the option expires on August 13, 2022. As of June 30, 2016, the option holder has not provided notice or exercised its option.

### ***Purchase Agreement***

In November 2013, a limited liability company entered into a build-to-suit purchase agreement whereby it agreed to purchase a 70-unit assisted living facility in Athens, Georgia for approximately \$12.4 million upon substantial completion of the facility. In the event the limited liability company did not purchase the building as provided for in the purchase agreement, it would be required to lease the facility from the seller for a ten-year term at an annual rent amount equal to 8% of the cost of the facility. Summit was obligated to guarantee the payments associated with that lease, however, in June 2016, the building was purchased by an independent third-party, the guarantee was terminated and Summit is no longer under any obligation to this purchase agreement.

### ***Indemnification and Employment Agreements***

The Company has entered into indemnification agreements with certain officers and directors of the Company against all judgments, penalties, fines and amounts paid in settlement and all expenses actually and reasonably incurred by him or her in connection with any proceeding. Additionally, in September 2015, the Company entered into three-year employment agreements with its officers which include customary terms relating to salary, bonus, position, duties and benefits (including eligibility for equity compensation), as well as a cash payment following a change in control of the Company, as defined in such agreements.

### ***Management of the SUL JV***

As the manager of the SUL JV, we are responsible for managing the day-to-day operations of the SUL JV and are, thus, subject to contingencies that may arise in the normal course of the SUL JV's operations.

### **11. Dispositions**

In accordance with ASC 360, *Property, Plant & Equipment*, we report results of operations from real estate assets that meet the definition of a component of an entity that have been sold, or meet the criteria to be classified as held for sale, as discontinued operations.

On January 7, 2015, we sold the Sherburne Commons property. We recorded approximately \$1.6 million as a loss on disposition during the six months ended June 30, 2015. See Note 6 for further information.

### ***Disposal of real estate***

In April 2015, we contributed the JV 2 Properties to the SUL JV (see Notes 3, 4 and 5).

The transaction had the following effect to reduce our consolidated assets and liabilities:

|                        |    |              |
|------------------------|----|--------------|
| Real estate properties | \$ | (40,391,000) |
| Other assets           |    | (832,000)    |
| Loans payable, net     |    | 30,133,000   |
| Other liabilities      |    | 1,182,000    |
| Total contribution:    | \$ | 9,908,000    |

We recorded a partial gain of approximately \$1.0 million during the quarter ended June 30, 2015 related to the disposition of the JV 2 Properties contributed to the SUL JV.

In December 2015, we contributed the Cottage Properties to the SUL JV which were acquired by us in November 2015 (see Notes 3, 4 and 5). The aggregate net value of the Cottage Properties that were contributed was approximately \$5.4 million, which approximated the Operating Partnership's carrying value on the date of contribution (total assets were approximately \$19.5 million less liabilities of approximately \$14.1 million, which included approximately \$13.5 million in loans payable).

On April 29, 2016, we contributed Riverglen to the SUL JV (see Note 3). This contribution resulted in the SUL JV owning Riverglen and, therefore, Riverglen is no longer consolidated in our condensed consolidated financial statements as of April 29, 2016. The aggregate net value of Riverglen at the date of the contribution was approximately \$3.9 million, which approximated the Operating Partnership's carrying value on the date of contribution (total assets were approximately \$9.2 million less liabilities of approximately \$5.3 million, which included approximately \$4.7 million in a HUD insured loan payable (see Note 4)). Concurrent with the contribution of Riverglen, Best Years contributed cash to the SUL JV in the amount of approximately \$3.4 million and the Operating Partnership received cash of approximately \$3.4 million from the SUL JV, not including approximately \$0.2 million we had received in 2015 for reimbursed acquisition costs related to Riverglen. This contribution increased our equity-method investment by approximately \$0.3 million.

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

The following “Management’s Discussion and Analysis of Financial Condition and Results of Operations” should be read in conjunction with our unaudited condensed consolidated financial statements and notes thereto contained elsewhere in this report. This section contains forward-looking statements, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based. These forward-looking statements generally are identified by the words “believes,” “project,” “expects,” “anticipates,” “estimates,” “intends,” “strategy,” “plan,” “may,” “will,” “would,” “will be,” “will continue,” “will likely result,” and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to numerous risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. Forward-looking statements that were true at the time made may ultimately prove to be incorrect or false. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise. All forward-looking statements should be read in light of the risks identified in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2015 filed with the U.S. Securities and Exchange Commission (the “SEC”) on March 18, 2016.

