

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 September 30, 2015  
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, 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 November 10, 2015, we had 23,027,978 shares issued and outstanding.

FORM 10-Q

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**PART I — FINANCIAL INFORMATION**

**Item 1. Financial Statements**

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

	<u>September 30, 2015</u>	<u>December 31, 2014</u>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 10,092,000	\$ 4,405,000
Restricted cash	4,212,000	3,759,000
Real estate properties (certain assets held in variable interest entity):		
Land	6,502,000	8,432,000
Buildings and improvements, net	60,026,000	84,428,000
Furniture and fixtures, net	3,373,000	5,862,000
Real estate properties, net	<u>69,901,000</u>	<u>98,722,000</u>
Notes receivable	4,840,000	132,000
Deferred costs and deposits	532,000	356,000
Deferred financing costs, net	1,340,000	1,453,000
Tenant and other receivables, net	3,797,000	2,599,000
Deferred leasing commissions, net	1,738,000	1,859,000
Other assets, net	346,000	657,000
Equity-method investment	884,000	—
Assets of variable interest entity held for sale	—	4,139,000
<b>Total assets</b>	<b><u>\$ 97,682,000</u></b>	<b><u>\$ 118,081,000</u></b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Accounts payable and accrued liabilities	\$ 2,475,000	\$ 1,995,000
Accrued salaries and benefits	153,000	342,000
Security deposits	1,399,000	2,029,000
Liabilities (certain liabilities held in variable interest entity):		
Loans payable, net of debt discounts	57,977,000	77,972,000
Liabilities of variable interest entity held for sale	—	2,700,000
<b>Total liabilities</b>	<b><u>62,004,000</u></b>	<b><u>85,038,000</u></b>
Commitments, contingencies and subsequent events		
Stockholders' Equity		
Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding at September 30, 2015 and December 31, 2014		
Common stock, \$0.001 par value; 290,000,000 shares authorized; 23,027,978 and 23,028,014 shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively	23,000	23,000
Additional paid-in capital	117,226,000	117,226,000
Accumulated deficit	<u>(83,121,000)</u>	<u>(80,873,000)</u>
<b>Total stockholders' equity</b>	<b>34,128,000</b>	<b>36,376,000</b>
Noncontrolling interest	<u>1,550,000</u>	<u>(3,333,000)</u>
<b>Total equity</b>	<b><u>35,678,000</u></b>	<b><u>33,043,000</u></b>
<b>Total liabilities and stockholders' equity</b>	<b><u>\$ 97,682,000</u></b>	<b><u>\$ 118,081,000</u></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)**

	<u>Three Months Ended September 30,</u>		<u>Nine months September 30,</u>	
	<u>2015</u>	<u>2014</u>	<u>2015</u>	<u>2014</u>
<b>Revenues:</b>				
Rental revenues	\$ 1,657,000	\$ 1,662,000	\$ 6,350,000	\$ 5,027,000
Resident services and fee income	2,381,000	2,100,000	6,931,000	3,559,000
Tenant reimbursements and other income	232,000	181,000	806,000	554,000
Acquisition and asset management fees	25,000	—	447,000	—
Interest income from notes receivable	2,000	—	6,000	4,000
	<u>4,297,000</u>	<u>3,943,000</u>	<u>14,540,000</u>	<u>9,144,000</u>
<b>Expenses:</b>				
Property operating costs	460,000	397,000	1,590,000	1,236,000
Resident services costs	1,924,000	1,784,000	5,548,000	2,990,000
General and administrative	999,000	1,141,000	3,076,000	2,917,000
Asset management fees and expenses	—	—	—	205,000
Real estate acquisition costs	—	(4,000)	—	—
Depreciation and amortization	889,000	873,000	3,154,000	2,984,000
Reserve for excess advisor obligation	—	—	—	189,000
	<u>4,272,000</u>	<u>4,191,000</u>	<u>13,368,000</u>	<u>10,521,000</u>
Operating income (loss)	25,000	(248,000)	1,172,000	(1,377,000)
Income from equity-method investee	26,000	—	43,000	—
Other income	16,000	—	26,000	104,000
Interest expense	(723,000)	(882,000)	(2,662,000)	(2,319,000)
Gain on disposition of real estate properties	—	—	991,000	—
Loss from continuing operations	(656,000)	(1,130,000)	(430,000)	(3,592,000)
Income (loss) from discontinued operations	(117,000)	36,000	(1,699,000)	(200,000)
Net loss	(773,000)	(1,094,000)	(2,129,000)	(3,792,000)
Noncontrolling interests' share in losses	(43,000)	135,000	(119,000)	713,000
Net loss applicable to common stockholders	<u>\$ (816,000)</u>	<u>\$ (959,000)</u>	<u>\$ (2,248,000)</u>	<u>\$ (3,079,000)</u>
<b>Basic and diluted income (loss) per common share:</b>				
Continuing operations applicable to common stockholders	\$ (0.03)	\$ (0.04)	\$ (0.02)	\$ (0.16)
Discontinued operations	\$ —	\$ —	\$ (0.07)	\$ 0.03
Net loss applicable to common stockholders	<u>\$ (0.03)</u>	<u>\$ (0.04)</u>	<u>\$ (0.09)</u>	<u>\$ (0.13)</u>
<b>Weighted average shares used to calculate basic and diluted net loss per common share</b>				
	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 nine months ended September 30, 2015  
(Unaudited)

	<u>Common Stock</u>			<u>Accumulated Deficit</u>	<u>Total Stockholders' Equity</u>	<u>Noncontrolling Interests</u>	<u>Total Equity</u>
	<u>Number of Shares</u>	<u>Common Stock Par Value</u>	<u>Additional Paid-In Capital</u>				
<b>Balance — January 1, 2015</b>	<b>23,028,014</b>	<b>\$ 23,000</b>	<b>\$ 117,226,000</b>	<b>\$ (80,873,000)</b>	<b>\$ 36,376,000</b>	<b>\$ (3,333,000)</b>	<b>\$ 33,043,000</b>
Distributions paid to noncontrolling interests	—	—	—	—	—	(114,000)	(114,000)
Surrendered shares	(36)	—	—	—	—	—	—
Decrease in noncontrolling interests related to disposition of a VIE	—	—	—	—	—	4,878,000	4,878,000
Net (loss) income	—	—	—	(2,248,000)	(2,248,000)	119,000	(2,129,000)
<b>Balance — September 30, 2015</b>	<b><u>23,027,978</u></b>	<b><u>\$ 23,000</u></b>	<b><u>\$ 117,226,000</u></b>	<b><u>\$ (83,121,000)</u></b>	<b><u>\$ 34,128,000</u></b>	<b><u>\$ 1,550,000</u></b>	<b><u>\$ 35,678,000</u></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>Nine months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (2,129,000)	\$ (3,792,000)
Adjustments to reconcile net loss to net cash and cash equivalents provided by (used in) operating activities:		
Amortization of deferred financing costs and debt discounts	172,000	263,000
Depreciation and amortization	3,154,000	2,984,000
Straight-line rents	(755,000)	(339,000)
Bad debt expense	225,000	37,000
Loss on disposition of VIE	1,582,000	—
Gain on disposition of real estate properties	(991,000)	—
Income from equity-method investee	(43,000)	—
Change in operating assets and liabilities:		
Tenant and other receivables, net	(330,000)	(849,000)
Prepaid and other assets	301,000	15,000
Prepaid rent, security deposit and deferred revenues	99,000	(425,000)
Related party receivables	—	(173,000)
Accounts payable and accrued liabilities	738,000	1,048,000
Accrued salaries and benefits	(188,000)	—
<b>Net cash and cash equivalents provided by (used in) operating activities</b>	<b>1,835,000</b>	<b>(1,231,000)</b>
<b>Cash flows from investing activities</b>		
Restricted cash	(710,000)	(2,422,000)
Deferred costs and deposits	(491,000)	(233,000)
Real estate acquisitions and capitalized costs	(14,300,000)	(8,036,000)
Real estate improvements, net	(82,000)	(226,000)
Distributions receivable	(490,000)	—
Distributions received from equity method investee	23,000	—
Payments from note receivable	22,000	69,000
Proceeds from contribution of properties	9,908,000	—
<b>Net cash and cash equivalents used in investing activities</b>	<b>(6,120,000)</b>	<b>(10,848,000)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of loans payable	11,440,000	30,240,000
Payments of loans payable	(1,240,000)	(22,020,000)
Security deposits received	—	21,000
Non-controlling interest contribution	—	257,000
Distributions paid to non-controlling interests	(114,000)	(28,000)
Deferred financing costs	(114,000)	(906,000)
<b>Net cash and cash equivalents provided by financing activities</b>	<b>9,972,000</b>	<b>7,564,000</b>
Net increase (decrease) in cash and cash equivalents	5,687,000	(4,515,000)
Cash and cash equivalents - beginning of period	4,405,000	10,662,000
Cash and cash equivalents - end of period (including cash of VIE held for sale)	10,092,000	6,147,000
Less cash and cash equivalents of VIE held for sale – end of period (see Note 10)	—	(17,000)
Cash and cash equivalents – end of period	<u>\$ 10,092,000</u>	<u>\$ 6,130,000</u>

