AXT INC
Form 10-K405
March 26, 2002

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark one)

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the fiscal year ended December 31, 2001**
	or
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the transition period from to**

Commission file Number: 0-24085

AXT, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**94-3031310**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
4281 Technology Drive, Fremont, California	**94538**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code: (510) 683-5900

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: Common Stock, $.001 par value

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

Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

The aggregate market value of the voting stock held by non-affiliates of the registrant, based upon the closing sale price of the common stock on December 31, 2001 as reported on the Nasdaq National Market, was approximately $272,076,813. Shares of common stock held by each officer, director and by each person who owns 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not a conclusive determination for other purposes.

As of January 31, 2002, 22,386,622 shares, $.001 par value, of the registrant s common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the registrant s 2002 annual meeting of stockholders to be filed with the Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this form are incorporated by reference into Part III of this Form 10-K report.

TABLE OF CONTENTS

PART I
- Item 1. Business
- Item 2. Properties
- Item 3. Legal Proceedings
- Item 4. Submission of Matters to a Vote of Security Holders

PART II
- Item 5. Market for Registrant s Common Equity and Related Stockholder Matters
- Item 6. Selected Consolidated Financial Data
- Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations
- Item 7A.Qualitative and Quantitative Disclosures About Market Risk
- Item 8. Consolidated Financial Statements and Supplementary Data
- Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

PART III
- Item 10. Directors and Executive Officers of the Registrant.
- Item 11. Executive Compensation.
- Item 12. Security Ownership of Certain Beneficial Owners and Management.
- Item 13. Certain Relationships and Related Transactions

PART IV
- Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

EXHIBIT 10.13

PART I

This report includes forward-looking statements that reflect our current views with respect to future events and our potential financial performance. These forward-looking statements are subject to certain risks and uncertainties, including those discussed in Business , Management s Discussion and Analysis of Financial Condition and Results of Operations , and elsewhere in this report, that could cause actual results to differ materially from historical results or those anticipated. In this report, the words anticipates, believes, expects, intends, future similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report.

Item 1. *Business*

Overview

We design, develop, manufacture and distribute high-performance compound semiconductor substrates, as well as opto-electronic semiconductor devices, such as high-brightness light emitting diodes, or HBLEDs, and laser diodes including vertical cavity surface emitting lasers, or VCSELs, and edge-emitting laser diodes. Our substrate products are used primarily in fiber optic communications, wireless communications and lighting display applications. We believe our proprietary vertical gradient freeze, or VGF, technique for manufacturing compound semiconductor substrates provides significant benefits over traditional methods and has enabled us to become a leading manufacturer of compound semiconductor substrates. We pioneered the commercial use of VGF technology to manufacture gallium arsenide, or GaAs, substrates and have used VGF technology to manufacture substrates from other materials, such as indium phosphide, or InP, and germanium, or Ge. Customers for our substrates include Alpha Industries, Agilent Technologies, EMCORE, Nortel Networks, RF Micro Devices, SDL and Sumitomo Chemical. Our acquisition of Lyte Optronics provided us with expertise in epitaxial processes for manufacturing opto-electronic semiconductor devices. We have used these capabilities to make blue, green and cyan HBLEDs and laser diodes. Our opto-electronic semiconductor devices are used in a wide range of applications, such as solid-state lighting and fiber optic communications. We have recently undertaken an initiative to reduce the cost of our substrate manufacturing operations by moving much of our manufacturing operations to China and by investing in sources of low cost raw materials. We are also expanding our HBLED manufacturing capacity in response to an increase in customer demand.

We were incorporated in California in December 1986 and reincorporated in Delaware in May 1988. We changed our name from American Xtal technology, Inc. to AXT, Inc. in July 2000. Our principal offices are located at 4281 Technology Drive, Fremont, California 94538, and our telephone number at this address is (510) 683-5900. Our web site is www.axt.com; however, the information on our web site does not constitute a part of this annual report on Form 10-K and is not incorporated herein.

Industry Background

Historically, most semiconductor devices were created on a single crystal base material, or substrate, of silicon. Today, however, a growing number of electronic and opto-electronic devices are being developed with requirements that exceed the capabilities of silicon. Many of these devices address the continually increasing demand to send, receive and display information on high-speed wireless and wireline networks. This demand has created a growing need for power-efficient high-performance systems that can operate at high frequencies and can be produced cost-effectively in high volumes. These systems enable the growth and development of a wide range of end-user applications. For example, Dataquest, Inc., expects worldwide cellular/PCS handset production to grow from 347 million units in 2001 to approximately 681 million units by 2005.

Other examples of applications for these systems include:

- fiber optic networks and optical systems within these networks;
- new voice and high-speed wireless data systems;
- infrared emitters and optical detectors in computer systems;

Table of Contents

- solid-state lighting, including exterior and interior automobile lighting; and
- satellite communications systems.

As a result of the limitations of silicon-based technologies, semiconductor device manufacturers are increasingly using compound semiconductor substrates to improve the performance of semiconductor devices and to enable these new applications. This shift is occurring even though these compound semiconductor substrates are more expensive. Compound semiconductor substrates are composed of multiple elements that include a metal, such as gallium, aluminum or indium, and a non-metal, such as arsenic, phosphorus or nitrogen. The resulting compounds include gallium arsenide, indium phosphide and gallium nitride. Advantages of devices manufactured on compound substrates over devices manufactured using silicon substrates include:

- operation at higher speeds;
- lower power consumption;
- less noise and distortion; and
- opto-electronic properties that enable devices to emit and detect light.

A key step in producing a compound semiconductor substrate is to grow a crystal of the materials. Historically, two processes have been used to grow crystals: the Liquid Encapsulated Czochralski, or LEC, technique and the Horizontal-Bridgeman, or HB, technique. We believe two trends are reducing the appeal of these techniques: more semiconductor devices are being formed using an epitaxial process and semiconductor device manufacturers are switching their production lines to six-inch diameter substrates. The LEC and HB techniques each have difficulties producing six-inch, high quality, low-cost compound semiconductor substrates for epitaxial processing. We introduced our VGF technique in 1986 to respond to the limitations inherent in the LEC and HB techniques.

Compound semiconductor substrates enable the development of a wide range of electronic products including power amplifiers and radio frequency integrated circuits used in wireless handsets. Compound substrates can also be used to create opto-electronic products including HBLEDs and VCSELs used in solid-state lighting and fiber optic communications.

HBLEDs are solid-state compound semiconductor devices that emit light. The global demand for HBLEDs is experiencing rapid growth because HBLEDs have a long useful life, consume approximately 10% of the power consumed by incandescent or halogen lighting and improve display visibility. Applications where HBLEDs are increasingly used include wireless handset displays, automotive displays, full color video displays, traffic lights and various consumer applications. According to Strategies Unlimited, an independent industry analyst, the market for HBLEDs is expected to grow from $1.2 billion in 2001 to approximately $3.0 billion by 2006.

VCSELs are semiconductor lasers that emit light in a cylindrical beam and offer significant advantages over traditional laser diodes, including greater control over beam size and wavelength, reduced manufacturing complexity and packaging costs, lower power consumption and higher frequency performance. Electronics and computing systems manufacturers are using VCSELs in a broad range of end-market applications, including fiber optic switching and routing, such as Gigabit Ethernet for communications networks and Fibre Channel for storage area networks. According to ElectroniCast, an independent industry analyst, the market for VCSELs is expected to grow from 5.0 million units in 2000 to approximately 50.0 million units, with a value of $4.9 billion, in 2005.

The AXT Advantage

We are a leading developer and supplier of high-performance compound semiconductor substrates and opto-electronic semiconductor devices, including HBLEDs and VCSELs. There are four key causes of our success:

Our VGF technology is a competitive advantage for our substrate business. We pioneered the commercial use of VGF technology to manufacture GaAs substrates and we believe that through the use of VGF we have become the leading worldwide supplier of GaAs substrates. Our VGF process produces substrates with high mechanical strength and physical and chemical uniformity, as well as a low defect rate. The following changes in our customers technologies are increasing demand for substrates with these features:

Greater use of epitaxy rather than ion implantation. Many of the newest generation of high-performance semiconductor devices for fiber optic and wireless communications applications, including heterojunction bipolar transistors, or HBTs, and pseudomorphic high electron mobility transistors, or PHEMTs, are popular because they offer lower power consumption and better device linearity than their predecessors. These devices are created using epitaxial processed substrates. Our VGF substrates are more suitable for these applications than are our competitors products manufactured using LEC and HB technologies.

Switch to six-inch diameter wafers. Many of our semiconductor device manufacturing customers are switching their GaAs production lines to six-inch diameter substrates in order to reduce unit costs and increase capacity. Our VGF technique is better suited to developing six-inch substrates than are competing methods.

Introduction of InP substrates. Even GaAs cannot meet the requirements for increasing system performance and network bandwidth of some applications, including SONET OC-768 applications that will operate at speeds up to 40 gigabits per second. Manufacturers of these devices are turning to Indium Phosphide (InP) substrates that can support these features. We have successfully used our VGF technique to develop InP and we were among the first to offer four-inch diameter InP substrates.

In addition, VGF technology gives us further benefits.

Customer technology independence. Our semiconductor device manufacturing customers often compete among themselves. For example, several of our customers compete for technological leadership in the wireless handset market. These customers or end-users all require devices made on GaAs substrates. We are, therefore, largely immune from the effects of such competition and benefit from an overall need for faster, more power efficient electronic and opto-electronic devices.

Faster and less expensive capacity expansion. We build our own crystal growing equipment rather than ordering it from third-party vendors. This capability, coupled with the fact that our equipment is less expensive and simpler to manufacture than LEC equipment, enables us to increase our capacity faster and at lower cost than our competitors. This ability is particularly beneficial in periods of rapid growth for six-inch GaAs and all InP substrates. Retaining the equipment manufacturing process within AXT also helps protect our proprietary technology.