### **Overview**

As of June 30, 2016, our ownership interests in senior housing facilities were as follows: 100% ownership of five properties, a 95% interest in a consolidated joint venture that owns six properties, and a 10% interest in an unconsolidated equity-method investment that owns 15 properties. As used in this report, the “Company,” “we,” “us” and “our” refer to Summit Healthcare REIT, Inc. and its consolidated subsidiaries, except where the context otherwise requires.

Our revenues are comprised largely of rental income, including rents reported on a straight-line basis over the initial term of each lease and fees earned for resident care from Friendship Haven (see Note 3 to the accompanying Notes to Condensed Consolidated Financial Statements). Our growth depends, in part, on our ability to acquire new healthcare properties at attractive prices, increase rental income from leases by increasing rental rates and by controlling our expenses. Our operations are impacted by property-specific, market-specific, general economic, regulatory and other conditions.

We believe that investing in senior housing facilities is accretive to earnings and stockholder value. Senior housing facilities include independent living facilities (“IL”), skilled-nursing facilities (“SNF”), assisted living facilities (“AL”), memory care (“MC”) and continuing care retirement communities (“CCRC”). Each of these types of facilities caters to different segments of the senior population. Our strategy includes purchasing SNF, AL, IL MC, and CCRC facilities.

### ***Joint Venture Portfolio Properties***

As part of our strategy to joint venture with institutional capital to grow the Company’s senior housing portfolio, through our operating partnership (“Operating Partnership”), in April 2015, we formed Summit Union Life Holdings, LLC (“SUL JV”) with Best Years, LLC (“Best Years”), an unrelated entity and a U.S.-based affiliate of Union Life Insurance Co, Ltd. (a Chinese corporation) and contributed six wholly-owned limited liability companies (collectively, the “JV 2 Properties”) to the SUL JV. In October 2015, through the SUL JV, we acquired a 10% interest in four separate SNFs in Texas (“Creative Properties”) and Best Years acquired a 90% interest. In December 2015, we contributed four wholly-owned limited liability companies, which we acquired in November 2015, that each own a senior housing facility (collectively, the “Cottage Properties”) to the SUL JV. On April 29, 2016, we contributed our limited liability company interest in Riverglen to the SUL JV. See Notes 3, 5 and 11 to the accompanying Notes to Condensed Consolidated Financial Statements).

The following reconciles our 10% equity investment in the SUL JV from inception through June 30, 2016:

|  |                            |
|--|----------------------------|
| Initial investment (JV 2 Properties)     | \$ 991,000                 |
| Creative Properties                      | 837,000                    |
| Cottage Properties                       | 544,000                    |
| Riverglenn                               | 346,000                    |
| Total investment                         | <u>2,718,000</u>           |
| Income from equity-method investee       | 188,000                    |
| Distributions                            | (584,000)                  |
| <b>Total investment at June 30, 2016</b> | <b><u>\$ 2,322,000</u></b> |

During the three months ended June 30, 2016 and 2015, we recorded distributions of approximately \$132,000 and \$60,000, respectively, and received cash of approximately \$108,000 and \$0, respectively, from the SUL JV. During the six months ended June 30, 2016 and 2015, we recorded distributions of approximately \$294,000 and \$60,000, respectively, from the SUL JV and received cash of approximately \$213,000 and \$0, respectively, from the SUL JV. As of June 30, 2016 and December 31, 2015, we have a distribution receivable of approximately \$262,000 and \$179,000, respectively, from the SUL JV.

We serve as the manager of the SUL JV and provide management services in exchange for fees and reimbursements. Under the SUL JV agreement, as the manager, we are paid an acquisition fee, as defined in the SUL JV agreement, based on the original purchase price paid for the properties. Additionally, we are paid an annual asset management fee equal to 0.25% of the original purchase price paid for the properties. During the three months ended June 30, 2016 and 2015, we recorded approximately \$78,000 and \$0.4 million, respectively, in acquisition and asset management fees. During the six months ended June 30, 2016, we recorded approximately \$0.1 million and \$0.4 million, respectively, in acquisition and asset management fees.