**NON-CASH INVESTING AND FINANCING**

**Supplemental disclosure of cash flow information:**

Cash paid for interest	\$ 2,456,000	\$ 2,023,000
Security deposit not received	—	198,000

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

In January 2015, the Company sold its interests in Sherburne Commons for a note receivable of \$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 a 10%-owned equity investment (see Note 11). This transaction had the following non-cash 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>

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**  
**SEPTEMBER 30, 2015**  
**(Unaudited)**

**1. Organization**

Summit Healthcare REIT, Inc. (“Summit”) is a real estate investment trust that owns 11 properties and has a 10% equity interest in an investment that holds six properties. Summit is a Maryland corporation, formed on October 22, 2004 under the General Corporation Law of Maryland for the purpose of engaging in the business of investing in and owning commercial real estate. As used in these notes, the “Company”, “we”, “us” and “our” refer to Summit Healthcare REIT, Inc. and its consolidated subsidiaries (including variable interest entities) except where the context otherwise requires. Until April 1, 2014, and subject to certain restrictions and limitations, our business was managed pursuant to an advisory agreement (the “Advisory Agreement”) with Cornerstone Realty Advisors, LLC (“CRA”). Beginning April 1, 2014, the Company became self-managed and hired employees to directly manage its operations.

Generally we conduct substantially all of our operations through Summit Healthcare Operating Partnership, L.P. (the “Operating Partnership”), which is a Delaware limited partnership. At September 30, 2015, we own a 99.88% general partner interest in the Operating Partnership, and 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. These financial statements include consolidation of a variable interest entity (“VIE”) that was classified as held for sale until January 7, 2015, at which time the VIE was sold (see Note 6).

***Cornerstone Healthcare Partners LLC***

In 2012, we formed Cornerstone Healthcare Partners LLC (“CHP LLC”) with Cornerstone Healthcare Real Estate Fund, Inc. (“CHREF”), an affiliate of CRA. We own 95% of CHP LLC, with the remaining 5% owned by CHREF. As CHP LLC’s equity holders have voting rights disproportionate to their economic interests in the entity, CHP LLC is considered to be a VIE. We have a controlling financial interest in CHP LLC because we have the power to direct the activities of the VIE that most significantly impact its economic performance and we have the obligation to absorb the VIE’s losses and the right to receive benefits from the VIE. Consequently, we are deemed to be the primary beneficiary of the VIE, and therefore have consolidated the operations of the VIE.

During 2012, we acquired the following healthcare properties through CHP LLC (collectively, the “JV Properties”): Sheridan Care Center, Fernhill Care Center, Farmington Square, Friendship Haven Healthcare and Rehabilitation Center (“Friendship Haven”) and Pacific Health and Rehabilitation Center. In the third quarter of 2013, CHP LLC sold a portion of its interests in the JV Properties to third party investors. Proceeds from the sale of interests in these JV Properties were approximately \$0.9 million and were received in January 2014, of which we received \$0.9 million and CHREF received \$41,000. As of September 30, 2015, we owned an 89.0% interest in the JV Properties, CHREF owned a 4.7% interest and third party investors owned 6.3%. In October 2015, Summit purchased the membership interests of the third party investors for approximately \$0.9 million. As a result of this transaction, we now own a 95.3% interest in the JV Properties, and CHREF owns a 4.7% interest (see Note 12).

***Friendswood TRS***

In May 2014, we formed a taxable REIT subsidiary (“Friendswood TRS”) which became the licensed operator and tenant of Friendship Haven (see Note 4).

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

On April 29, 2015, through our Operating Partnership, we entered into a limited liability company agreement (“SUL LLC Agreement”) with Best Years, LLC (“Best Years”), an unrelated entity and a U.S.-based affiliate of Union Life Insurance Co, Ltd. (“Union Life”), and formed Summit Union Life Holdings, LLC (“SUL JV”).

In conjunction with the SUL JV, the Operating Partnership contributed all of its limited liability company interest in each of six limited liability companies that collectively own Lamar Estates, Monte Vista Estates, Myrtle Point Care Center, Gateway Care and Retirement Center, Applewood Retirement Community and Loving Arms Assisted Living (collectively, the “JV 2 Properties”) to the SUL JV, resulting in the SUL JV owning each of the JV 2 Properties. Best Years, in conjunction with the SUL JV, contributed cash in the amount of approximately \$9.9 million to the SUL JV of which we received a net amount of \$9.2 million after paying down the Loving Arms Assisted Living loan payable of \$715,000 (see Note 8). Under the SUL LLC Agreement, as a result of these contributions and cash distributions, the Operating Partnership and Best Years own a 10% and 90% equity interest in the SUL JV, respectively. The Operating Partnership recorded a distribution 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. The distribution receivable is included in tenant and other receivables on the condensed consolidated balance sheets.

As a result of the SUL JV, the JV 2 Properties are no longer consolidated in the Company’s financial results, commencing April 30, 2015. The SUL JV is accounted for under the equity-method in the Company’s consolidated financial statements (see Note 11). We recorded a partial gain of approximately \$1.0 million during the quarter ended June 30, 2015 related to the disposition of these properties (see Note 10).

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

Additionally, as part of the SUL JV, we formed Summit Healthcare Asset Management, LLC (the “Management Company”) as a wholly-owned taxable REIT subsidiary (TRS). We serve as the manager of the SUL JV and provide various services in exchange for fees and reimbursements. All acquisition fees and management fees will be paid to the Management Company and expenses incurred by us, as the manager, will be reimbursed from the Management Company. Under the SUL LLC Agreement, Best Years paid the Management Company a one-time acquisition fee equal to 1% of the original purchase price paid for the JV 2 Properties, approximately \$405,000. Annual asset management fees to be paid by the SUL JV to the Management Company are equal to 0.25% of the original purchase price paid for the JV 2 Properties.

## **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, 2014 filed with the U.S. Securities and Exchange Commission (“SEC”) on March 20, 2015. There have been no material changes to our policies since that filing, except as disclosed herein.

The accompanying condensed consolidated balance sheet at December 31, 2014 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, 2014 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, 2014 filed with the SEC on March 20, 2015 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, 2014 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, CHP LLC (of which the Company owns 95%) and Nantucket Acquisition LLC, a VIE through January 7, 2015 (see Note 6). 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 nine months ended September 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015.

### ***Equity-Method Investment***

We report our investment in an unconsolidated entity, over whose operating and financial policies we have the ability to exercise significant influence but not control, under the equity method of accounting. Under this method of accounting, our pro rata share of the entity's earnings or losses is included in our condensed consolidated statements of operations. Additionally, we adjust our investment carrying amount to reflect our share of changes in an equity-method investee's capital resulting from its capital transactions.

The initial carrying value of our equity-method investment in the SUL JV is based on the carrying value of the net assets of the JV 2 Properties at the time of contribution.

We evaluate our equity-method investment for impairment whenever events or changes in circumstances indicate that the carrying value of our investment may exceed the fair value. If it is determined that a decline in the fair value of our investment is not temporary, and if such reduced fair value is below its carrying value, an impairment is recorded. Determining fair value involves significant judgment. Our estimates consider all available evidence including the present value of the expected future cash flows discounted at market rates, general economic conditions and other relevant factors.