Some customers specify VGF substrates. Our wafers are qualified with most of the key suppliers of GaAs and InP semiconductor devices. The qualification process, which is lengthy and must be repeated for each customer, can be a barrier to entry for a new material or supplier. Furthermore, certain of our customers now specify that they will only accept VGF-grown substrates for their manufacturing processes. As the businesses of these customers grow, we are well positioned to grow with them as a key supplier.

Our low-cost manufacturing is an advantage. We use our technology and economics of scale to be a low-cost manufacturer. Our current effort to move much of our substrate manufacturing operations to China and our investment in sources of raw materials provides us with a combination of lower costs for facilities, labor and materials than we encounter in the United States.

Table of Contents

We entered the opto-electronic semiconductor device market quickly through our acquisition of Lyte Optronics. Our acquisition of Lyte Optronics provided us with expertise in epitaxial processes for manufacturing high-volumes of opto-electronic semiconductor devices. High-quality epitaxy is a key requirement for most of today s advanced opto-electronic semiconductor devices, such as HBLEDs and VCSELs. Since acquiring Lyte Optronics, we have developed opto-electronic products that are among the more difficult to create using epitaxy, including blue and green HBLEDs and VCSELs. We have filed five patent applications for our approach to fabricating HBLEDs. We believe that we can be an important additional domestic source of these devices.

The AXT Strategy

Our goals are to strengthen our position as the leading developer and supplier of high-performance compound semiconductor substrates and to develop a leading position in the market for opto-electronic semiconductor devices. Key elements of our strategy include:

Decreasing our substrate manufacturing cost structure. We are moving much of our substrate manufacturing operations to China and investing in sources of key raw material supplies in order to lower unit production costs.

Strengthen our leadership position in the InP market. We believe that there will be growth in demand for the next generation of high-speed fiber optic devices, such as devices used in SONET OC-768 applications. These products are manufactured on InP substrates and we are positioning ourselves to be the leading supplier of InP substrates. Our sales of InP substrates during the year ended December 31, 2001 grew 102.0% compared to our sales of InP substrates during 2000.

Advance VGF technology leadership. We believe that our ability to produce high-quality substrates using VGF technology continues to provide us with a competitive advantage in the compound semiconductor substrate markets. We intend to continue our investment in research and development in order to expand our leadership position in the commercial use of VGF technology. For example, we intend to leverage our existing knowledge in growing six-inch GaAs substrates to grow longer crystals, which will further reduce our costs. We are also launching an effort to develop six-inch diameter InP substrates in response to customer requests.

Enhance our opto-electronic semiconductor devices. We intend to further penetrate the HBLED market through continued investment in research and development and expansion of production capacity. We expanded our manufacturing capacity by adding metal-organic chemical vapor deposition, or MOCVD, reactors and are modifying our epitaxial process to improve device performance and yield. We have invested in the research and infrastructure required to grow our own sapphire substrates, which are used in producing blue, green and cyan LEDs.

Leverage existing customer relationships. We currently sell our GaAs substrates to more than 400 customers and believe that we are a qualified provider to most of the significant users worldwide of GaAs substrates. We intend to capitalize on our relationships with our customers in order to both expand sales of GaAs substrates and sell other compound substrates, such as InP. We also intend to establish alliances and joint development arrangements with customers in emerging high growth markets to develop new products, increase manufacturing efficiencies and more effectively serve our customers needs.

Table of Contents

Technology

Our core technologies include our proprietary VGF technique used to produce high quality crystals that are processed into compound substrates, and our epitaxy technologies that enable us to manufacture blue, green and cyan HBLEDs, VCSELs and edge-emitting laser diodes.

Our VGF technique is designed to control the crystal-growth process with minimal temperature variation and is the technique we use to produce our GaAs, InP and Ge substrates. Unlike traditional techniques, our VGF technique places the hot compound melt above the cool crystal, thereby reducing the turbulence at the interface of the melt and the solid crystal, compared with the LEC technique in which the melt and crystal are inverted. The temperature gradient between the melt and the crystal in the VGF technique is significantly lower than in traditional techniques. These aspects of the VGF technique enable us to grow crystals that have a relatively low defect density and high uniformity. The crystal and the resulting substrate are mechanically strong, resulting in lower breakage rates during a customer s manufacturing process. Since the temperature gradient is controlled electronically rather than by physical movement, the sensitive crystal is not disturbed. In addition, the melt and growing crystal are contained in a closed chamber, which isolates the crystal from the outside environment to reduce potential contamination. This substrate isolation allows for more precise control of the gallium-to-arsenic ratio, resulting in better consistency and uniformity of the crystals.

Our VGF technique offers several benefits when compared to traditional crystal growing technologies. The Liquid Encapsulated Czochralski, or LEC, technique is the traditional method for producing semi-insulating GaAs substrates for electronic applications. During the LEC process, the crystal is grown by dipping a seed crystal through molten boric oxide into a melt and slowly pulling the seed up into the cool zone above the boric oxide where the crystal hardens. Unlike the VGF technique, the LEC technique is designed so that the hotter GaAs melt is located beneath the cooler crystal, resulting in greater turbulence in the melt, and at a temperature gradient that is significantly higher than the VGF technique. The turbulence and high temperature cause LEC-grown crystals to have a higher dislocation density than VGF-grown crystals, resulting in a higher rate of breakage during the device manufacturing process. As an open process, the LEC technique also results in greater propensity for contamination and difficulty controlling the ratio of gallium to arsenic. It requires large, complex electro-mechanical systems that are expensive and require highly skilled personnel to operate.

Table of Contents

Our VGF technique also offers advantages over the Horizontal-Bridgeman, or HB, technique, for producing semi-conducting GaAs substrates for opto-electronic applications. The HB technique holds the GaAs melt in a semi-cylindrical container, causing crystals grown using the HB method to have a semi-circular, or D-shaped, cross-section. Accordingly, more crystal material is discarded when the D-shaped substrate is subsequently trimmed to a round shape. In addition, crystals grown using the HB technique have a higher defect density than VGF-grown crystals. The HB technique cannot be used cost-effectively to produce substrates greater than three inches in diameter. The HB technique houses the GaAs melt in a quartz container during the growth process, which can contaminate the GaAs melt with silicon impurities, making it unsuitable for producing semi-insulating GaAs substrates.

The following table provides a comparison of these three techniques:

	VGF	HB	LEC
Substrate applications	Electronic and opto-electronic	Opto-electronic	Electronic
Largest wafer size available	6	3	6
Stress/defect levels	Very Low	Low	High
Crystal purity	Good	Poor	Good
Applicability to multiple materials	GaAs, InP, Ge	GaAs	GaAs, InP, GaP
Equipment and labor cost	Very Low	Low	High
Amount of waste material	Very Low	High	Low
Equipment flexibility	Versatile	Limited	Limited
Equipment downtime	Minimal	Moderate	High
Number of competitors	Several	Many	Many

VCSEL devices include single lasers as well as one- and two-dimensional arrays of lasers. Array products are more highly valued than single lasers because they provide greater bandwidth, but are harder to form because they require epitaxial structures that possess very high uniformity in chemical composition and low variation in thickness. These features are hard to achieve because the epitaxial process used to make a VCSEL device places approximately 200 layers of epitaxial structure on a substrate, as compared to the less than 10 layers of material deposited on a substrate to make an HBLED. Our epitaxial process, which includes proprietary in situ monitoring techniques, allows us to manufacture highly reliable VCSEL wafers that demonstrate comparatively low threshold currents and high output power and are sufficiently uniform to produce one- and two-dimensional VCSEL devices. We employ both ion implantation and oxidation processes to produce VCSEL devices from our wafers.

We create our opto-electronic semiconductor devices using MOCVD, which is an epitaxial technique to synthesize compound semiconductor thin films onto substrates. MOCVD reactors are available from multiple sources and wafers fabricated using MOCVD generally possess a better combination of uniformity and optical and electronic properties and are easier to produce cost-effectively in high volumes than wafers manufactured by other methods, such as molecular beam epitaxy, vapor phase epitaxy or liquid phase epitaxy. As a result, MOCVD reactors have become the choice of the opto-electronic industry for fabricating devices such as LEDs, VCSELs and laser diodes. We modify our MOCVD reactors to improve their performance and use a proprietary growth recipe that controls temperature, material impurity, defect density, material thickness and layer composition while allowing for multiple wafer batch replication.

Table of Contents

Products

We design, develop, manufacture and distribute high-performance semiconductor substrates, as well as opto-electronic devices, such as HBLEDs, VCSELs and laser diodes. The table below sets forth our products and selected applications:

Product	Applications	
	Electronic	Opto-electronic
Substrates		
GaAs	Cellular phones	LEDs
	Direct broadcast television	Lasers
	High-performance transistors	Optical couplers
	Satellite communications	Displays
InP	Fiber optic communications	Fiber optic communications
	Satellite communications	Lasers
	High-performance transistors	
	Automotive collision avoidance radars	
Ge	Satellite solar cells	
Opto-electronics		
Blue, green and cyan HBLEDs	Full color displays	
	Lighting for the interior and exterior of automobiles	
	Traffic signals	
	Back lighting for cellular phones and instrument panels	
	White light for general illumination	
VCSELs	Fiber optic and wireless communications	
Laser Diodes	Fiber optic and wireless communications	

Substrates. We currently sell compound substrates manufactured from GaAs and InP, as well as single-element substrates manufactured from Ge. We supply GaAs substrates in two-, three-, four-, five- and six-inch diameters. We manufacture InP substrates in two-, three- and four-inch diameters and Ge substrates in four-inch diameters. We developed and intend to initiate production of sapphire substrates.