A summary of the unaudited condensed consolidated financial data for the balance sheets and statement of income (operations commenced on May 1, 2015) for the unconsolidated SUL JV, of which we own a 10% equity interest, is as follows:

| <b>Condensed Consolidated Balance Sheets of SUL JV:</b> | <b>June 30,<br/>2016</b>    | <b>December 31,<br/>2015</b> |
|---|-----------------------------|------------------------------|
| Real estate properties and intangibles, net             | \$ 93,047,000               | \$ 86,069,000                |
| Cash and cash equivalents                               | 2,377,000                   | 5,174,000                    |
| Other assets  | 4,062,000                   | 2,970,000                    |
| <b>Total Assets:</b>                                    | <b><u>\$ 99,486,000</u></b> | <b><u>\$ 94,213,000</u></b>  |
| Loans payable, net                                      | \$ 67,256,000               | \$ 62,707,000                |
| Other liabilities                                       | 4,905,000                   | 3,848,000                    |
| Members' equity   | 27,325,000                  | 27,658,000                   |
| <b>Total Liabilities and Members' Equity</b>            | <b><u>\$ 99,486,000</u></b> | <b><u>\$ 94,213,000</u></b>  |

| <b>Condensed Consolidated Statement of Income of SUL JV:</b> | <b>Three Months Ended June 30,</b> |                          | <b>Six months June 30,</b> |                          |
|--|------------------------------------|--------------------------|----------------------------|--------------------------|
|  | <b>2016</b>                        | <b>2015</b>              | <b>2016</b>                | <b>2015</b>              |
| Revenues:  |                                    |                          |                            |                          |
| Revenue  | \$ 2,589,000                       | \$ 807,000               | \$ 5,046,000               | \$ 807,000               |
| Property and general expenses                                | (330,000)                          | (105,000)                | (695,000)                  | (105,000)                |
| Depreciation and amortization expense                        | (839,000)                          | (265,000)                | (1,614,000)                | (265,000)                |
| Income from operations                                       | 1,420,000                          | 437,000                  | 2,737,000                  | 437,000                  |
| Interest expense   | (816,000)                          | (240,000)                | (1,595,000)                | (240,000)                |
| Amortization of finance costs                                | (74,000)                           | (25,000)                 | (149,000)                  | (25,000)                 |
| <b>Net Income</b>  | <b><u>\$ 530,000</u></b>           | <b><u>\$ 172,000</u></b> | <b><u>\$ 993,000</u></b>   | <b><u>\$ 172,000</u></b> |

### Summit Portfolio Properties

At June 30, 2016, our portfolio consisted of 11 properties, five of which are 100% owned by us and six of which are owned by us through our 95% interest in Cornerstone Healthcare Partners LLC. All of the properties are 100% leased on a triple net basis. The following table (excluding the 15 properties held by the SUL JV, our unconsolidated 10% equity-method investment) provides summary information regarding these properties as of June 30, 2016:

#### Real Estate Properties:

|                                     | Properties | Beds       | Square Footage | Purchase Price       |
|-------------------------------------|------------|------------|----------------|----------------------|
| SNF                                 | 4          | 337        | 109,306        | \$ 31,740,000        |
| AL or AL/MC                         | 7          | 498        | 222,043        | 45,625,000           |
| <b>Total Real Estate Properties</b> | <b>11</b>  | <b>835</b> | <b>331,349</b> | <b>\$ 77,365,000</b> |

| Property  | Location            | Date Purchased     | Type  | Beds       | 2016 Revenue <sup>1</sup> |
|---|---------------------|--------------------|-------|------------|---------------------------|
| Sheridan Care Center                                  | Sheridan, OR        | August 3, 2012     | SNF   | 51         | \$ 246,000                |
| Fern Hill Care Center                                 | Portland, OR        | August 3, 2012     | SNF   | 63         | 262,000                   |
| Farmington Square                                     | Medford, OR         | September 14, 2012 | AL/MC | 71         | 433,000                   |
| Friendship Haven Healthcare and Rehabilitation Center | Galveston County TX | September 14, 2012 | SNF   | 150        | 801,000 <sup>2</sup>      |
| Pacific Health and Rehabilitation Center              | Tigard, OR          | December 24, 2012  | SNF   | 73         | 484,000                   |
| Danby House   | Winston-Salem, NC   | January 31, 2013   | AL/MC | 100        | 481,000                   |
| Brookstone of Aledo                                   | Aledo, IL           | July 2, 2013       | AL    | 66         | 382,000                   |
| The Shelby House                                      | Shelby, NC          | October 4, 2013    | AL    | 72         | 228,000                   |
| The Hamlet House                                      | Hamlet, NC          | October 4, 2013    | AL    | 60         | 329,000                   |
| The Carteret House                                    | Newport, NC         | October 4, 2013    | AL    | 64         | 217,000                   |
| Sundial Assisted Living                               | Redding, CA         | December 18, 2013  | AL    | 65         | 180,000                   |
| <b>Total</b>  |                     |                    |       | <b>835</b> |                           |

<sup>1</sup> Represents year-to-date through June 30, 2016 revenue based on in-place leases, including straight-line rent.