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

The Financial Accounting Standards Board ("FASB") has issued 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 recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU.

For public business entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. For all other entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.

Early adoption of the amendments is permitted for financial statements that have not been previously issued.

The amendments should be applied on a retrospective basis, wherein the balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. Upon transition, an entity is required to comply with the applicable disclosures for a change in an accounting principle. These disclosures include the nature of and reason for the change in accounting principle, the transition method, a description of the prior-period information that has been retrospectively adjusted, and the effect of the change on the financial statement line items (i.e., debt issuance cost asset and the debt liability). 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.

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, certain not-for-profit entities, and certain employee benefit plans 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 statements of operations for property operating costs and resident services costs for the prior period have been reclassified to conform to the current period presentation. These reclassifications had no effect on total consolidated results of operations for prior periods.

### 3. 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, 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 September 30, 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 September 30, 2015 and December 31, 2014, the fair value of loans payable was \$59.6 million and \$80.1 million compared to the gross carrying value of \$58.6 million and \$78.8 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 September 30, 2015, we utilized discount rates ranging from 4.4% to 4.75% and a weighted average discount rate of 4.47%. 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 (see Note 4). No impairments were recorded during the three and nine months ended September 30, 2015.

At September 30, 2015 and December 31, 2014, 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.

### 4. Investments in Real Estate Properties

As of September 30, 2015 and December 31, 2014, adjusted cost and accumulated depreciation related to investments in real estate, and excluding assets of a VIE held for sale, were as follows:

	<u>September 30, 2015</u>	<u>December 31, 2014</u>
Land	\$ 6,502,000	\$ 8,432,000
Buildings and improvements	65,319,000	88,241,000
Less: accumulated depreciation	(5,293,000)	(3,813,000)
Buildings and improvements, net	60,026,000	84,428,000
Furniture and fixtures	6,550,000	8,133,000
Less: accumulated depreciation	(3,177,000)	(2,271,000)
Furniture and fixtures, net	3,373,000	5,862,000
Real estate properties, net	<u>\$ 69,901,000</u>	<u>\$ 98,722,000</u>

In April 2015, we formed the SUL JV with Best Years and contributed the JV 2 Properties to the SUL JV. See Notes 10 and 11 for further information regarding the disposition of our real estate properties and equity-method investment.

As of September 30, 2015, our portfolio consists of 11 properties which were 100% leased to the operators of the related facilities. The following table provides summary information regarding our properties:

Property <sup>(1)</sup>	Location	Date Purchased	Type <sup>(3)</sup>	Purchase Price	Loans Payable as of September 30, 2015	Number of Beds
Sheridan Care Center	Sheridan, OR	August 3, 2012	SNF	\$ 4,100,000	\$ 5,081,000	51
Fernhill Care Center	Portland, OR	August 3, 2012	SNF	4,500,000	4,458,000	63
Farmington Square	Medford, OR	September 14, 2012	AL/MC	8,500,000	6,792,000	71
Friendship Haven Healthcare and Rehabilitation Center <sup>(2)</sup>	Galveston County, TX	September 14, 2012	SNF	15,000,000	6,374,000	150
Pacific Health and Rehabilitation Center	Tigard, OR	December 24, 2012	SNF	8,140,000	7,431,000	73
Danby House	Winston-Salem, NC	January 31, 2013	AL/MC	9,700,000	7,275,000	100
Brookstone of Aledo	Aledo, IL	July 2, 2013	AL	8,625,000	5,843,000	66
The Shelby House	Shelby, NC	October 4, 2013	AL	4,500,000	4,886,000	72
The Hamlet House	Hamlet, NC	October 4, 2013	AL	6,500,000	4,129,000	60
The Carteret House	Newport, NC	October 4, 2013	AL	4,300,000	3,483,000	64
Sundial Assisted Living	Redding, CA	December 18, 2013	AL	3,500,000	2,800,000	65
Total:				\$ 77,365,000	\$ 58,552,000	835

- (1) The above table excludes Sherburne Commons Residences, LLC (“Sherburne Commons”), a VIE that was sold on January 7, 2015 (see Note 6).
- (2) We terminated the lease with the operator of this facility on March 16, 2014 and became the licensed operator of the facility on May 1, 2014 through a wholly-owned taxable REIT subsidiary (Friendswood TRS).
- (3) 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 the properties owned as of September 30, 2015 for the period from October 1, 2015 to December 31, 2015 and for each of the four following years and thereafter are as follows:

Year	
October 1, 2015 to December 31, 2015	\$ 1,851,000
2016	7,498,000
2017	7,669,000
2018	7,844,000
2019 and thereafter	66,729,000
	<u>\$ 91,591,000</u>

The schedule does not reflect future rental revenues from the potential renewal or replacement of existing and future leases, includes the rental revenues for the tenant of Friendship Haven and excludes tenant reimbursements.

#### **Friendswood TRS**

Beginning in January 2014, the tenant/operator of Friendship Haven ceased paying rent payments due to us under the lease agreement. On March 16, 2014, we terminated the lease agreement. Effective May 1, 2014, we became the licensed operator and tenant of the facility through Friendswood TRS. Upon becoming the licensed operator of the facility, we entered into a management agreement with an affiliate of Stonegate Senior Living (“Stonegate”). In October 2015, we amended the management agreement with Stonegate to increase the term from two years to 12 years (see Note 12). We plan to operate the facility with Stonegate until a long-term lease agreement can be secured with a new operator.

### **Leasing Commissions**

Leasing commissions (paid to CRA prior to April 1, 2014) were capitalized at cost and are being amortized on a straight-line basis over the related lease term. As of September 30, 2015 and December 31, 2014, total costs incurred were \$2.2 million and the unamortized balance of capitalized leasing commissions was \$1.7 million and \$1.9 million, respectively. In March 2014, the amortization of Friendship Haven's leasing commission totaling \$0.4 million was accelerated due to the lease termination on March 16, 2014. Amortization expense for the three months ended September 30, 2015 and 2014 was \$40,000. Amortization expense for the nine months ended September 30, 2015 and 2014 was \$121,000 and \$489,000, respectively.

### **Acquisitions – 2015**

#### **Loving Arms Assisted Living**

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 as described in Note 8. Loving Arms is leased under a 15-year triple net lease.

The following sets forth the allocation of the purchase price of the property acquired in 2015 as well as the associated acquisitions costs, all of which have been capitalized. We have accounted for the acquisition as an asset purchase under generally accepted accounting principles ("GAAP").

	<b>Total</b>
Land	\$ 500,000
Buildings & improvements	12,707,000
Site improvements	540,000
Furniture & fixtures	760,000
Real estate acquisition and capitalized costs	<u>\$ 14,507,000</u>
Third-party acquisition costs, capitalized (included above)	<u>\$ 207,000</u>

Loving Arms was contributed to the SUL JV in April 2015. See Note 11.

### **5. Concentration of Risk**

Our cash is generally invested in investment-grade short-term instruments. As of September 30, 2015, 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 September 30, 2015, 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. For the three months ended September 30, 2015, we leased our 11 healthcare properties to affiliates of five different operators under long-term triple net leases, two of which comprise 49% and 29% of our tenant rental revenue. For the three months ended September 30, 2014, we leased our 11 healthcare properties to affiliates of five different operators under long-term triple net leases, two of which comprise 49% and 29% of our tenant rental revenue. For the nine months ended September 30, 2015, we leased our 11 healthcare properties to affiliates of five different operators under long-term triple net leases, two of which comprise 49% and 29% of our tenant rental revenue. For the nine months ended September 30, 2014, we leased our 11 healthcare properties to affiliates of five different operators under long-term triple net leases, two of which comprise 48% and 28% of our tenant rental revenue.

## 6. Notes Receivable

### *Servant Healthcare Investments, LLC*

The Servant Healthcare Investments, LLC note was paid in full on May 2, 2014. For the three months ended September 30, 2015 and 2014, interest income related to the note receivable was \$0. For the nine months ended September 30, 2015 and 2014, interest income related to the note receivable was \$0 and \$4,000, respectively.