Opto-electronics. We sell blue, green and cyan HBLED products in wafer and chip form. We began selling blue HBLED products in the first quarter of 2000 and in 2001 began shipping green and cyan HBLEDs. We introduced our first VSCEL product in August 2000.

Customers

We sell our compound semiconductor substrates worldwide to leading semiconductor device manufacturers. Our substrate customers include:

Agilent Technologies	Kopin	RF Micro Devices
Alpha Industries	Motorola	SDL
Alpha Photonics	Nortel Networks	Spectrolab
EMCORE	Osram	Sumitomo Chemical
Epistar	Picogiga	TRW Space & Defense
Eptaxial Products	Precision Opto Wafer	Visual Photonics Epitaxy
Epitronics	Quantum Epitaxial Designs	

We sell our HBLED products primarily to customers that incorporate them into lighting products. Our HBLED customers include Agilent, Harvatek, Liteon, Kindwin, and King Brite.

Historically, we have sold a significant portion of our products in any particular period to a limited number of customers. Our five largest customers accounted for 28.3% of our total revenue from continuing operations in 2001, 26.1% in 2000 and 24.8% in 1999. No customer accounted for more than 10% of our total revenue in 2001, 2000 or 1999. We expect that sales to certain customers will continue to comprise a

significant portion of our net sales in the future.

Table of Contents

Manufacturing, Raw Materials and Supplies

We believe that our success is partially due to our manufacturing efficiency and high product yields and we continually emphasize quality and process control throughout our manufacturing operations. We perform our substrate manufacturing operations at our facilities in Fremont, California and Beijing, China. As part of our plan to reduce manufacturing costs, we are shifting most of our processes to our facilities in China, where costs are generally lower. We intend to transfer much of our substrate manufacturing operations to China by the end of 2002. We believe that our capital investment and subsequent operating costs are lower for our manufacturing facilities in China relative to the U.S. Many of our manufacturing operations are fully automated and computer monitored or controlled, enhancing reliability and yield. We use proprietary equipment in our substrate manufacturing operations to protect our intellectual property and control the timing and pace of capacity additions. By assembling our own substrate manufacturing equipment, we can quickly increase capacity without incurring delays caused by ordering additional equipment or converting older equipment to new technologies. Our epitaxial wafer production is located in El Monte, California. All of our manufacturing facilities are ISO 9001 or 9002 certified.

Although we purchase supply parts, components and raw materials from several domestic and international suppliers, we depend on a single or limited number of suppliers for certain critical materials used in the production of our substrates. We generally purchase these materials through standard purchase orders and not pursuant to long-term supply contracts. Although we seek to maintain sufficient inventory levels of certain materials to guard against interruptions in supply and to meet our near term needs, and have to date been able to obtain sufficient supplies of materials in a timely manner, there may be shortages of certain key materials, such as gallium. Accordingly, to help ensure continued supply of materials, we have formed strategic alliances with suppliers of key raw materials required to manufacture our products. We believe that these alliances will be advantageous in procuring materials to support our growth.

We use MOCVD equipment to manufacture our opto-electronic devices. We installed several new MOCVD reactors during the past twelve months and may add additional capacity as demand warrants. The substrate materials and raw wafers used in our visible emitter products are purchased from our substrate division and other sources.

Sales and Marketing

Each of our divisions is responsible for its own sales and marketing activities, and each maintains its own sales and marketing personnel. In addition, each of our divisions advertises in trade publications, distributes promotional materials, publishes technical articles, conducts marketing programs and participates in industry trade shows and conferences in order to raise market awareness of our products.

Substrates. We sell our substrate products through our direct sales force in the U.S. and Japan and through independent sales representatives in France, Japan, South Korea, Taiwan and the United Kingdom. Our direct sales force consists of sales engineers who are knowledgeable in the manufacture and use of compound and single-element substrates. Our sales engineers work with customers during all stages of the substrate manufacturing process, from developing the precise composition of the substrate through manufacturing and processing the substrate to the customer s exact specifications. We believe that maintaining a close relationship with customers and providing them with ongoing technical support improves customer satisfaction and will provide us with a competitive advantage in selling other substrates to our customers. The substrate division launched a program in late 2000 with selected customers in which we guaranteed that certain volumes of six-inch GaAs and other substrates will be delivered on specific dates and the customer made a prepayment for part of the value of its order. Several major customers participate in this program which we expect will conclude during 2002.

Opto-electronics. We sell our HBLED products through our direct sales force in the U.S. and Taiwan and through independent sales representatives to lamp package manufacturers in Asia. We intend to expand sales of these products in the U.S. and Europe primarily using our direct sales force. We sell our VCSEL and edge emitting laser diodes through our direct sales force and through independent sales representatives.

International Sales. International sales are an important part of our business. In the year ended December 31, 2001, sales to customers outside of the United States accounted for 50.4% of our revenue, as compared to 48.2% in 2000 and 51.6% in 1999. The primary markets for sales of our products outside of the United States include countries in Asia and Western Europe. Our ability to sustain and increase our international sales involves significant risks, including volatile political, social and economic instabilities abroad, possible fluctuations in currency exchange rates, and changes in tariffs, import restrictions or other trade barriers.

Research and Development

To maintain and improve our competitive position, we focus our research and development efforts on designing new proprietary processes and products, improving the performance of existing products and reducing manufacturing costs. We have assembled a multi-disciplinary team of highly skilled scientists, engineers and technicians to meet our research and development objectives. As a result of our ongoing research and development activities, we believe that we offer superior quality products. For example, some customers now qualify substrates manufactured using our VGF technique as the only acceptable material in their design specifications.

Our current substrate research and development activities focus on continued development and enhancement of six-inch GaAs crystals, including improved yield, greater substrate strength and increased crystal length. We continue to develop other compound substrates, such as InP and a low boron version of our standard GaAs substrates and are initiating research into development of six-inch InP products. We developed and intend to initiate production of sapphire substrates.

We are focusing on all three major stages of HBLED development: epitaxy, wafer fabrication and die fabrication. Our goal is to improve brightness and yield, create specific colors and enhance uniformity of product, both within and across production runs. Specific colors are created by controlling the indium content of the epitaxial layers, which we achieve, in part, from modifications that we make to our MOCVD reactors. The wafer and die fabrication experience we gained in our Lyte Optronics laser diode operation has helped us develop similar techniques for HBLEDs.

We began research in 1999 to develop VCSEL devices with uniform epitaxy structures on three-inch wafers and announced VCSEL wafer products in August 2000. We continue to improve their performance characteristics and developed one-dimensional VCSEL arrays. We also developed edge-emitting laser diodes with emission wavelengths of 980nm, 1.3 microns and 1.5 microns.

We historically funded a significant portion of our research and development efforts through contracts with the U.S. government and customer funded research projects, although we do not have any projects underway currently. Under our contracts, we retain rights to the VGF and wafer fabrication technology that we have developed. The U.S. government retains the rights to utilize the technologies we develop for government purposes only. In 1999 these contracts amounted to $1.6 million. Currently, our research and development is internally funded.

Research and development expenses were $8.2 million in 2001, as compared to $8.8 million in 2000 and $2.6 million in 1999.

Table of Contents

Competition

The semiconductor industry is characterized by rapid technological change and price erosion, as well as intense foreign and domestic competition. We believe we currently have a leading position in the existing markets for compound semiconductor substrates primarily as a result of our expertise in VGF technology. However, we believe we face actual and potential competition from a number of established domestic and international companies.

We believe that the primary competitive factors in the markets in which our products compete are:

- quality;
- price;
- performance;
- meeting customer specifications;
- customer support and satisfaction; and
- customer investment in competing technologies.

Our ability to compete in target markets also depends on factors such as:

- the timing and success of the development and introduction of new products by us and our competitors;
- the availability of adequate sources of raw materials; and
- protection of our products by effective use of intellectual property laws and general economic conditions.

Our primary competition in the market for compound semiconductor substrates includes Freiberger, Hitachi Cable, Japan Energy and Sumitomo Electric. In addition, we also face competition from compound semiconductor device manufacturers that produce substrates for their own internal use, and from companies such as IBM and Motorola that are actively developing alternative compound semiconductor materials.

Our primary competition in the market for HBLED products include Cree, LumiLED, Nichia Chemicals, Toyoda Gosei and United Epitaxy. In general, HBLED manufacturers in Taiwan and China have a competitive pricing advantage due to low overhead and small research and development investments. Cree, Nichia Chemicals, Sony and Toyoda Gosei have significant patent portfolios that other competitors, including us, must either design around or license.

We primarily compete with EMCORE, Honeywell, Trulight, Picolight, Zarlink, Infineon, Cielo and E2O in the market for VCSEL devices and with Mitsubishi for edge-emitting laser diodes.

Protection of our Intellectual Property

Our success and the competitive position of our VGF technique depend on our ability to maintain trade secrets and other intellectual property protections. We rely on a combination of patents, copyrights, trademark and trade secret laws, non-disclosure agreements and other intellectual property protection methods to protect our proprietary technology. We believe that, due to the rapid pace of technological innovation in the markets for our products, our ability to establish and maintain a position of technology leadership depends as much on the skills of our development personnel as upon the legal protections afforded our existing technologies. To protect our trade secrets, we take certain measures to ensure their secrecy, such as executing non-disclosure agreements with our employees, customers and suppliers. However, reliance on trade secrets is only an effective business practice insofar as trade secrets remain undisclosed and a proprietary product or process is not reverse engineered or independently developed.