<sup>2</sup> Represents year-to-date through June 30, 2016 rent due under a lease between the Company and a wholly-owned taxable REIT subsidiary ("Friendswood TRS"). Such rental income is eliminated in consolidation.

#### Critical Accounting Policies

There have been no material changes to our critical accounting policies as previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2015 as filed with the SEC on March 18, 2016, except as noted under Recently Adopted Accounting Pronouncements in Note 2 to the accompanying Notes to Condensed Consolidated Financial Statements.

## Results of Operations

Our results of operations are described below:

### Three Months Ended June 30, 2016 Compared to Three Months Ended June 30, 2015

|   | Three Months Ended<br>June 30, |              | \$ Change      |
|---|--------------------------------|--------------|----------------|
|   | 2016                           | 2015         |                |
| Rental revenues                                     | \$ 1,702,000                   | \$ 2,022,000 | \$ (320,000)   |
| Tenant reimbursements and other income              | 223,000                        | 262,000      | (39,000)       |
| Resident services and fee income                    | 2,002,000                      | 2,307,000    | (305,000)      |
| Total revenues                                      | 3,927,000                      | 4,591,000    | (664,000)      |
| Less expenses:                                      |                                |              |                |
| Property operating costs                            | (443,000)                      | (555,000)    | 112,000        |
| Resident services costs                             | (1,760,000)                    | (1,887,000)  | 127,000        |
| Net operating income <sup>(1)</sup>                 | 1,724,000                      | 2,149,000    | (425,000)      |
| Acquisition & asset management fees                 | 78,000                         | 422,000      | (344,000)      |
| Interest income from notes receivable               | 45,000                         | 2,000        | 43,000         |
| General and administrative                          | (1,186,000)                    | (1,133,000)  | (53,000)       |
| Depreciation and amortization                       | (920,000)                      | (1,020,000)  | 100,000        |
| Income from equity-method investee                  | 53,000                         | 17,000       | 36,000         |
| Other income  | 41,000                         | 8,000        | 33,000         |
| Interest expense                                    | (774,000)                      | (856,000)    | 82,000         |
| Gain on disposition of real estate properties       | —                              | 991,000      | (991,000)      |
| Income (loss) from continuing operations            | (939,000)                      | 580,000      | (1,519,000)    |
| Loss from discontinued operations                   | —                              | —            | —              |
| Net income (loss)                                   | (939,000)                      | 580,000      | (1,519,000)    |
| Noncontrolling interests' share in income (losses)  | (17,000)                       | (39,000)     | 22,000         |
| Net income (loss) applicable to common stockholders | \$ (956,000)                   | \$ 541,000   | \$ (1,497,000) |

(1) Net operating income ("NOI") is a non-GAAP supplemental measure used to evaluate the operating performance of real estate properties. We define NOI as total rental revenues, resident service and fee income, tenant reimbursements and other income less property operating and resident services costs. NOI excludes acquisition and asset management fees, interest income from notes receivable, general and administrative expense, depreciation and amortization, income from equity-method investee, other income, interest expense, gain on disposition of real estate, and loss from discontinued operations. We believe NOI provides investors relevant and useful information because it measures the operating performance of the REIT's real estate at the property level on an unleveraged basis. We use NOI to make decisions about resource allocations and to assess and compare property-level performance. We believe that net income (loss) is the most directly comparable GAAP measure to NOI. NOI should not be viewed as an alternative measure of operating performance to net income (loss) as defined by GAAP since it does not reflect the aforementioned excluded items. Additionally, NOI as we define it may not be comparable to NOI as defined by other REITs or companies, as they may use different methodologies for calculating NOI.

Total rental revenue for our properties includes rental revenues and tenant paid and/or reimbursements for property taxes and insurance. Property operating expenses include insurance, property taxes and other operating expenses, including management fees. Resident service and fee income and resident services costs are generated from Friendswood TRS. Net operating income decreased by approximately \$0.4 million for the three months ended June 30, 2016 mainly due to the decrease in rental revenue from the contribution of the JV2 properties to the SUL JV in April 2015 as we recorded rental revenue for one month in the period ended June 30, 2015 and none for the three months ended June 30, 2016.