### *Fernhill Note*

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

### *Nantucket Note - Consolidation and Sale of VIE*

We held a note receivable from a participating first mortgage loan made to Nantucket Acquisition LLC (“Nantucket”), a Delaware limited liability company owned and managed by Cornerstone Ventures Inc., an affiliate of CRA, which was collateralized by Sherburne Commons. As of October 19, 2011, the Sherburne Commons property was reclassified to real estate held for sale. Consequently, the related assets and liabilities of the property were classified as assets of a VIE held for sale and liabilities of a VIE held for sale on our condensed consolidated balance sheets. Operating results for the property have been reclassified to discontinued operations on our condensed consolidated statements of operations for all periods presented. On October 6, 2014, we foreclosed on the Sherburne Commons property, however we did not take possession of the property.

On January 7, 2015, through our Operating Partnership, we sold Sherburne Commons 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. In conjunction with the sale of the property, we assigned our foreclosure bid to the Buyer.

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. At Sherburne Buyer’s election, interest may accrue and not be payable through December 31, 2015 with all accrued but unpaid interest being payable in full on January 1, 2016. Interest income for the three and nine months ended September 30, 2015 was \$43,000 and \$126,000, respectively, has been fully reserved and will be recognized as cash is received. Outstanding and unpaid principal and interest 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 September 30, 2015, we have not collected any funds related to the principal or interest on the note and the outstanding balance on the note receivable was \$4.7 million.

As we are no longer the primary beneficiary of the VIE, it is no longer being consolidated as of January 7, 2015. As of December 31, 2014, the VIE was classified as assets of a VIE held for sale and liabilities of a VIE held for sale and as of September 30, 2014, the results of operations for the VIE held for sale was presented in discontinued operations on the condensed consolidated statements of operations. For the three and nine months ended September 30, 2015, we recorded a loss on disposition of \$0.1 million and \$1.7 million for this VIE, which is included in the condensed consolidated statements of operations.

## 7. Related Party Transactions

### *CRA*

Related party transactions relate to fees paid and costs reimbursed to CRA for services rendered to us through March 31, 2014, prior to the termination of the Advisory Agreement on April 1, 2014.

Specific fees described in the Advisory Agreement which would have been owed to CRA are described below. We do not believe that we owe CRA any amounts due under the Advisory Agreement. The fees and expense reimbursements payable to CRA under the Advisory Agreement are described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the SEC on March 20, 2015.

Organizational and Offering Costs - The Advisory Agreement provided for reimbursement by CRA for organizational and offering costs in excess of 3.5% of the gross proceeds from our primary offering and follow-on offering. Under the Advisory Agreement, within 60 days after the end of the month in which our follow-on offering terminates, CRA was obligated to reimburse us to the extent that the organization and offering expenses related to our follow-on offering borne by us exceeded 3.5% of the gross proceeds of the follow-on Offering.

As of June 10, 2012, the date that our follow-on offering terminated, we had reimbursed CRA a total of \$1.1 million in organizational and offering costs related to our follow-on offering, of which \$1.0 million was in excess of the contractual limit. Consequently, in the second quarter of 2012, we recorded a receivable from CRA for \$1.0 million reflecting the excess reimbursement. However, based on our evaluation of various factors related to collectability of this receivable, we reserved the full amount of the receivable.

As of September 30, 2015 and December 31, 2014, the gross balance of this receivable was \$0.7 million. CRA has not made any payments in 2014 or 2015. The balance of this receivable has been fully reserved for as of September 30, 2015 and December 31, 2014.

Acquisition Fees and Expenses - No acquisition fees were earned by CRA during the three and nine months ended September 30, 2015 and 2014.

Management Fees and Expenses - For the three months ended September 30, 2015 and 2014, CRA earned \$0 of asset management fees. For the nine months ended September 30, 2015 and 2014, CRA earned \$0 and \$0.2 million, respectively. These costs are included in asset management fees and expenses in our condensed consolidated statements of operations.

In addition, the Advisory Agreement provided for our reimbursement to CRA for the direct and indirect costs and expenses incurred by CRA in providing asset management services to us, including related personnel and employment costs. For the three months ended September 30, 2015 and 2014, CRA was reimbursed \$0 of such direct and indirect costs and expenses. For the nine months ended September 30, 2015 and 2014, CRA was reimbursed \$0 and \$36,000, respectively, of such direct and indirect costs and expenses. These costs are included in asset management fees in our condensed consolidated statements of operations.

As of March 2014, we overpaid CRA \$32,000 for asset management fees. We have recorded this amount as receivable from related party in our condensed consolidated balance sheets and reserved for the entire amount due to the uncertainty of collectability.

Operating Expenses - For the three months ended September 30, 2015 and 2014, no operating expenses incurred on our behalf were reimbursed to CRA. For the nine months ended September 30, 2015 and 2014, we reimbursed \$0 million and \$0.2 million of operating costs incurred by CRA on our behalf, respectively. These costs are included in general and administrative expenses on our condensed consolidated statements of operations. We paid \$189,000 in excess operating expense reimbursements to CRA in prior periods. Accordingly, we have recorded this receivable due from CRA and reserved for the entire amount due to the uncertainty of collectability.

Pursuant to provisions contained in our terminated Advisory Agreement, our board of directors had the responsibility of limiting our total operating expenses for each trailing four consecutive quarters to amounts that do not exceed the greater of 2% of our average invested assets or 25% of our net income, calculated in the manner set forth in our charter, unless a majority of the directors (including a majority of the independent directors) made a finding that a higher level of expenses was justified (the "2%/25% Test"). In the event that a majority of the directors had not determined that such excess expenses were justified, CRA was required to reimburse to us the amount of the excess expenses paid or incurred (the "Excess Amount").

For each four-fiscal-quarter period prior to March 31, 2014, our board of directors determined that the Excess Amount was justified and had consequently waived such Excess Amount. For the four-fiscal-quarter period ended March 31, 2014, our total operating expenses exceeded the greater of 2% of our average invested assets and 25% of our net income. We incurred operating expenses of approximately \$3.7 million and incurred an Excess Amount of approximately \$1.7 million during this period. Our board of directors did not waive this Excess Amount and therefore such Excess Amount is due to the Company from CRA. Accordingly, we have recorded this receivable and reserved for the entire amount due to the uncertainty of collectability.

**Property Management and Leasing Fees and Expenses** - For the three months ended September 30, 2015 and 2014, CRA earned no property management fees. For the nine months ended September 30, 2015 and 2014, CRA earned approximately \$0 and \$42,000, respectively, of property management fees. CRA did not earn any leasing fees for the three and nine months ended September 30, 2015 and 2014. These costs are included in property operating and maintenance expenses in our condensed consolidated statements of operations.

**Disposition Fee** – No disposition fees were earned during the three and nine months ended September 30, 2015 and 2014.

**Subordinated Participation Provisions** – No subordinated participation fees were earned during the three and nine months ended September 30, 2015 and 2014.

### **SUL JV**

See Notes 1 and 11 for further discussion of related party distributions and asset management fees related to the SUL JV. Certain deferred acquisition costs paid by us relate to acquisitions to be acquired by the SUL JV and will be reimbursed to us upon closing of such acquisitions. As such, as of September 30, 2015, approximately \$0.1 million has been recorded as a receivable and included in tenant and other receivables in the condensed consolidated balance sheets.

### **8. Loans Payable**

In April 2015, we formed the SUL JV with Best Years and contributed the JV 2 Properties to the SUL JV: Lamar Estates, Monte Vista Estates, Myrtle Point Care Center, Gateway Care and Retirement Center, Applewood Retirement Community, and Loving Arms. Approximately \$30.4 million of loans payable were transferred to the SUL JV upon disposition of the properties (approximately \$10.6 million from GE Capital Corporation and \$19.8 million from The PrivateBank and Trust Company). See Notes 10 and 11 for further information regarding the disposition of real estate properties.