To date, we have been issued four U.S. patents and have two patent applications pending, which relate to our VGF products and processes. We have five U.S. patent applications pending which relate to our HBLED or laser diode technology, and have patent applications pending in Europe, Canada, China, Japan and Korea which are based on one of our U.S. patents that relates to our VGF processes. We have no issued

foreign patents.

Table of Contents

Environmental Regulations

We are subject to federal, state and local environmental laws and regulations. These laws, rules and regulations govern the use, storage, discharge and disposal of hazardous chemicals during manufacturing, research and development and sales demonstrations. If we fail to comply with applicable regulations, we could be subject to substantial liability for clean-up efforts, personal injury and fines or suspension or cessation of our operations. We cooperated with the California Occupational Safety and Health Administration, or Cal-OSHA, in an investigation primarily regarding impermissible levels of potentially hazardous materials in certain areas of our manufacturing facility in Fremont, California. In May 2000, Cal-OSHA levied a fine against us in the amount of $313,655 for alleged health and safety violations. In March 2001, we settled this claim in the amount of $200,415, and have put in place engineering, administrative and personnel protective equipment programs to address these issues. On May 1, 2001, the Santa Clara Center for Occupational Safety and Health filed a complaint for injunctive relief and civil penalties against us alleging violations of California Business Professions Code 17200 et seq., and Health and Safety Code section 25249 et seq. as a result of our use of arsenic and inorganic arsenic compounds in our workplace. See Legal Proceedings below.

Employees

As of December 31, 2001, we had 1,308 full-time employees, of whom 1,107 were principally engaged in manufacturing, 161 in sales and administration and 40 in research and development. Of these employees, 641 are located in the U.S., 666 in China and 1 in Japan. As a result of shifting more of our substrate manufacturing to China, we have implemented headcount reductions in our Fremont, California facilities. Our success is in part dependent on our ability to attract and retain highly skilled workers. Our employees are not represented by a union and we have never experienced a work stoppage. Although moral has been affected by our workforce reductions, we consider our relations with our employees to be good.

Item 2. ***Properties***

Our principal properties as of March 15, 2002 are as follows:

Location	Square Feet	Principal Use	Ownership
Fremont, CA	58,000	Production and Administration	Owned
Fremont, CA	80,000	Production	Owned
Fremont, CA	20,292	Administration	Operating lease, expires May 2005
Fremont, CA	9,280	Warehouse	Operating lease, expires June 2005
Fremont, CA	24,100	Warehouse	Operating lease, expires July 2006
Monterey Park, CA	22,000	Production and Administration	Owned
Torrance, CA	6,674	Administration	Operating lease, expires May 2003
Torrance, CA	15,027	Production	Operating lease, expires May 2003
El Monte, CA	26,652	Production	Owned
El Monte, CA	6,281	Production	Operating lease, expires Dec. 2006
Beijing, China	31,000	Production and Administration	Owned
Beijing, China	31,000	Production	Owned
Beijing, China	32,000	Production	Owned

Beijing, China	16,000	Housing	Owned
Xiamen, China	14,000	Production	Operating lease, expires Dec. 2002

We consider each facility to be in good operating condition and adequate for its present use, and believe that each facility has sufficient plant capacity to meet its current and anticipated operating requirements.

Table of Contents

Item 3. ***Legal Proceedings***

On May 1, 2001, the Santa Clara Center for Occupational Safety and Health filed a complaint for injunctive relief and civil penalties against us in the Superior Court of California, County of Alameda, Hayward Division, Case No. H218237-5. The Complaint alleges violations of California Business and Professions Code section 17200 et seq., and Health and Safety Code section 25249 et seq. as a result of our use of arsenic and inorganic arsenic compounds in our workplace. Mediation is scheduled for June 2002. We believe that we have meritorious defenses against the alleged claims, and intend to defend ourselves vigorously. However, due to the nature of litigation and fact that the case is still in its early stages, we cannot determine the possible loss, if any, that may ultimately be incurred either in the context of a trial or as a result of a negotiated settlement. We may also incur substantial legal fees in this matter. However, we do not believe that this action is likely to have a material adverse effect on our business, financial condition, cash flows or results of operation.

From time to time we are involved in judicial or administrative proceedings concerning matters arising in the ordinary course of our business. We do not expect that any of these matters, individually or in the aggregate, will have a material adverse effect on our business, financial condition, cash flows or results of operation.

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

None

PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

Our common stock has been trading publicly on the Nasdaq National Market under the symbol AXTI since May 20, 1998, the date we consummated our initial public offering. The following table sets forth, for the periods indicated, the range of quarterly high and low closing sales prices for our common stock on the Nasdaq National Market.

	High	Low
Fiscal 2001		
First Quarter ended March 31, 2001	$44.560	$14.500
Second Quarter ended June 30, 2001	$40.670	$13.720
Third Quarter ended September 30, 2001	$26.700	$10.200
Fourth Quarter ended December 31, 2001	$16.850	$10.300
Fiscal 2000		
First Quarter ended March 31, 2000	$45.750	$14.500
Second Quarter ended June 30, 2000	$46.000	$21.250
Third Quarter ended September 30, 2000	$44.375	$31.125
Fourth Quarter ended December 31, 2000	$41.688	$24.500

As of December 31, 2001, there were 93 registered holders of record of our common stock. Because many shares of AXT s common stock are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these registered holders.

We have never paid or declared any cash dividends on our common stock and do not anticipate paying cash dividends in the foreseeable future. We are restricted in our ability to pay dividends under the terms of our credit facility with our bank. Dividends accrue on our preferred stock at the rate of $0.20 per annum.

Table of Contents

Item 6. ***Selected Consolidated Financial Data***

The following selected consolidated financial data should be read in conjunction with, and are referenced to, our consolidated financial statements and related notes and Management s Discussion and Analysis of Financial Condition and Results of Operations.

	Years Ended December 31,				
	2001	2000	1999	1998	1997
	(In thousands, except per share data)				
Income Statement Data:					
Revenue	$119,530	$121,503	$75,372	$49,074	$25,335
Cost of revenue, including restructuring costs of $1,844 in 2000	82,191	73,684	50,026	29,003	15,227
Gross profit	37,339	47,819	25,346	20,071	10,108
Operating expenses:					
Selling, general, and administrative	21,487	18,041	10,474	6,019	2,959
Research and development	8,204	8,769	2,566	2,504	1,289
Restructuring costs		6,409			
Acquisition costs			2,810		
Total operating expenses	29,691	33,219	15,850	8,523	4,248
Income from operations	7,648	14,600	9,496	11,548	5,860
Interest expense	2,081	3,616	2,201	875	570
Other (income) and expense	13,373	(28,432)	(1,423)	(715)	34
Income (loss) from continuing operations before provision	(7,806)	39,416	8,718	11,388	5,256

for income taxes					
Provision for income taxes	(2,810)	14,978	4,380	4,668	1,216
Income (loss) from continuing operations	(4,996)	24,438	4,338	6,720	4,040
Discontinued operations:					
Loss from discontinued operations, net of tax benefits		(1,487)	(3,658)	(2,436)	(3,220)
Loss on disposal, net of tax benefits		(1,341)			
Extraordinary item, net of tax benefits			(508)		

	March 31, 2005	December 31, 2004
Accrued wages and related liabilities	$488	$488
General and professional liabilities	57,099	54,216
Other liabilities and deferred items	115,755	117,962
	$173,342	$172,666

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 3. Asset Impairments, Workforce Reductions and Other Unusual Items

We recorded pre-tax charges (credits) for asset impairments, workforce reductions and other unusual items as follows for the three months ended March 31 (in thousands):

	2005	2004
Asset impairments	$ (112)	$ 2,885
Workforce reductions		(132)
Other unusual items, including exit costs	(4)	71
	$ (116)	$ 2,824

Asset Impairments

During 2005, we recorded a credit of $112,000, primarily related to the sale of a previously impaired asset at an amount above its carrying value. During March 2004, we recorded asset impairments of $2.9 million, primarily related to the write-down of property and equipment on two nursing facilities included in the Nursing Facilities segment. During the first quarter of 2004, management made a determination to close these nursing facilities, which led to an impairment assessment. We estimated the fair market values of these facilities based on sales values for the land and buildings.

Workforce Reductions

During the three months ended March 31, 2004, we recorded $214,000 for workforce reductions, less $346,000 in related credits primarily due to the cancellation of restricted stock. The $214,000 for workforce reductions primarily related to six associates who were notified in the first quarter of 2004 that their positions would be eliminated and included $196,000 of cash expenses, which was paid during the year ended December 31, 2004.

Other Unusual Items

During the three months ended March 31, 2005 and 2004, we recorded special pre-tax credits of $4,000 and special pre-tax charges of $71,000, respectively, for certain exit costs under retention and severance agreements with employees associated with facilities affected by our divestiture strategy. The following table summarizes activity in our accruals for estimated workforce reductions and exit costs for the three months ended March 31 (in thousands):

	2005		2004	
	Workforce Reductions	Exit Costs	Workforce Reductions	Exit Costs
Balance beginning of quarter	$ 1,166	$ 4,572	$ 3,029	$ 7,270
Charged to continuing operations		(4)	196	71
Charged to discontinued operations		1,331		1,596
Cash payments	(654)	(900)	(1,114)	(1,194)
Reversals	(19)	(84)	18	
Balance end of quarter	$ 493	$ 4,915	$ 2,129	$ 7,743

Workforce reduction and exit cost accruals are included in "Accrued wages and related liabilities" and "Other accrued liabilities" on our condensed consolidated balance sheets.