The decrease in the acquisition and asset management fees of approximately \$0.3 million is due to the acquisition fees earned on the JV2 properties acquired by the SUL JV in April 2015.

Interest income from notes receivable increased due to collection of interest income on the Nantucket Note (see Note 6 to the accompanying Notes to Condensed Consolidated Financial Statements).

Depreciation and amortization decreased by approximately \$0.1 million for the second quarter of 2016 due to the contribution of the JV 2 properties to the SUL JV in April 2015.

In April 2015, as a result of the disposition of the JV 2 Properties contributed to the SUL JV, we recorded a partial gain on disposition of approximately \$1.0 million related to the disposition of these properties (see Note 11 to the accompanying Notes to Condensed Consolidated Financial Statements).

Six Months Ended June 30, 2016 Compared to Six Months Ended June 30, 2015

|   | Six Months Ended<br>June 30, |                | \$ Change      |
|---|------------------------------|----------------|----------------|
|   | 2016                         | 2015           |                |
| Rental revenues                               | \$ 3,544,000                 | \$ 4,693,000   | \$ (1,149,000) |
| Tenant reimbursements and other income        | 448,000                      | 574,000        | (126,000)      |
| Resident services and fee income              | 4,145,000                    | 4,550,000      | (405,000)      |
| Total revenues                                | 8,137,000                    | 9,817,000      | (1,680,000)    |
| Less expenses:                                |                              |                |                |
| Property operating costs                      | (928,000)                    | (1,130,000)    | 202,000        |
| Resident services costs                       | (3,517,000)                  | (3,624,000)    | 107,000        |
| Net operating income <sup>(1)</sup>           | 3,692,000                    | 5,063,000      | (1,371,000)    |
| Acquisition and asset management fees         | 132,000                      | 422,000        | (290,000)      |
| Interest income from notes receivable         | 75,000                       | 4,000          | 71,000         |
| General and administrative                    | (2,113,000)                  | (2,077,000)    | (36,000)       |
| Depreciation and amortization                 | (1,893,000)                  | (2,265,000)    | 372,000        |
| Income from equity-method investee            | 99,000                       | 17,000         | 82,000         |
| Other income                                  | 72,000                       | 10,000         | 62,000         |
| Interest expense                              | (1,589,000)                  | (1,939,000)    | 350,000        |
| Gain on disposition of real estate properties | —                            | 991,000        | (991,000)      |
| Loss from continuing operations               | (1,525,000)                  | 226,000        | (1,751,000)    |
| Loss from discontinued operations             | —                            | (1,582,000)    | 1,582,000      |
| Net loss                                      | (1,525,000)                  | (1,356,000)    | (169,000)      |
| Noncontrolling interests' share in losses     | (34,000)                     | (76,000)       | 42,000         |
| Net loss applicable to common stockholders    | \$ (1,559,000)               | \$ (1,432,000) | \$ (127,000)   |

(1) Net operating income (“NOI”) is a non-GAAP supplemental measure used to evaluate the operating performance of real estate properties. We define NOI as rental revenues, tenant reimbursements and other income, and resident services and fee income, less property operating costs and resident services costs. NOI excludes acquisition and asset management fees, interest income from notes receivable, general and administrative expense, depreciation and amortization, income from equity-method investee, other income, interest expense, gain on disposition of real estate properties, and loss from discontinued operations. We believe NOI provides investors relevant and useful information because it measures the operating performance of the REIT’s real estate at the property level on an unleveraged basis. We use NOI to make decisions about resource allocations and to assess and compare property-level performance. We believe that net income (loss) is the most directly comparable GAAP measure to NOI. NOI should not be viewed as an alternative measure of operating performance to net income (loss) as defined by GAAP since it does not reflect the aforementioned excluded items. Additionally, NOI as we define it may not be comparable to NOI as defined by other REITs or companies, as they may use different methodologies for calculating NOI.

Total rental revenue for our properties includes rental revenues and tenant reimbursements for property taxes and insurance. Property operating expenses include insurance, property taxes and other operating expenses, including management fees. Resident services and fee income and resident services costs are generated from Friendswood TRS. Net operating income decreased by approximately \$1.4 million for the six months ended June 30, 2016 mainly due to the contribution of the JV 2 properties to the SUL JV in April 2015 as we recorded four months of rental revenue in the six months ended June 30, 2015 and none for the six months ended June 30, 2016.