As of September 30, 2015 and December 31, 2014, loans payable consisted of the following:

	<b>September 30, 2015</b>	<b>December 31, 2014</b>
Loans payable to GE Capital Corporation in monthly installments of approximately \$82,000, including interest at LIBOR (floor of 0.50%) plus 4.5% (5.0% at September 30, 2015 and December 31, 2014, respectively), due in September 2017 through July 2018, collateralized by Friendship Haven, Brookstone of Aledo, and Redding as of September 30, 2015, and Friendship Haven, Brookstone of Aledo, Redding, Gateway and Applewood as of December 31, 2014.	\$ 15,016,000	\$ 25,617,000
Loans payable to The PrivateBank and Trust Company in monthly installments of approximately \$45,000, including interest at LIBOR (floor of up to 1.0%) plus 4% (5.0% at September 30, 2015 and 4.50% to 5.0% at December 31, 2014, respectively), collateralized by Danby House and due in January 2016 as of September 30, 2015, and Danby House, Myrtle Point, Lamar Estates and Monte Vista Estates as of December 31, 2014.	7,275,000	16,350,000
Loans payable to Lancaster Pollard Mortgage Company, LLC (insured by HUD) in monthly installments of approximately \$119,000, including interest ranging from a fixed rate of 3.75% to 3.78%, plus 0.65% for mortgage insurance, due in September 2039 through December 2049, collateralized by Sheridan, Fernhill, Tigard, Medford, Shelby, Hamlet and Carteret.	36,261,000	36,785,000
	<b>58,552,000</b>	<b>78,752,000</b>
<b>Less debt discount</b>	<b>(575,000)</b>	<b>(780,000)</b>
<b>Total loans payable</b>	<b>\$ 57,977,000</b>	<b>\$ 77,972,000</b>

We have total debt obligations of approximately \$58.6 million that will mature between 2016 and 2049. See Note 4 for loans payable balance for each owned property.

In connection with our loans payable, we incurred debt discounts and financing costs. The unamortized balance of the deferred financing costs totaled \$1.6 million and \$1.5 million, as of September 30, 2015 and December 31, 2014, respectively. The unamortized balance of the debt discount totaled \$0.6 million and \$0.8 million, as of September 30, 2015 and December 30, 2014, respectively. The capitalized financing costs and 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 September 30, 2015 and 2014, \$42,000 and \$0.2 million, respectively, of deferred financing costs and debt discounts were amortized and included in interest expense in our condensed consolidated statements of operations. For the nine months ended September 30, 2015 and 2014, \$0.2 million and \$0.3 million, respectively, of deferred financing costs and debt discounts were amortized and included in interest expense in our condensed consolidated statements of operations.

The principal payments due on the loans payable (excluding debt discount) for the period from October 1, 2015 to December 31, 2015 and for each of the four following years and thereafter ending December 31 are as follows:

<b>Year</b>	<b>Principal Amount</b>
October 1, 2015 to December 31, 2015	\$ 384,000
2016	8,154,000
2017	9,855,000
2018	6,354,000
2019 and thereafter	33,805,000
	<u>\$ 58,552,000</u>

***General Electric Capital Corporation (“GE”)***

As of September 30, 2015 and December 31, 2014, we had net borrowings of \$15.0 million and \$25.6 million, respectively, under the GE loan agreements. See table above for further information. During the three months ended September 30, 2015 and 2014, we incurred approximately \$0.2 million and \$0.5 million, respectively, of interest expense related to the GE loans. During the nine months ended September 30, 2015 and 2014, we incurred approximately \$0.7 million and \$1.3 million, respectively, of interest expense related to the GE loans. In October 2015, we refinanced the GE loans for Friendship Haven with Oxford Finance Corporation and Brookstone of Aledo with Lancaster Pollard Mortgage Company, LLC. See Note 12 for further information.

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

In January 2015, in conjunction with the acquisition of Loving Arms Assisted Living (see Note 4), we entered into a first priority mortgage loan collateralized by the Loving Arms Assisted Living property and cross-collateralized with three of our other properties, Lamar Estates, Monte Vista Estates and Myrtle Point. On January 23, 2015, we amended an existing loan agreement with PrivateBank to increase the principal amount available under that existing loan by \$11.4 million for a total principal availability of \$20.5 million collateralized by a first priority security interest in the four properties noted above. All availability under this loan is outstanding. The loan, which bears interest at the One Month LIBOR (London Interbank Rate), with a floor of 25 basis points, plus a spread of 4.50%, has a 25 year amortization schedule and matures on September 21, 2017. The loan may be prepaid with no penalty if the four properties are refinanced through HUD (see below). In April 2015, in conjunction with the funds received from the SUL JV, \$715,000 was paid to reduce the PrivateBank loan balance for Loving Arms Assisted Living.

As of September 30, 2015 and December 31, 2014, we had net borrowings of \$7.3 million and \$16.4 million, respectively, under the PrivateBank loans. See table above for further information. During the three months ended September 30, 2015 and 2014, we incurred approximately \$0.1 million and \$0.3 million of interest expense, respectively, related to the PrivateBank loans. During the nine months ended September 30, 2015 and 2014, we incurred approximately \$0.6 million and \$0.7 million of interest expense, respectively, related to the PrivateBank loans.

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

In September 2014 and November 2014, we refinanced certain properties with Housing and Urban Development (“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 the Company’s condensed consolidated balance sheets.

As of September 30, 2015 and December 31, 2014, we had net borrowings of \$36.3 million and \$36.8 million under the HUD loans. During the three months ended September 30, 2015 and 2014, we incurred approximately \$0.4 million and \$0.1 million, respectively, of interest expense related to the HUD loans. During the nine months ended September 30, 2015 and 2014, we incurred approximately \$1.2 million and \$0.1 million, respectively, of interest expense related to the HUD loans.

#### **9. 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 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.

In connection with our becoming the licensed operator of Friendship Haven through a wholly-owned taxable REIT subsidiary, we have entered into a management agreement with an affiliate of Stonegate. The management agreement, as amended, calls for us to pay to Stonegate a termination fee if we terminate the agreement before October 6, 2016. As of September 30, 2015, the agreement with them has not been terminated.

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

As of September 30, 2015, we own one property with a book value of approximately \$7.6 million that 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. The option expires August 13, 2022. As of September 30, 2015, the option holder has not provided notice or exercised their option.

### **Purchase Agreement**

In November 2013, a limited liability company in which we hold a minority interest entered into a build-to-suit purchase agreement whereby the entity agreed to purchase a 70-unit assisted living facility in Athens, Georgia for approximately \$12.4 million upon receipt of certificate of occupancy. In the event the entity defaults on the purchase of the building as provided for in the purchase agreement, the entity 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. The Company executed a guarantee for the payments associated with that lease. In the event that the lease is executed, the lease payment will equal approximately \$1.0 million per year.

### **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.

### **10. 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.

#### **Real Estate Held for Sale and Disposed**

As of December 31, 2014, the Sherburne Commons property had been classified as real estate held for sale and the results of operations for the VIE held for sale have been presented in discontinued operations in the Company's condensed consolidated statements of operations for all periods presented. On January 7, 2015, we sold the Sherburne Commons property. See Note 6 for further information.

The following is a summary of the components of loss from discontinued operations for the three and nine months ended September 30, 2015 and 2014:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Rental revenues, tenant reimbursements and other income	\$ —	\$ 700,000	\$ —	\$ 1,853,000
Operating expenses and real estate taxes	—	(664,000)	—	(2,053,000)
Loss on disposition of VIE	(117,000)	—	(1,699,000)	—
Loss from discontinued operations	<u>\$ (117,000)</u>	<u>\$ 36,000</u>	<u>\$ (1,699,000)</u>	<u>\$ (200,000)</u>

The following table presents balance sheet information for the properties classified as held for sale as of September 30, 2015 and December 31, 2014. FASB ASC 360 requires that assets classified as held for sale be carried at the lesser of their carrying amount or estimated fair value, less estimated selling costs.

	September 30, 2015	December 31, 2014
<b>Assets of variable interest entity held for sale:</b>		
Cash and cash equivalents	\$ —	\$ 36,000
Investments in real estate, net	—	3,905,000
Accounts receivable, inventory and other assets	—	198,000
<b>Total assets</b>	<b>\$ —</b>	<b>\$ 4,139,000</b>
<b>Liabilities of variable interest entity held for sale:</b>		
Note payable	\$ —	\$ 1,332,000
Loans payable	—	117,000
Accounts payable and accrued liabilities	—	466,000
Intangible lease liabilities, net	—	145,000
Interest payable	—	640,000
<b>Liabilities of variable interest entity held for sale</b>	<b>\$ —</b>	<b>\$ 2,700,000</b>

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

In April 2015, we formed the SUL JV with Best Years and contributed the JV 2 Properties to the SUL JV (see Notes 1 and 11). For additional information on the SUL JV, see the Company's Form 8-K filed on May 1, 2015.