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 4. Sale of the Company and Related Items

In January 2005, a group including Formation Capital, LLC, Appaloosa Management, LP, Franklin Mutual Advisers LLC and Northbrook NBV LLC (the Formation Capital Consortium), publicly announced an unsolicited indication of interest in acquiring all of our outstanding common stock. Arnold M. Whitman, the Chief Executive Officer of Formation Capital, also nominated a slate of six individuals for election to our Board of Directors.

On February 3, 2005, our Board of Directors unanimously rejected the Formation Capital Consortium s proposal. On March 22, 2005, we announced that our Board of Directors had unanimously voted to conduct an auction process to maximize value for all of our stockholders as soon as practicable through a sale of BEI. The Board also adopted procedures to enable the beneficial owners of not less than 20% of our outstanding common stock to cause us to call a special meeting of stockholders to be held on October 21, 2005 to remove and replace the Board and for the nomination of individuals for election as directors at the special meeting, if held.

On April 11, 2005, we entered into a Settlement Agreement with the Formation Capital Consortium and Mr. Whitman under which the Formation Capital Consortium and Mr. Whitman agreed to discontinue the solicitation of proxies in connection with the Company s April 21, 2005 Annual Meeting of Stockholders and Mr. Whitman withdrew his nominees for election to our Board of Directors and other proposals for consideration at the 2005 Annual Meeting. In addition, we agreed to reimburse the Formation Capital Consortium for up to $600,000 of out-of-pocket fees and expenses incurred by them and Mr. Whitman in connection with their proxy solicitation. We have also entered into a Confidentiality Agreement with the members of the Formation Capital Consortium under which the Formation Capital Consortium and its representatives may examine our confidential information for the purpose of evaluating a possible transaction with us pursuant to the same restrictions imposed on other bidders involved in the sales process. We committed in the Confidentiality Agreement to allow the Formation Capital Consortium to participate in our on-going sales process on the same basis as all other potential buyers.

Our results of operations, financial condition and cash flows may be adversely impacted by the ongoing sales process. To date, we have incurred various costs as a result of the expression of interest, the proxy contest and the sales process including legal, investment banking advisory fees and other related costs. During the three months ended March 31, 2005, we engaged two investment banking firms to assist us in evaluating proposals, both solicited and unsolicited, to acquire the Company or any of its assets or businesses. Under the terms of the engagement we are required to pay a fee to these two firms equal to a percentage of any consideration received in connection with a sale of the Company, with their percentage compensation increasing with an increase in the sales value, or a flat fee if no sale was to occur. As a result, we recorded a liability of $16.5 million at March 31, 2005. In addition, we have incurred other costs related to the proxy contest and have recorded a liability of $2.2 million of which $807,000 was paid and $1.4 million remains accrued at March 31, 2005. In addition, the sales process may impact our ability to attract and retain customers, management and employees and may result in the incurrence of significant additional advisory fees, legal fees and other expenses; however the amount and impact of these potential additional expenses cannot be reasonably estimated at this time.

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 5. Discontinued Operations

During the three months ended March 31, 2005, we recognized net pre-tax losses of $878,000 relating to the following 2005 disposal activities:

five nursing facilities (456 beds) for cash proceeds totaling $134,000. These assets were part of our Nursing Facilities segment and were held for sale as of December 31, 2004; and

10 outpatient clinics for $4.6 million, including $710,000 in cash and $3.9 million of notes receivable. These assets and related liabilities were part of our former Matrix segment and were held for sale as of December 31, 2004.

We have included the remaining assets of 22 facilities (2,116 beds) of our Nursing Facilities segment as held for sale in the accompanying condensed consolidated balance sheet as of March 31, 2005. We expect to dispose of these facilities in the next three to six months. The remaining assets and liabilities of our former Matrix segment and the assets of 27 nursing facilities were included in assets and liabilities held for sale as of December 31, 2004.

A summary of the asset and liability line items from which the reclassifications have been made at March 31, 2005 and December 31, 2004 is as follows (in thousands):

	2005	2004		
	Nursing Facilities	Nursing Facilities	Matrix	Total
Current assets	$ 453	$ 479	$ 1,970	$ 2,449
Property and equipment, net	10,785	10,655	1,212	11,867
Goodwill			332	332
Other assets	205	222	28	250
Total assets held for sale	$ 11,443	$ 11,356	$ 3,542	$ 14,898
Current liabilities held for sale	$	$	$ 676	$ 676

The results of operations of disposed facilities and other assets in the three months ended March 31, 2005, as well as the results of operations of held-for-sale assets, have been reported as discontinued operations for all periods presented in the accompanying condensed consolidated statements of income. Also included in discontinued operations are the gains and losses on sales and exit costs relative to these transactions. Discontinued operations for the three months ended March 31, 2004 also include the results of operations for all facilities, clinics and businesses disposed of during 2004.

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 5. Discontinued Operations (Continued)

A summary of discontinued operations by operating segment for the three months ended March 31 is as follows (in thousands):

	2005				2004			
	Nursing Facilities	Matrix	Home Care	Total	Nursing Facilities	Matrix	Home Care	Total
Revenues	$ 30,159	$ 2,546	$	$ 32,705	$ 49,131	$ 3,301	$ 148	$ 52,580
Operating income (loss)(1)	$ 274	$ 405	$ (97)	$ 582	$ (630)	$ 153	$ (7)	$ (484)
Gain (loss) on sales and exit costs	(878)			(878)	4,488		(17)	4,471
Impairments and other unusual items	207			207	(1,258)			(1,258)
Pre-tax income (loss)	$ (397)	$ 405	$ (97)	(89)	$ 2,600	$ 153	$ (24)	2,729
Provision for (benefit from) state income taxes				(1,495)				423
Discontinued operations, net of taxes				$ 1,406				$ 2,306

(1) Includes net interest income of $3,000 for 2005 and net interest expense of $44,000 for 2004, as well as depreciation and amortization expense of $277,000 and $859,000 for 2005 and 2004, respectively.

Note 6. Long-Term Debt

As of April 1, 2005, our 2.75% convertible subordinated notes became eligible for conversion into common stock. Under the indenture governing the notes, a holder may convert any of their notes into our common stock during any fiscal quarter if the sale price of our common stock for at least 20 consecutive trading days in the 30 trading days ending on the last trading day of the immediately preceding fiscal quarter exceeds 120 percent of the conversion price on that 30th trading day.

Our $7^7/8$% senior subordinated notes are jointly and severally, fully and unconditionally guaranteed by most of our subsidiaries (the Guarantor Subsidiaries). As of March 31, 2005, the non-guarantor subsidiaries included Beverly Indemnity, Ltd., our captive insurance subsidiary, and Beverly Funding Corporation, our receivables-backed financing subsidiary (the Non-Guarantor Subsidiaries). Since the carrying value of the assets of the non-guarantor subsidiaries exceeds three percent of the consolidated assets of Beverly Enterprises, Inc., we are required to disclose consolidating financial statements in our periodic filings with the SEC.

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating balance sheets as of March 31, 2005 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Total
ASSETS					
Current assets:					
Cash and cash equivalents	$ 151,563	$ 6,476	$ 75,771	$	$ 233,810
Accounts receivable, less allowance for doubtful accounts	4,887	229,450	42,108	(176)	276,269
Notes receivable, less allowance for doubtful notes	2,206	2,772	34		5,012
Operating supplies	124	9,021			9,145
Assets held for sale		11,443			11,443
Prepaid expenses and other	7,552	7,966	15,993		31,511
Total current assets	166,332	267,128	133,906	(176)	567,190
Property and equipment, net	6,370	650,998			657,368
Other assets:					
Goodwill, net		122,863			122,863
Other, less allowance for doubtful accounts and notes	302,887	30,659	701	(264,501)	69,746
Due from affiliates	442,742		109,760	(552,502)	
Total other assets	745,629	153,522	110,461	(817,003)	192,609
	$ 918,331	$ 1,071,648	$ 244,367	$ (817,179)	$ 1,417,167
LIABILITIES AND STOCKHOLDERS EQUITY					
Current liabilities:					
Accounts payable	$ 10,303	$ 65,137	$	$	$ 75,440
Accrued wages and related liabilities	20,137	64,486			84,623
Accrued interest	7,458	1,100	307		8,865
General and professional liabilities	18,903		38,196		57,099
Federal government settlement obligations		14,711			14,711
Liabilities held for sale					

Other accrued liabilities	30,905	95,581		(176)	126,310
Current portion of long-term debt	1,350	10,817			12,167
Total current liabilities	89,056	251,832	38,503	(176)	379,215
Long-term debt	467,583	76,348			543,931
Other liabilities and deferred items	68,363	54,779	77,550		200,692
Due to affiliates		552,502		(552,502)	
Commitments and contingencies					
Stockholders equity:					
Preferred stock					
Common stock	11,796	5,908	121	(6,029)	11,796
Additional paid-in capital	908,179	414,340	44,434	(458,774)	908,179
Retained earnings (accumulated deficit)	(518,148)	(284,061)	83,759	200,302	(518,148)
Treasury stock, at cost	(108,498)				(108,498)
Total stockholders equity	293,329	136,187	128,314	(264,501)	293,329
	$ 918,331	$ 1,071,648	$ 244,367	$ (817,179)	$ 1,417,167