The decrease in the acquisition and asset management fees of approximately \$0.3 million is due to the acquisition fees earned on the JV2 properties acquired by the SUL JV in April 2015.

Interest income from notes receivable increased due to collection of interest income on the Nantucket Note (see Note 6 to the accompanying Notes to Condensed Consolidated Financial Statements).

Depreciation and amortization decreased by approximately \$0.4 million for the six months ended June 30, 2016 due to the contribution of the JV 2 properties to the SUL JV in April 2015.

Interest expense decreased by approximately \$0.4 million for the six months ended June 30, 2016 due to the contribution of the JV 2 properties to the SUL JV in April 2015.

In April 2015, as a result of the disposition of the JV 2 Properties contributed to the SUL JV, we recorded a partial gain on disposition of approximately \$1.0 million related to the disposition of these properties (see Note 11 to the accompanying Notes to Condensed Consolidated Financial Statements).

The loss from discontinued operations represents Sherburne Commons. On January 7, 2015, we sold Sherburne Commons (see Note 11 to the accompanying Notes to Condensed Consolidated Financial Statements).

### **Liquidity and Capital Resources**

As of June 30, 2016, we had approximately \$9.6 million in cash and cash equivalents on hand. Based on current conditions, we believe that we have sufficient capital resources for the next twelve months.

Going forward, we expect our primary sources of cash to be rental revenues, tenant reimbursements, joint venture equity and distributions, and refinancing of existing debt. In addition, we may increase cash through the sale of additional properties, which may result in the deconsolidation of properties we already own, or borrowing against currently-owned properties. For the foreseeable future, we expect our primary uses of cash to be for the repayment of principal on loans payable, funding future acquisitions, operating expenses, and interest expense on outstanding indebtedness. We may also incur expenditures for renovations of our existing properties, such as increasing the size of the properties by developing additional rentable square feet and/or making the space more appealing.

We continue to pursue options for repaying and/or refinancing debt obligations with long-term, fixed rate “HUD insured loans. In October and December 2015, we successfully refinanced two of our existing loan arrangements with Lancaster Pollard (HUD insured) loans (see Note 4 to the accompanying Notes to Condensed Consolidated Financial Statements). We believe that market conditions may be acceptable to continue to raise capital through additional joint venture arrangements with either our existing joint venture partner or new partners, although there can be no assurances that any such transactions will have terms acceptable to us or will be consummated.

Our liquidity will increase if cash from operations exceeds expenses, we receive net proceeds from the sale of whole or partial interest in a property or properties or refinancing results in excess loan proceeds. Our liquidity will decrease as proceeds are expended in connection with the acquisitions and operation of properties. Our ability to repay or refinance debt could be adversely affected by an inability to secure financing at reasonable terms, if at all.

### ***Credit Facilities and Loan Agreements***

As of June 30, 2016, we had debt obligations of approximately \$60.7 million. The outstanding balance by loan agreement is as follows:

- Healthcare Financial Solutions, LLC (formerly GE Capital)—approximately \$2.8 million maturing October 2018
- Oxford Finance, LLC— approximately \$7.0 million maturing October 2019
- Lancaster Pollard (HUD insured)—approximately \$50.9 million maturing from September 2039 through January 2051

### ***Distributions***

We made no stockholder distributions during the six months ended June 30, 2016.

### **Funds from Operations (“FFO”)**

FFO is a non-GAAP supplemental financial measure that is widely recognized as a measure of REIT operating performance. We compute FFO in accordance with the definition outlined by the National Association of Real Estate Investment Trusts (“NAREIT”). NAREIT defines FFO as net income (loss), computed in accordance with GAAP, excluding gains or losses from sales of property, plus depreciation and amortization and after adjustments for unconsolidated partnerships and joint ventures.

Our FFO may not be comparable to FFO reported by other REITs that do not define the term in accordance with the current NAREIT definition or that interpret the current NAREIT definition differently than we do. We believe that FFO is helpful to investors and our management as a measure of operating performance because it excludes depreciation and amortization, gains and losses from property dispositions, impairments and extraordinary items, and as a result, when compared period to period, reflects the impact on operations from trends in occupancy rates, rental rates, operating costs, development activities, general and administrative expenses, and interest costs, which is not immediately apparent from net income. Historical cost accounting for real estate assets in accordance with GAAP implicitly assumes that the value of real estate diminishes predictably over time. Since real estate values have historically risen or fallen with market conditions, many industry investors and analysts have considered the presentation of operating results for real estate companies that use historical cost accounting alone to be insufficient. As a result, our management believes that the use of FFO, together with the required GAAP presentations, provide a more complete understanding of our performance. Factors that impact FFO include start-up costs, fixed costs, delays in buying assets, lower yields on cash held in accounts pending investment, income from portfolio properties and other portfolio assets, interest rates on acquisition financing and operating expenses. FFO should not be considered as an alternative to net income (loss), as an indication of our performance, nor is it indicative of funds available to fund our cash needs, including our ability to make distributions.