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
<b>Total contribution:</b>	<b>\$ 9,908,000</b>

We recorded a partial gain of approximately \$1.0 million for the nine months ended September 30, 2015 related to the disposition of the real estate properties contributed to the SUL JV.

### **11. 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 as we have greater than 3% to 5% ownership interest and significant influence over the SUL JV.

Under the SUL LLC Agreement, net operating cash flow of the SUL JV will be distributed quarterly, first to the Operating Partnership and Best Years *pari passu* up to a 10% annual return, and thereafter to Best Years 75% and the Operating Partnership 25%. All capital proceeds (from the sale of the JV 2 Properties, refinancing, or other 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 10% return plus its total contribution, and thereafter to Best Years 75% and the Operating Partnership 25%. As of September 30, 2015, the Operating Partnership has recorded a distribution receivable of approximately \$127,000. This is included in tenant and other receivables on our condensed consolidated balance sheets.

We serve as the manager of the SUL JV and provide various services in exchange for fees and reimbursements. Under the SUL LLC Agreement, the manager will be paid a 1% acquisition fee based on the purchase price paid for the properties and an annual asset management fee equal to 0.25% of the purchase price paid for the properties. Total asset management fees earned in connection with the SUL JV were approximately \$25,000 and \$42,000 for the three and nine months ended September 30, 2015, respectively, and are included in acquisition and asset management fees in the condensed consolidated statements of operations.

Our initial equity method investment was approximately \$1.0 million. The difference between our initial equity method investment and our equity in the SUL JV (\$1.1 million, as agreed upon by the members of the SUL JV) was approximately \$0.1 million, which will be amortized over the life of the contributed properties. As of September 30, 2015, the balance of our equity method investment was approximately \$0.9 million.

## **12. Subsequent Events**

### ***Loan Refinancing***

On October 6, 2015, we refinanced our existing GE loan for the Brookstone of Aledo facility with Lancaster Pollard. The note is collateralized by the Brookstone of Aledo facility and is insured by HUD. The note has a principal balance of \$7.4 million, an “all in” interest rate of 4.35% inclusive of the mortgage insurance premium, and amortization term of 35 years. The note contains a prepayment penalty of 10% in year 1, which reduces each year by 100 basis points, until there is no longer a prepayment penalty beginning in year 11. The net loan proceeds of \$7.4 million have been used to pay down outstanding principal debt on the existing GE loan maturing in July 2018 and to establish certain reserve accounts required by HUD.

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 for \$7.0 million, which is collateralized by a first priority security interest in the Friendship Haven facility. The loan, which bears interest at the One Month LIBOR (London Interbank Offer Rate), with a floor of 75 basis points, plus a spread of 6.50%, is interest only for the first 12 months, has a 25 year amortization schedule, and matures on October 6, 2019. Additionally, we can qualify for an additional \$1.1 million loan during the first 24 months subject to certain conditions, as defined in the loan agreement. The loan may not be prepaid within the first six months. The loan may be prepaid with no penalty after six months if the property is refinanced through HUD. The net loan proceeds of \$7.0 million have been used to pay down outstanding principal debt on the existing GE loan maturing in 2017 and to establish certain reserve accounts required by the lender. In conjunction with this refinancing, we extended our management agreement with Stonegate (see Note 4).

### ***Membership Interests Purchase***

In October 2015, Summit purchased the limited liability company interests of the CHP LLC JV Properties third party investors for approximately \$0.9 million. As a result of this transaction, we now own a 95.3% interest (previously was an 89% interest) in the CHP LLC JV Properties, and CHREF owns a 4.7% interest. See Note 1 for further information.

### ***Incentive Plan***

On October 28, 2015, the Company’s stockholders approved the Summit Healthcare REIT, Inc. 2015 Omnibus Incentive Plan. Additionally, the Board of Directors has approved the issuance of 500,000 stock options to be granted in 2015 to certain employees, subject to the determination of the exercise price. No options have been granted to date.

### ***Acquisitions***

#### ***SUL JV - Texas Properties***

On October 30, 2015, through the SUL JV, we acquired a 10% interest in four separate skilled-nursing facilities in Texas (“Creative Properties”) for an aggregate purchase price of \$27.0 million, which was funded through Best Years 90%, approximately \$7.5 million and the Operating Partnership 10%, approximately \$0.8 million, plus the proceeds from the loan described below. The properties are leased to affiliates under 15 year triple net leases.

The Creative properties are subject to a first priority mortgage loan collateralized by the four properties and cross-collateralized with three other properties, Gateway and Applewood (owned by SUL JV) and Redding (wholly-owned by the Operating Partnership). In conjunction with closing, we amended an existing loan agreement with GE to increase the principal amount available under that existing loan by \$19.3 million for a total principal availability of \$32.7 million, collateralized by a first priority security interest in all seven properties. All availability under this loan is outstanding. The loan, which bears interest at the Three Month LIBOR (London Interbank Offer Rate), with a floor of 50 basis points, plus a spread of 4.25%, has a 25 year amortization schedule and matures on October 30, 2018. The loan is interest only for the first 12 months, and may be prepaid after nine months with no penalty.

### *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 the loan described below. The properties are leased under 12 year triple net leases.

The Cottage properties are subject to a first priority mortgage loan collateralized by the four properties. We entered into a loan agreement with Pacific Western Bank for \$13.5 million. All availability under this loan is outstanding. The loan, which bears interest at the One Month LIBOR (London Interbank Offer Rate), with a floor of 19 basis points, plus a spread of 4.50%, has a 25 year amortization schedule and matures on November 3, 2018. The loan is interest only for the first 18 months, and may be prepaid after 12 months with no penalty if the four properties are refinanced through HUD.

### **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 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, 2014 filed with the U.S. Securities and Exchange Commission (the “SEC”) on March 20, 2015.

#### ***Overview***

As of September 30, 2015, we own 11 healthcare properties and have a 10% equity interest in an investment that holds six healthcare properties. As used in this report, the “Company,” “we,” “us” and “our” refer to Summit Healthcare REIT, Inc. and its Consolidated Subsidiaries (including variable interest entities) except where the context otherwise requires.

We believe that becoming self-managed as of April 1, 2014 has provided us numerous intermediate and long term benefits, despite certain non-recurring transition costs, and will allow us to realize increased funds from operations (“FFO”) and net asset value (“NAV”) in a shorter period of time than if we had remained externally managed.

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 4 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 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. The Company’s strategy includes purchasing SNF, AL, IL MC, and CCRC facilities.

On April 29, 2015, through Summit Healthcare Operating Partnership, L.P. (our “Operating Partnership”), we entered into a limited liability company agreement (“SUL LLC Agreement”) with Best Years, LLC (“Best Years”), an unrelated entity and a U.S.-based affiliate of Union Life Insurance Co, Ltd. (“Union Life”) and formed Summit Union Life Holdings, LLC (“SUL JV”).

In conjunction with the SUL JV, the Operating Partnership contributed all of its limited liability company interest in each of six limited liability companies that collectively own Lamar Estates, Monte Vista Estates, Myrtle Point Care Center, Gateway Care and Retirement Center, Applewood Retirement Community and Loving Arms Assisted Living (collectively, the “JV 2 Properties”) to the SUL JV entity, resulting in the SUL JV owning each of the JV 2 Properties. Best Years, in conjunction with the SUL JV, contributed cash in the amount of approximately \$9.9 million to the SUL JV, of which we received a net amount of \$9.2 million after paying down the Loving Arms loan payable of \$715,000 (see Note 9 to the accompanying Notes to Condensed Consolidated Financial Statements). Under the SUL LLC Agreement, as a result of these contributions and cash distributions, the Operating Partnership and Best Years own a 10% and 90% equity interest in the SUL JV, respectively. In keeping with our overall strategy, we intend to use the \$9.2 million in proceeds received from the SUL JV to acquire additional healthcare properties and potentially participate in the growth of the SUL JV portfolio.