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating balance sheets as of December 31, 2004 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Total
ASSETS					
Current assets:					
Cash and cash equivalents	$ 142,515	$ 5,237	$ 67,913	$	$ 215,665
Accounts receivable, less allowance for doubtful accounts	8,160	183,920	43,397		235,477
Notes receivable, less allowance for doubtful notes	18	2,768			2,786
Operating supplies	101	9,080			9,181
Assets held for sale		14,898			14,898
Prepaid expenses and other	10,952	10,285	16,029		37,266
Total current assets	161,746	226,188	127,339		515,273
Property and equipment, net	6,392	647,264			653,656
Other assets:					
Goodwill, net		124,066			124,066
Other, less allowance for doubtful accounts and notes	255,350	32,385	709	(220,054)	68,390
Due from affiliates	453,483		132,141	(585,624)	
Total other assets	708,833	156,451	132,850	(805,678)	192,456
	$ 876,971	$ 1,029,903	$ 260,189	$ (805,678)	$ 1,361,385
LIABILITIES AND STOCKHOLDERS EQUITY					
Current liabilities:					
Accounts payable	$ 2,696	$ 65,082	$	$	$ 67,778
Accrued wages and related liabilities	28,240	75,797			104,037
Accrued interest	2,618	875	109		3,602
General and professional liabilities	23,323		45,934	(15,041)	54,216
Federal government settlement obligations		14,359			14,359
Liabilities held for sale		676			676

Other accrued liabilities	18,694	64,403			83,097
Current portion of long-term debt	1,350	10,890			12,240
Total current liabilities	76,921	232,082	46,043	(15,041)	340,005
Long-term debt	467,858	78,085			545,943
Other liabilities and deferred items	59,779	56,269	86,976		203,024
Due to affiliates		585,624		(585,624)	
Commitments and contingencies					
Stockholders equity:					
Preferred stock					
Common stock	11,662	5,908	121	(6,029)	11,662
Additional paid-in capital	902,053	414,340	44,434	(458,774)	902,053
Retained earnings (accumulated deficit)	(532,804)	(342,405)	82,615	259,790	(532,804)
Treasury stock, at cost	(108,498)				(108,498)
Total stockholders equity	272,413	77,843	127,170	(205,013)	272,413
	$ 876,971	$ 1,029,903	$ 260,189	$ (805,678)	$ 1,361,385

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating statements of income for the three months ended March 31, 2005 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Total
Revenues	$ 191	$ 562,289	$ 14,185	$ (14,185)	$ 562,480
Costs and expenses:					
Wages and related	17,477	287,122			304,599
Provision for insurance and related items	1,407	28,513	14,364	(14,364)	29,920
Other operating and administrative	26,577	142,902	155	(309)	169,325
Overhead allocation	(20,401)	20,401			
Depreciation and amortization	1,570	15,214			16,784
Asset impairments, workforce reductions and other unusual items		(116)			(116)
Total costs and expenses	26,630	494,036	14,519	(14,673)	520,512
Income (loss) before other income (expenses)	(26,439)	68,253	(334)	488	41,968
Other income (expenses):					
Interest expense		(11,613)	(176)	1,192	(10,597)
Interest income	1,387	214	1,654	(1,192)	2,063
Costs related to the sales process of the Company	(18,721)				(18,721)
Net gains on dispositions		84			84
Equity in income of affiliates	59,976			(59,976)	
Total other income (expenses), net	42,642	(11,315)	1,478	(59,976)	(27,171)
Income before provision for income taxes and discontinued operations	16,203	56,938	1,144	(59,488)	14,797
Provision for income taxes	1,547				1,547
	14,656	56,938	1,144	(59,488)	13,250

Income before discontinued operations					
Discontinued operations, net of taxes of $(1,495)		1,406			1,406
Net income	$ 14,656	$ 58,344	$ 1,144	$ (59,488)	$ 14,656

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating statements of income for the three months ended March 31, 2004 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Total
Revenues	$ 1,039	$ 479,579	$ 12,847	$ (12,847)	$ 480,618
Costs and expenses:					
Wages and related	11,724	262,579			274,303
Provision for insurance and related items	2,389	25,967	11,665	(11,665)	28,356
Other operating and administrative	5,732	121,677			127,409
Overhead allocation	(20,282)	20,282			
Depreciation and amortization	1,542	13,365			14,907
Asset impairments, workforce reductions and other unusual items	(225)	3,049			2,824
Total costs and expenses	880	446,919	11,665	(11,665)	447,799
Income (loss) before other income (expenses)	159	32,660	1,182	(1,182)	32,819
Other income (expenses):					
Interest expense		(13,139)		1,335	(11,804)
Interest income	743	628	1,487	(1,335)	1,523
Net gains on dispositions		37			37
Equity in income of affiliates	23,979			(23,979)	
Total other income (expenses), net	24,722	(12,474)	1,487	(23,979)	(10,244)
Income before provision for income taxes and discontinued operations	24,881	20,186	2,669	(25,161)	22,575
Provision for income taxes	1,442				1,442
Income before discontinued operations	23,439	20,186	2,669	(25,161)	21,133
		2,306			2,306

Discontinued operations, net of taxes of $423					
Net income	$ 23,439	$ 22,492	$ 2,669	$ (25,161)	$ 23,439

16

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating statements of cash flows for the three months ended March 31, 2005 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Total
Cash flows provided by (used for) operating activities:	$ 5,868	$ 20,968	$ 7,934	$ 34,770
Cash flows from investing activities:				
Capital expenditures	(2,233)	(18,246)		(20,479)
Proceeds from dispositions of facilities and other assets, net		994		994
Collections on notes receivable		29		29
Proceeds from (payments for) designated funds, net	(35)	568		533
Other, net	2,064	(1,327)	(34)	703
Net cash used for investing activities	(204)	(17,982)	(34)	(18,220)
Cash flows from financing activities:				
Repayments of long-term debt	(338)	(1,747)		(2,085)
Proceeds from exercise of stock options	3,884			3,884
Deferred financing costs paid	(162)		(42)	(204)
Net cash provided by (used for) financing activities	3,384	(1,747)	(42)	1,595
Net increase (decrease) in cash and cash equivalents	9,048	1,239	7,858	18,145
Cash and cash equivalents at beginning of period	142,515	5,237	67,913	215,665
Cash and cash equivalents at end of period	$ 151,563	$ 6,476	$ 75,771	$ 233,810

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 6. Long-Term Debt (Continued)

Condensed consolidating statements of cash flows for the three months ended March 31, 2004 for Beverly Enterprises, Inc. (parent only), the combined Guarantor Subsidiaries and the combined Non-Guarantor Subsidiaries are as follows (in thousands):

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Total
Cash flows provided by (used for) operating activities:	$ (41,051)	$ (8,691)	$ 13,170	$ (36,572)
Cash flows from investing activities:				
Capital expenditures	(987)	(8,790)		(9,777)
Proceeds from dispositions of facilities and other assets, net		19,198		19,198
Collections on notes receivable		6,765		6,765
Payments for designated funds, net	(3)	(711)		(714)
Other, net	(881)	(2,865)		(3,746)
Net cash used for investing activities	(1,871)	13,597		11,726
Cash flows from financing activities:				
Repayments of long-term debt	(338)	(3,291)		(3,629)
Proceeds from exercise of stock options	293			293
Deferred financing costs paid	(406)			(406)
Net cash provided by (used for) financing activities	(451)	(3,291)		(3,742)
Net increase (decrease) in cash and cash equivalents	(43,373)	1,615	13,170	(28,588)
Cash and cash equivalents at beginning of period	223,575	5,351	29,889	258,815
Cash and cash equivalents at end of period	$ 180,202	$ 6,966	$ 43,059	$ 230,227

Note 7. Income Taxes

The provisions for income taxes from continuing operations of $1.5 million and $1.4 million for the three months ended March 31, 2005 and 2004, respectively, primarily relate to state income taxes estimated to be due in separate return filing states where we conduct business and to federal alternative minimum tax (AMT). We recorded a tax benefit in discontinued operations of $1.5 million for the three months ended March 31, 2005, related to state tax refunds in a state where we have ceased operations.

The provisions differ from those calculated using the federal statutory rate due to changes in the valuation allowance, established at December 31, 2001, for net deferred tax assets. In 2005, the valuation allowance decreased

$36.5 million primarily due to the reversal of temporary differences and the utilization of net operating loss carryforwards, general business credits and AMT credits to offset taxable income during the quarter. In 2004, the valuation allowance decreased primarily due to the reversal of temporary differences and the utilization of net operating loss carryforwards to offset taxable income during the quarter, partially offset by an increase in AMT credits generated during the quarter.

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 8. Stockholders Equity

During March 2005, we issued approximately 722,000 shares of restricted stock to certain officers and other employees, all of which vest on the third anniversary of the grant date. If these additional shares had been issued prior to January 1, 2005, there would have been no material impact on our diluted net income per share for the three months ended March 31, 2005.

Statement of Financial Accounting Standards (SFAS) No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS No. 148), issued on December 31, 2002, provides companies alternative methods of transitioning to the fair value method of accounting for stock-based compensation, and amends certain disclosure requirements. SFAS No. 148 does not mandate fair value accounting for stock-based compensation. We currently do not recognize compensation expense for our stock option grants, which are issued at fair market value on the date of grant and are accounted for under the intrinsic value method. We are in compliance with the current accounting rules regarding stock-based compensation (see discussion of SFAS No. 123R below).

For purposes of pro forma disclosures, the estimated fair market value of all outstanding stock options is amortized to expense over the respective vesting periods. The fair market value has been estimated at the date of grant using a Black-Scholes option pricing model. The pro forma effects are not necessarily indicative of the effects on future quarters or future years. The following table summarizes our pro forma net income and diluted net income per share for the three months ended March 31 assuming we accounted for our stock option grants using the fair value method, (in thousands, except per share amounts):

	2005	2004
Reported net income(a)	$ 14,656	$ 23,439
Stock option compensation expense	1,148	1,790
Pro forma net income	$ 13,508	$ 21,649
Reported basic net income per share	$ 0.13	$ 0.22
Pro forma basic net income per share	$ 0.12	$ 0.20
Reported diluted net income per share	$ 0.12	$ 0.20
Pro forma diluted net income per share	$ 0.11	$ 0.18

(a) Includes total charges to our condensed consolidated statements of income related to restricted stock grants for the three months ended March 31, 2005 and 2004 of approximately $1.4 million and $620,000, respectively.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123 (revised), *Share-Based Payment* (SFAS No. 123R), which eliminates the intrinsic value method as an alternative method of accounting for stock-based awards. SFAS No. 123R also revises the fair value-based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarifies guidance surrounding measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. In addition, SFAS No. 123R amends SFAS No. 95 to require that excess tax

benefits be reported as a financing cash inflow rather than as a reduction of taxes paid, which is included within operating cash flows.