Our FFO has been positive over the past year primarily due to increased rental revenue from our acquisitions, and reduced expenses. FFO for the six months ended June 30, 2016 and 2015 were \$0.5 million and \$1.3 million, respectively. The decrease in 2016 was due to the contribution of the JV 2 properties to the SUL JV in April 2015. We owned 10% of the JV 2 properties for the six months ended June 30, 2016 as opposed to 100% of the JV 2 properties for four months in 2015.

The following is the reconciliation from net (loss) income applicable to common stockholders, the most direct comparable financial measure calculated and presented with GAAP, to FFO for the three and six months ended June 30, 2016 and 2015:

|  | Three months ended<br>June 30, |                | Six months ended<br>June 30, |                  |
|--|--------------------------------|----------------|------------------------------|------------------|
|  | 2016                           | 2015           | 2016                         | 2015             |
| Net income (loss) applicable to common stockholders (GAAP)           | \$ (956,000)                   | \$ 541,000     | \$ (1,559,000)               | \$ (1,432,000)   |
| Adjustments:   |                                |                |                              |                  |
| Depreciation and amortization  | 920,000                        | 1,020,000      | 1,893,000                    | 2,265,000        |
| Depreciation and amortization related to non-controlling interests   | (24,000)                       | (48,000)       | (48,000)                     | (97,000)         |
| Depreciation related to SUL JV                                       | 84,000                         | —              | 162,000                      | —                |
| Gain on disposition of real estate properties                        | —                              | (991,000)      | —                            | (991,000)        |
| Loss on disposition of VIE   | —                              | —              | —                            | 1,582,000        |
| Funds provided by operations (FFO) applicable to common stockholders | <u>\$ 24,000</u>               | <u>522,000</u> | <u>448,000</u>               | <u>1,327,000</u> |
| Weighted-average number of common shares                             |                                |                |                              |                  |
| Outstanding - basic and diluted                                      | 23,027,978                     | 23,028,014     | 23,027,978                   | 23,028,014       |
| FFO per weighted average common shares                               | \$ 0.00                        | \$ 0.02        | \$ 0.02                      | \$ 0.06          |

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Not applicable.

### **Item 4. Controls and Procedures**

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934, as amended (the “Exchange Act”)) that are designed to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our senior management, including our President (Principal Executive Officer) and our Chief Financial Officer (Principal Financial Officer), to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Our President (Principal Executive Officer) and Chief Financial Officer (Principal Financial Officer) evaluated the effectiveness of our disclosure controls and procedures and concluded that the disclosure controls and procedures were effective as of the end of the period covered by this report.

There have been no changes in our internal control over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II — OTHER INFORMATION**

### **Item 1. Legal Proceedings**

On April 1, 2014, CRA and Cornerstone Ventures, Inc. filed a complaint in the Superior Court of California for the County of Orange-Central Justice Center, Case No. 30-2014-00714004-CU-BT-CJC, naming the Company, its directors and two of its officers as defendants, seeking declaratory and injunctive relief and compensatory and punitive damages. On April 17, 2014, Judge Nakamura denied in its entirety plaintiffs’ ex parte application for a temporary restraining order to show cause why a preliminary injunction against the defendants should not issue. On May 19, 2014, the Company filed a counter claim against plaintiffs and certain individuals affiliated with CRA and affiliated entities. The Company continues to believe that all of plaintiffs’ claims are without merit and will continue to vigorously defend itself. Plaintiffs and defendants are conducting discovery.

A bankruptcy petition was filed against HCRE by the investors in Healthcare Real Estate Fund, LLC or Healthcare Real Estate Qualified Purchasers Fund, LLC. Following the dismissal of the involuntary bankruptcy petition filed against it, in the United States Bankruptcy Court of the District of Delaware HCRE filed a motion for attorneys’ fees and damages and a separate complaint for violation of the automatic stay against the petitioning creditors and the Company. At a status hearing, the Bankruptcy Court expressed concern about HCRE commencing this litigation and urged the parties to mediate the issues. A mediation schedule has not yet been set. The Company believes that all of HCRE’s claims are without merit and will vigorously defend itself.