As a result of the SUL JV, the six JV 2 Properties are no longer consolidated in the Company’s financial results, commencing April 30, 2015. The SUL JV is accounted for under the equity-method in the Company’s consolidated financial statements (see Note 11 to the accompanying Notes to Condensed Consolidated Financial Statements). Additionally, as part of the SUL JV, we formed Summit Healthcare Asset Management, LLC (the “Management Company”) as a wholly-owned taxable REIT subsidiary (TRS). All acquisition fees and management fees will be paid to the Management Company and expenses incurred in the management of SUL JV will be reimbursed from the Management Company.

The SUL JV transaction had the following effect to reduce our assets and liabilities in the second quarter of 2015:

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

The following reconciles our 10% equity investment in the SUL JV at September 30, 2015:

Initial investment	\$ 991,000
Income from equity-method investee	43,000
Distributions	<u>(150,000)</u>
Total investment:	\$ 884,000

During the three months ended September 30, 2015, we received cash of approximately \$23,000 in distributions and as of September 30, 2015, have a distribution receivable of approximately \$127,000 from our equity investment in the SUL JV. On October 30, 2015, through the SUL JV, we acquired a 10% interest in four separate skilled-nursing facilities in Texas (“Creative Properties”) for an aggregate purchase price of \$27.0 million, which was funded 90% through Best Years, approximately \$7.5 million, and 10% through the Operating Partnership, approximately \$0.8 million, plus the proceeds from a loan.

We may acquire additional properties through joint venture investments in the future, or sell a percentage of our existing properties to a joint venture partner, which may result in the deconsolidation of properties we already own. We anticipate acquiring properties through joint ventures in order to diversify our portfolio of properties in terms of geographic region, facility type and operator, among other reasons. Joint ventures typically also allow us to acquire an interest in a property without requiring that we fund the entire equity portion of the purchase price. In addition, certain properties may be available to us only through joint ventures. In determining whether to recommend a particular joint venture, management will evaluate the structure of the joint venture, the real property that such joint venture owns or is being formed to own under the same criteria. We may form additional entities in conjunction with joint ventures. These entities may employ debt financing consistent with our borrowing policies. Our joint ventures may take the form of equity joint ventures with one or more large institutional partners. They may also include ventures with developers who contribute land, development services and expertise rather than cash.

## Portfolio

At September 30, 2015, we own 11 healthcare facilities, located in five states. The following tables summarize our investments in real estate as of September 30, 2015:

### Real Estate Properties:

	<u>Properties</u>	<u>Beds</u>	<u>Square Footage</u>	<u>Purchase Price</u>
SNF or SNF/IL	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>

<u>Property</u>	<u>Location</u>	<u>Date Purchased</u>	<u>Type</u>	<u>Beds</u>	<u>2015 Revenue<sup>1</sup></u>
Sheridan Care Center	Sheridan, OR	August 3, 2012	SNF	51	\$ 369,000
Fern Hill Care Center	Portland, OR	August 3, 2012	SNF	63	394,000
Farmington Square	Medford, OR	September 14, 2012	AL/MC	71	650,000
Friendship Haven Healthcare and Rehabilitation Center	Galveston County TX	September 14, 2012	SNF	150	1,202,000 <sup>2</sup>
Pacific Health and Rehabilitation Center	Tigard, OR	December 24, 2012	SNF	73	726,000
Danby House	Winston-Salem, NC	January 31, 2013	AL/MC	100	717,000
Brookstone of Aledo	Aledo, IL	July 2, 2013	AL	66	557,000
The Shelby House	Shelby, NC	October 4, 2013	AL	72	342,000
The Hamlet House	Hamlet, NC	October 4, 2013	AL	60	493,000
The Carteret House	Newport, NC	October 4, 2013	AL	64	326,000
Sundial Assisted Living	Redding, CA	December 18, 2013	AL	65	269,000
Total				<u>835</u>	

<sup>1</sup> Represents year to date through September 30, 2015 revenue based on in-place leases, including straight-line rent.

<sup>2</sup> Represents year to date through September 30, 2015 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, 2014 as filed with the SEC on March 20, 2015, except as disclosed in Note 2 to the accompanying Notes to Condensed Consolidated Financial Statements.

## Results of Operations

Our results of operations that were significantly impacted are described below:

Three months ended September 30, 2015 and 2014

	Three Months Ended September 30,		\$ Change
	2015	2014	
Rental revenues	\$ 1,657,000	\$ 1,662,000	\$ (5,000)
Resident services and fee income	2,381,000	2,100,000	281,000
Tenant reimbursements and other income	232,000	181,000	51,000
Total revenues	<u>4,270,000</u>	<u>3,943,000</u>	<u>327,000</u>
Less expenses:			
Property operating costs	(460,000)	(397,000)	(63,000)
Resident services costs	<u>(1,924,000)</u>	<u>(1,784,000)</u>	<u>(140,000)</u>
Net operating income <sup>(1)</sup>	1,886,000	1,762,000	124,000
Acquisition and asset management fees	25,000	—	25,000
Interest income from notes receivable	2,000	—	2,000
General and administrative	(999,000)	(1,141,000)	142,000
Real estate acquisition costs	—	4,000	(4,000)
Depreciation and amortization	(889,000)	(873,000)	(16,000)
Income from equity-method investee	26,000	—	26,000
Other income	16,000	—	16,000
Interest expense	<u>(723,000)</u>	<u>(882,000)</u>	<u>159,000</u>
Loss from continuing operations	(656,000)	(1,130,000)	474,000
Loss from discontinued operations	<u>(117,000)</u>	<u>36,000</u>	<u>(153,000)</u>
Net loss	(773,000)	(1,094,000)	321,000
Noncontrolling interests' share in losses	(43,000)	135,000	(178,000)
Net loss applicable to common stockholders	<u>\$ (816,000)</u>	<u>\$ (959,000)</u>	<u>\$ 143,000</u>

(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 interest income from notes receivable, general and administrative expense, real estate acquisition costs, acquisition and asset management fees, depreciation and amortization, other income, income from equity-method investee, 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 healthcare 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. The minor change in rental revenue is due rental increases offset by the contribution of two properties we owned as of September 30, 2014 which were contributed to the SUL JV in April 2015.

Resident services and fee income and resident services costs are generated from Friendswood TRS. The Friendswood TRS financials have been consolidated beginning on May 1, 2014. The net increase in resident services and fee income and resident services costs is mainly due to increased occupancy resulting from the completed renovation of an existing wing.

Net operating income increased to approximately \$1.9 million for the three months ended September 30, 2015 from \$1.8 million for the three months ended September 30, 2014, an increase of approximately \$0.1 million. The increase is mainly due to the increase in resident services, as noted above, offset by the contribution of the two properties we owned as of September 30, 2014 which were contributed to the SUL JV in April 2015.

The increase in the acquisition and asset management fees of approximately \$25,000 is due to the fees received from the SUL JV.

Income from equity-method investee represents the income for the third quarter of 2015 related to the SUL JV.

Interest expense decreased for the three months ended September 30, 2015 primarily due to the contribution of two of the six properties to the SUL JV that were owned as of September 30, 2014, resulting in owning 11 properties as of September 30, 2015 versus 13 during the three months ended September 30, 2014.

The loss from discontinued operations for the three months ended September 30, 2014 represents the Sherburne Commons activities in 2014. On January 7, 2015, we sold Sherburne Commons (see Note 10 to the accompanying Notes to Condensed Consolidated Financial Statements). The loss from discontinued operations for the three months ended September 30, 2015 represents certain expenses incurred in the disposition of the property.