In the first quarter of 2005, the SEC issued Staff Accounting Bulletin No. 107, which provided further clarification on the implementation of SFAS No. 123R and provided alternative phase-in methods. The SEC

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 8. Stockholders Equity (Continued)

announced in the second quarter of 2005 that it is extending the phase-in period, which will extend our effective date for implementation of SFAS No. 123R to January 1, 2006. We expect to use the modified version of prospective application when we implement SFAS No. 123R. Based on the estimated value of unvested stock options, we expect wages and related expenses to increase $469,000 in 2006.

Note 9. Contingencies and Legal Proceedings

We are contingently liable for approximately $11.8 million of long-term debt maturing on various dates through 2019, as well as annual interest on that debt. These contingent liabilities principally arose from previous sales of nursing facilities. We also guarantee certain third-party operating leases. Those guarantees arose from our dispositions of leased facilities and the underlying leases have $56.0 million of minimum rental commitments remaining through the initial lease terms. In accordance with the FASB s Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* we have recorded approximately $685,000, included in Other accrued liabilities on the condensed consolidated balance sheets, as the estimated fair value of guarantees.

We are a party to various legal matters relating to patient care, including claims that our services have resulted in injury or death to residents of our facilities. Over the past few years, we have experienced an increasing trend in the number and severity of the claims asserted against us. We believe that there has been, and will continue to be, an increase in governmental investigations of long-term care providers. Adverse determinations in legal proceedings or governmental investigations, whether currently asserted or arising in the future, could have a material adverse effect on us.

There are various other lawsuits and regulatory actions pending against us arising in the normal course of business, some of which seek punitive damages that are generally not covered by insurance. We do not believe that the ultimate resolution of such other matters will have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Note 10. Segment Information

Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information,* provides disclosure guidelines for segments of a company based on a management approach to defining operating segments. Our operations are organized into three primary segments:

Nursing Facilities, which provide long-term healthcare through the operation of skilled nursing homes and assisted living centers;

Aegis, which provides rehabilitation therapy services under contract to our nursing facilities and third-party nursing facilities; and

AseraCare, which primarily provides hospice services.

Table of Contents

BEVERLY ENTERPRISES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2005
(Unaudited)

Note 10. Segment Information (Continued)

The following table summarizes certain information for each of our operating segments (in thousands):

	Nursing Facilities	Aegis(1)	AseraCare	All Other(2)	Total	Discontinued Operations(3)
Three months ended March 31, 2005						
Revenues from external customers	$ 500,872	$ 36,204	$ 24,043	$ 1,361	$ 562,480	$ 32,705
Intercompany revenues	87	40,462		708	41,257	
Interest income	86	5	57	1,915	2,063	3
Interest expense	1,500			9,097	10,597	
Depreciation and amortization	14,419	250	197	1,918	16,784	277
Pre-tax income (loss)	34,185	15,141	1,963	(36,492)	14,797	(89)
Goodwill	44,758		78,104	1	122,863	
Total assets	891,343	32,699	105,126	362,514	1,391,682	25,485
Capital expenditures	16,987	246	348	2,345	19,926	553
Three months ended March 31, 2004						
Revenues from external customers	$ 439,988	$ 27,180	$ 10,970	$ 2,480	$ 480,618	$ 52,580
Intercompany revenues		37,527		453	37,980	
Interest income	623			900	1,523	45
Interest expense	1,989			9,815	11,804	89
Depreciation and amortization	12,725	205	108	1,869	14,907	859
Pre-tax income (loss)	24,279	12,380	1,317	(15,401)	22,575	2,729
Goodwill	44,747		11,723		56,470	365
Total assets	865,502	25,912	21,444	363,750	1,276,608	64,942
Capital expenditures	8,141	222	36	1,009	9,408	369

(1) Pre-tax income includes profit on intercompany revenues, which is eliminated in All Other.

(2) Consists of the operations of our corporate headquarters and related overhead, as well as certain non-operating revenues and expenses. Such amounts also include special pre-tax credits totaling $116,000 and pre-tax charges totaling $2.8 million for the three months ended March 31, 2005 and 2004, respectively, for asset impairments, workforce reductions and other unusual items, as well as $18.7 million of costs related to the sales process.

(3) In accordance with the provisions of SFAS No. 144, the results of operations of certain nursing facilities, clinics and other assets have been reclassified, for all periods presented, as discontinued operations. Pre-tax income (loss) for discontinued operations includes net gains (losses) on sales, exit costs, asset impairments and other unusual items of $671,000 and $3.2 million for the three months ended March 2005 and 2004, respectively. The remaining assets of 22 nursing facilities are classified as held for sale at March 31, 2005. (See Note 5.)

Table of Contents

REPORT OF ERNST & YOUNG LLP,
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Beverly Enterprises, Inc.

We have reviewed the accompanying condensed consolidated balance sheet of Beverly Enterprises, Inc. as of March 31, 2005, and the related condensed consolidated statements of income and cash flows for the three months ended March 31, 2005 and 2004 (Form 10-Q). These financial statements are the responsibility of the Company s management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Beverly Enterprises, Inc. as of December 31, 2004 and the related consolidated statements of income, stockholders equity, and cash flows for the year then ended, not presented in the Company s Form 10-Q, and in our report dated March 8, 2005, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2004, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Fort Smith, Arkansas
April 29, 2005

BEVERLY ENTERPRISES, INC.
ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

This document contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by words such as expects, anticipates, intends, plans, believes, seeks, estimates or words of similar meaning and include, but are not limited to, statements about o expected future business and financial performance. Forward-looking statements are based on management s current expectations and assumptions, which are inherently subject to uncertainties, risks and changes in circumstances that are difficult to predict. Actual outcomes and results may differ materially from these expectations and assumptions due to changes in, among other things, political, economic, business, competitive, market, regulatory, demographic and other factors. In addition, our results of operations and financial condition, cash flows and liquidity may be adversely impacted by the ongoing sales process (see Item 1. Note 4). The sales process may impact our ability to attract and retain customers, management and employees and will result in the incurrence of significant advisory fees, legal fees and other expenses. We undertake no obligation to publicly update or revise any forward-looking information, whether as a result of new information, future developments or otherwise.

Overview

Sales Process and Related Items

In January 2005, a group including Formation Capital, LLC, Appaloosa Management, LP, Franklin Mutual Advisers LLC and Northbrook NBV LLC (the Formation Capital Consortium), publicly announced an unsolicited indication of interest in acquiring all of our outstanding common stock. Arnold M. Whitman, the Chief Executive Officer of Formation Capital also nominated a slate of six individuals for election to our Board of Directors.

On February 3, 2005, our Board of Directors unanimously rejected the Formation Capital Consortium s proposal. On March 22, 2005, we announced that our Board of Directors had unanimously voted to conduct an auction process to maximize value for all of our stockholders as soon as practicable through a sale of BEI. The Board also adopted procedures to enable the beneficial owners of not less than 20% of our outstanding common stock to cause us to call a special meeting of stockholders to be held on October 21, 2005 to remove and replace the Board and for the nomination of individuals for election as directors at the special meeting, if held.

On April 11, 2005, we entered into a Settlement Agreement with the Formation Capital Consortium and Mr. Whitman under which the Formation Capital Consortium and Mr. Whitman agreed to discontinue the solicitation of proxies in connection with the Company s April 21, 2005 Annual Meeting of Stockholders and Mr. Whitman withdrew his nominees for election to our Board of Directors and other proposals for consideration at the 2005 Annual Meeting. In addition, we agreed to reimburse the Formation Capital Consortium for up to $600,000 of out-of-pocket fees and expenses incurred by them and Mr. Whitman in connection with their proxy solicitation. We have also entered into a Confidentiality Agreement with the members of the Formation Capital Consortium under which the Formation Capital Consortium and its representatives may examine our confidential information for the purpose of evaluating a possible transaction with us pursuant to the same restrictions imposed on other bidders involved in the sales process. We committed in the Confidentiality Agreement to allow the Formation Capital Consortium to participate in our on-going sales process on the same basis with all other potential buyers.

The sales process is being overseen by independent members of our Board of Directors. We have established a due diligence process to assist potential bidders in evaluating their level of interest in acquiring us and in developing bids. Multiple potential bidders or bidding groups already have signed confidentiality agreements and obtained access to information about BEI contained in an online data room we established.

Table of Contents

BEVERLY ENTERPRISES, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

All interested parties have been requested to submit initial proposals that would include information on price, financing plans, and potential financial and operating partners. The independent board members plan to evaluate these proposals when received, and then select a smaller number of interested parties to participate in a second round of more detailed due diligence and bidding.