### **Item 1A. Risk Factors**

Not applicable.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

- (a) We did not sell any equity securities that were not registered under the Securities Act of 1933, as amended, during the periods covered by this Form 10-Q.
- (b) Not applicable.
- (c) During the six months ended June 30, 2016, we redeemed no shares pursuant to our stock repurchase program.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

| <b>Ex.</b> | <b>Description</b>   |
|------------|--|
| 3.1        | Amendment and Restatement of Articles of Incorporation of the Company (incorporated by reference to Exhibit 3.2 to the Company's Annual Report on Form 10-K filed on March 24, 2006).  |
| 3.2        | Amended and Restated Bylaws of the Company (incorporated by reference to Exhibit 3.3 to Post-Effective Amendment No. 1 to the Registration Statement on Form S-11 (No. 333-121238) filed on December 23, 2005).  |
| 3.3        | Articles of Amendment of the Company dated October 16, 2013 (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on October 22, 2013).  |
| 3.4        | Second Articles of Amendment and Restatement of Articles of Incorporation of the Company dated June 30, 2010 (incorporated by reference to Exhibit 3.4 to the Company's Annual Report on Form 10-K filed on March 20, 2015).   |
| 4.1        | Subscription Agreement (incorporated by reference to Appendix A to the prospectus included on Post-Effective Amendment No. 2 to the Registration Statement on Form S-11 (No. 333-155640) filed on April 16, 2010 ("Post-Effective Amendment No. 2")).  |
| 4.2        | Statement regarding restrictions on transferability of shares of common stock (to appear on stock certificate or to be sent upon request and without charge to stockholders issued shares without certificates) (incorporated by reference to Exhibit 4.2 to the Registration Statement on Form S-11 (No. 333-121238) filed on December 14, 2004). |
| 4.3        | Amended and Restated Distribution Reinvestment Plan (incorporated by reference to Appendix B to the prospectus dated April 16, 2010 included on Post-Effective Amendment No. 2).   |
| 4.4        | 2015 Omnibus Incentive Plan dated October 28, 2015 (incorporated by reference to Appendix A to the Definitive Proxy Statement on Schedule 14A filed on September 28, 2015).  |
| 31.1       | Certification of Principal Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 31.2       | Certification of Principal Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 32         | Certification of Principal Executive Officer and Principal Financial Officer, pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 101.1      | The following information from the Company's quarterly report on Form 10-Q for the quarter ended June 30, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets; (ii) Condensed Consolidated Statements of Operations; (iii) Condensed Consolidated Statements of Cash Flows.                |

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this quarterly report to be signed on its behalf by the undersigned, thereunto duly authorized this 11th day of August 2016.

SUMMIT HEALTHCARE REIT, INC.

By: /s/ Kent Eikanas

Kent Eikanas

*President*

*(Principal Executive Officer)*

By: /s/ Elizabeth A. Pagliarini

Elizabeth A. Pagliarini

*Chief Financial Officer*

*(Principal Financial Officer)*

## CERTIFICATIONS OF PRINCIPAL EXECUTIVE OFFICER

I, Kent Eikanas, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Summit Healthcare REIT, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2016

/s/ Kent Eikanas  
Kent Eikanas  
President  
(Principal Executive Officer)

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## CERTIFICATIONS OF PRINCIPAL FINANCIAL OFFICER

I, Elizabeth A. Pagliarini, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Summit Healthcare REIT, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2016

/s/ Elizabeth A. Pagliarini  
Elizabeth A. Pagliarini  
Chief Financial Officer  
(Principal Financial Officer)

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CERTIFICATIONS PURSUANT TO  
18 U.S.C. §1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Kent Eikanas and Elizabeth A. Pagliarini, do each hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of their knowledge, the Quarterly Report of Summit Healthcare REIT, Inc. on Form 10-Q for the period ended June 30, 2016 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-Q fairly presents in all material respects the financial condition and results of operations of Summit Healthcare REIT, Inc.

Date: August 11, 2016

/s/ Kent Eikanas  
Kent Eikanas  
President  
(Principal Executive Officer)

Date: August 11, 2016

/s/ Elizabeth A. Pagliarini  
Elizabeth A. Pagliarini  
Chief Financial Officer  
(Principal Financial Officer)

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