*Nine months ended September 30, 2015 and 2014*

	<b>Nine Months Ended</b>		<b>\$ Change</b>
	<b>September 30,</b>		
	<b>2015</b>	<b>2014</b>	
Rental revenues	\$ 6,350,000	\$ 5,027,000	\$ 1,323,000
Resident services and fee income	6,931,000	3,559,000	3,372,000
Tenant reimbursements and other income	806,000	554,000	252,000
Total revenues	14,087,000	9,140,000	4,947,000
Less expenses:			
Property operating costs	(1,590,000)	(1,236,000)	(354,000)
Resident services costs	(5,548,000)	(2,990,000)	(2,558,000)
Net operating income <sup>(1)</sup>	6,949,000	4,914,000	2,035,000
Acquisition and asset management fees	447,000	—	447,000
Interest income from notes receivable	6,000	4,000	2,000
General and administrative	(3,076,000)	(2,917,000)	(159,000)
Asset management fees and expenses	—	(205,000)	205,000
Depreciation and amortization	(3,154,000)	(2,984,000)	(170,000)
Reserve for advisor obligations	—	(189,000)	189,000
Income from equity-method investee	43,000	—	43,000
Other income	26,000	104,000	(78,000)
Interest expense	(2,662,000)	(2,319,000)	(343,000)
Gain on disposition of real estate properties	991,000	—	991,000
Loss from continuing operations	(430,000)	(3,592,000)	3,162,000
Loss from discontinued operations	(1,699,000)	(200,000)	(1,499,000)
Net loss	(2,129,000)	(3,792,000)	1,663,000
Noncontrolling interests' share in losses	(119,000)	713,000	(832,000)
Net loss applicable to common stockholders	\$ (2,248,000)	\$ (3,079,000)	\$ 831,000

(1) 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 services and fee income, tenant reimbursements and other income less property operating and resident services costs. NOI excludes interest income from notes receivable, general and administrative expense, acquisition and asset management fees and expenses, real estate acquisition costs, depreciation and amortization, 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 healthcare 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. The increase is due to the revenue derived from our 2015 healthcare acquisition and owning the 2014 acquisitions purchased in the third and fourth quarters of 2014 for four months during the nine months ended September 30, 2015.

Resident services and fee income and resident services costs are generated from Friendswood TRS, which was consolidated on May 1, 2014. The net increase is due to the financial statements including five months of activities for the nine months ended September 30, 2014 as opposed to nine months for the nine months ended September 30, 2015 and increased occupancy resulting from the completed renovation of an existing wing.

Net operating income increased to approximately \$6.9 million for the nine months ended September 30, 2015 from \$4.9 million for the nine months ended September 30, 2014, an increase of approximately \$2.0 million. Approximately \$1.3 million of the increase is due to the revenue derived from our 2015 healthcare acquisition and owning the 2014 acquisitions purchased in the third and fourth quarters of 2014 for seven months during the nine months ended September 30, 2015 and \$0.7 million is due to the increase in the residents services as noted above.

The increase in the acquisition and asset management fees of approximately \$447,000 is due to the fees received from the SUL JV.

General and administrative expense was \$3.1 million for the nine months ended September 30, 2015 and \$2.9 million for the nine months ended September 30, 2014. The increase was primarily due to increases in employee payroll expenses of \$0.7 million, offset by lower advisor fees of \$0.2 million and consulting fees of \$0.3 million as a result of being self-managed for the five month in 2014 and nine months in 2015.

Depreciation and amortization increased by approximately \$0.2 million for the nine months ended September 30, 2015 due to the timing of our 2014 property acquisitions. We owned 17 healthcare properties for the four months in the nine months of 2015 as opposed to 11 properties in the nine months of 2014. The increase is offset by the contribution of six properties to the SUL JV.

Reserve for excess advisor obligation represents organizational and offering costs incurred in excess of the 3.5% limitation of the gross proceeds from our follow-on offering which terminated on June 10, 2012 (see Note 7 to the accompanying Notes to Condensed Consolidated Financial Statements). The Advisory Agreement provided that CRA would reimburse any excess costs that were paid by us. In 2012, we recorded a receivable for the excess of \$1.0 million which we fully reserved for based on our evaluation of CRA's ability to repay at that time. In March 2014, we increased our reserve by \$0.2 million for additional excess operating expenses paid to CRA in prior periods.

Income from equity-method investee represents the income for the nine months of 2015 related to the SUL JV.

Interest expense increased in 2015 primarily due to the interest expense incurred on our loans payable for new properties acquired at the end of 2014, offset by our contribution of six properties to the SUL JV.

Other income decreased due to the collection of the Servant Note in 2014.

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 10 to the accompanying Notes to Condensed Consolidated Financial Statements).

The loss from discontinued operations represents the Sherburne Commons activities in 2014. On January 7, 2015, we sold Sherburne Commons (see Note 10 to the accompanying Notes to Condensed Consolidated Financial Statements) and recorded a loss on disposition of \$1.7 million.

### ***Liquidity and Capital Resources***

As of September 30, 2015, we had approximately \$10.1 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, asset management fees, joint venture equity 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. We believe that 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 FFO have increased considerably over the past year primarily due to increased rental revenue from our acquisitions, reduced expenses and the elimination of asset management and acquisition related fees paid to Cornerstone Realty Advisors, LLC (“CRA”) resulting from the termination of the Advisory Agreement offset by the transition to self-management. FFO for the three months ended September 30, 2015 and 2014 were \$182,000 and (\$170,000), respectively. FFO for the nine months ended September 30, 2015 and 2014 were \$1,536,000 and (\$79,000), respectively.

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 September 30, 2015, we had debt obligations of approximately \$58.6 million. The outstanding balance by lender is as follows:

- The PrivateBank and Trust Company – approximately \$7.3 million maturing January 2016;
- GE Capital – approximately \$15.0 million maturing September 2017 through July 2018;
- Lancaster Pollard (HUD) – approximately \$23.8 million maturing from September 2039 through September 2049; and
- Lancaster Pollard (HUD) – approximately \$12.5 million maturing December 2049

In October 2015, we refinanced two of our GE Capital outstanding loans (see Note 12 to the accompanying Notes to Condensed Consolidated Financial Statements).

#### ***Distributions***

We made no stockholder distributions during the three and nine months ended September 30, 2015.

#### ***Funds from Operations***

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, 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.

The following is reconciliation from net loss applicable to common stockholders, the most direct comparable financial measure calculated and presented with GAAP, to FFO (presentation has been prepared to conform to other REIT presentation) for the three and nine months ended September 30, 2015 and 2014:

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Net loss applicable to common stockholders (GAAP)	\$ (816,000)	\$ (959,000)	\$ (2,248,000)	\$ (3,079,000)
Adjustments:				
Depreciation and amortization	889,000	873,000	3,154,000	2,984,000
Depreciation and amortization related to non-controlling interests	(49,000)	(48,000)	(145,000)	(184,000)
Depreciation related to SUL JV	41,000	—	67,000	—
Gain on disposition of real estate properties	—	—	(991,000)	—
Loss (income) on disposition of VIE	117,000	(36,000)	1,699,000	200,000
Funds provided by (used in) operations (FFO) applicable to common stockholders	<u>\$ 182,000</u>	<u>(170,000)</u>	<u>1,536,000</u>	<u>(79,000)</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	<u>\$ 0.01</u>	<u>\$ (0.01)</u>	<u>\$ 0.07</u>	<u>\$ —</u>

### 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.

### **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 report.

(b) Not applicable.

(c) During the three months and nine months ended September 30, 2015, 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 (incorporated by reference to Exhibit 3.2 to the Registrant's Annual Report on Form 10-K filed on March 24, 2006).
3.2	Amended and Restated Bylaws (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 Cornerstone Core Properties REIT, Inc. 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 Cornerstone Core Properties REIT, Inc. dated June 30, 2010 (incorporated by reference to Exhibit 3.4 to the Registrant'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).
10.1	Employment Agreement, dated as of September 23, 2015, between Kent Eikanas and the Company (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on September 28, 2015)
10.2	Employment Agreement, dated as of September 23, 2015, between Peter Elwell and the Company (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on September 28, 2015).
10.3	Employment Agreement, dated as of September 23, 2015, between Elizabeth Pagliarini and the Company (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K 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 September 30, 2015, 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 12<sup>th</sup> day of November 2015.

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: November 12, 2015

/s/ Kent Eikanas  
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*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: November 12, 2015

/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 three month period ended September 30, 2015 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: November 12, 2015

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

Date: November 12, 2015

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

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