Our results of operations, financial condition and cash flows may be adversely impacted by the ongoing sales process. To date we have incurred various costs as a result of the expression of interest, the proxy contest and the sales process including legal, investment banking advisory fees and other related costs. During the three months ended March 31, 2005, we engaged two investment banking firms to assist us in evaluating proposals, both solicited and unsolicited, to acquire the Company or any of its assets or businesses. Under the terms of the engagement we are required to pay a fee to these two firms equal to a percentage of any consideration received in connection with a sale of the Company, with their percentage compensation increasing with an increase in the sales value, or a flat fee if no sale was to occur. As a result, we recorded a liability of $16.5 million at March 31, 2005. In addition, we have incurred other costs related to the proxy contest and have recorded a liability of $2.2 million of which $807,000 was paid and $1.4 million remains accrued at March 31, 2005. In addition, the sales process may impact our ability to attract and retain customers, management and employees and will result in the incurrence of significant additional advisory fees, legal fees and other expenses; however the amount and impact of these potential additional expenses cannot be reasonably estimated at this time.

General

Despite the expression of interest and subsequent sales process, our business unit operating and financial trends continue to be positive. Our first quarter included revenue growth of nearly 17% with improvements in operating margins, compared to the year-earlier period. We are dedicated to providing quality of care and executing the specific initiatives we have developed to achieve profitable growth in our business segments and to increase our financial position.

Our three principal business segments performed well ahead of 2004 first-quarter results. On a continuing operations basis, our Nursing Facility revenues increased 13.8% and pre-tax income increased $13.0 million primarily due to favorable rate increases in Pennsylvania. Aegis revenues from third-party customers rose 33%, compared with the 2004 first quarter, reflecting increased business with existing clients and the net addition of 13 customers. AseraCare revenues from core operations were up 38%, primarily due to an increase in average daily census of 35%. The balance of the revenue growth from AseraCare is related to our July 2004 acquisition of Hospice USA, LLC and the openings of 15 new hospice locations.

Based on the growth trends we are seeing in our principal business units, improved operating metrics and a generally positive reimbursement environment at both federal and state levels, our pre-tax income from continuing operations, excluding $18.7 million of costs related to the sales process discussed above, would have increased 48% to $33.5 million for the 2005 first quarter compared to $22.6 million for the same period in 2004.

Operating Results

Reclassification

Results of operations for the three months ended March 31, 2005, and 2004, reflect asset dispositions during 2005 and 2004, and assets classified as held for sale, as discontinued operations. The following discussions reflect this reclassification.

BEVERLY ENTERPRISES, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

First Quarter 2005 Compared to First Quarter 2004

Results of Operations Continuing Operations

We reported a 34% decrease in pre-tax income from continuing operations to $14.8 million for the three months ended March 31, 2005, compared to $22.6 million for the same period in 2004. The quarter-over-quarter comparisons of our financial results are affected by material special pre-tax charges discussed below. Excluding these special pre-tax charges, our pre-tax income from continuing operations would have increased 32% for the three months ended March 31, 2005, compared to the same period in 2004.

Pre-tax income from continuing operations for 2005 included a special pre-tax charge of $18.7 million for costs related to the expression of interest, the proxy contest and the sales process, of which $807,000 was paid and $17.9 million remains accrued as of March 31, 2005 (see Item 1. Note 4). These costs include legal, investment banking advisory fees and other related costs.

Pre-tax income from continuing operations for 2004 included the following special pre-tax charges:

$2.9 million for asset impairments, primarily related to two nursing facilities;

$214,000 for workforce reduction charges, less $346,000 in related credits primarily due to the cancellation of restricted stock. The $214,000 for workforce reductions primarily related to six associates who were notified in the first quarter of 2004 that their positions would be eliminated and included $196,000 of cash expenses paid during the year ended December 31, 2004 (see Item 1. Note 3).

Revenues

Revenues from external customers by operating segment for the three months ended March 31 (in thousands) are as follows:

			Change 2005 vs. 2004	
	2005	**2004**	**$**	**%**
Nursing Facilities	$ 500,872	$ 439,988	$ 60,884	13.8%
Aegis Therapies	36,204	27,180	9,024	33.2%
AseraCare	24,043	10,970	13,073	119.2%
Other	1,361	2,480	(1,119)	(45.1)%
Total revenues	$ 562,480	$ 480,618	$ 81,862	17.0%

Approximately 89% and 92% of our revenues for the three months ended March 31, 2005 and 2004, respectively, were derived from services provided by our Nursing Facilities segment. The increase in total revenues of $81.9 million for the three months ended March 31, 2005, as compared to the same period in 2004, is primarily due to the following, by operating segment:

Nursing Facilities:

an increase of $35.7 million primarily due to a retroactive Medicaid rate adjustment in Pennsylvania;

an increase of $17.8 million, $7.4 million and $3.7 million due to increases in Medicaid, Medicare and private payment rates, respectively;

an increase of $3.3 million in Medicare Part B revenues, primarily due to increased therapy-related services;

**BEVERLY ENTERPRISES, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

an increase of $1.7 million due to a positive shift in our patient mix; partially offset by

a decrease of $4.6 million due to one less calendar day during the first quarter of 2005, as compared to the same period in 2004;

a decrease of $3.0 million due to a decline in census;

Aegis:

an increase of $9.0 million from growth in Aegis external therapy business, including a 9.3% increase in the number of contracts and a 5% growth in average revenue per contract;

AseraCare:

an increase of $8.8 million due to the Hospice USA acquisition; and

an increase of $4.3 million, primarily due to openings of new hospice locations and a 35% increase in average daily census in our AseraCare business.

Costs and Expenses

The following table details costs and expenses, excluding special pre-tax charges, for the three months ended March 31 (in thousands):

			Change 2005 vs. 2004	
	2005	**2004**	**$**	**%**
Wages and related	$ 304,599	$ 274,303	$ 30,296	11.0%
Provision for insurance and related items	29,920	28,356	1,564	5.5%
Other operating and administrative	169,325	127,409	41,916	32.9%
Depreciation and amortization	16,784	14,907	1,877	12.6%
Total costs and expenses excluding special pre-tax charges (adjustments)	$ 520,628	$ 444,975	$ 75,653	17.0%

Excluding special pre-tax charges discussed above, our total costs and expenses increased $75.7 million, primarily due to the following:

an increase of $35.4 million in state-imposed provider taxes, primarily associated with the retroactive Medicaid rate adjustment in Pennsylvania, included in our Nursing Facilities segment; and

an increase of $10.2 million in Aegis wages and related expenses due to increased staffing related to the increased volume of new contracts. This increase also includes a $2.2 million, or 65%, increase in Aegis contract therapy cost;

an increase of $9.5 million in our Nursing Facilities wages and related expenses, primarily due to a 4.5% increase in our weighted average wage rate and an increase in nursing hours per patient day;

an increase of $9.3 million due to the Hospice USA acquisition and the opening of 15 new hospice locations;

an increase of $2.6 million in contracted services, primarily due to outsourcing certain housekeeping, laundry and dietary services in our Nursing Facilities segment;

BEVERLY ENTERPRISES, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

an increase in depreciation and amortization expense, primarily due to an increase in capital expenditures in our Nursing Facilities segment.

Other Income and Expenses, Net

Other income and expenses for the three months ended March 31 (in thousands) are as follows:

			Change 2005 vs. 2004	
	2005	**2004**	**$**	**%**
Other income (expenses):				
Interest expense	$ (10,597)	$ (11,804)	$ 1,207	(10.2)%
Interest income	2,063	1,523	540	35.5%
Costs related to the sales process of the Company[(1)]	(18,721)		(18,721)	
Net gains on dispositions	84	37	47	127.0%

(1) See *Results of Operations Continuing Operations* for a discussion of this special pre-tax charge.

Interest Expense

Interest expense decreased 10% in the 2005 first quarter, as compared to the same period in 2004, primarily due to the June 2004 refinancing of our 9 5/8% senior notes and the reduction of debt using proceeds from sales of facilities in 2004.

Results of Operations Discontinued Operations

The results of operations of facilities, clinics and other assets disposed of in the three-month period ended March 31, 2005, as well as the results of operations of held-for-sale assets, have been reported as discontinued operations for all periods presented in the accompanying condensed consolidated statements of income. Also included in discontinued operations are gains and losses on sales, additional impairments and exit costs related

Table of Contents

BEVERLY ENTERPRISES, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

to these transactions. A summary of discontinued operations by operating segment for the three months ended March 31, 2005, is as follows (in thousands):

	2005				2004			
	Nursing Facilities	Matrix	Home Care	Total	Nursing Facilities	Matrix	Home Care	Total
Revenues	$ 30,159	$ 2,546	$	$ 32,705	$ 49,131	$ 3,301	$ 148	$ 52,580
Operating income (loss)(1)	$ 274	$ 405	$ (97)	$ 582	$ (630)	$ 153	$ (7)	$ (484)
Gain (loss) on sales and exit costs	(878)			(878)	4,488		(17)	4,471
Impairments and other unusual items	207			207	(1,258)			(1,258)
Pre-tax income (loss)	$ (397)	$ 405	$ (97)	(89)	$ 2,600	$ 153	$ (24)	2,729
Provision for (benefit from) state income taxes				(1,495)				423
Discontinued operations, net of taxes				$ 1,406				$ 2,306

(1) Includes net interest income of $3,000 for 2005 and net interest expense of $44,000 for 2004, as well as depreciation and amortization expense of $277,000, and $859,000 for 2005, and 2004, respectively.

Income Taxes

Our provision for income taxes from continuing operations of $1.5 million for the three months ended March 31, 2005, primarily relates to state income taxes estimated to be due in separate return states where we conduct business and to federal alternative minimum tax. We recorded a tax benefit in discontinued operations of $1.5 million for the three months ended March 31, 2005, relating to state tax refunds in a state where we have ceased operations. We decreased the valuation allowance on our deferred tax assets by $36.5 million during the three months ended March 31, 2005 to $121.8 million, primarily due to the reversal of temporary differences and the utilization of net operating loss carryforwards, general business tax credits, and alternative minimum tax credits to offset taxable income for the quarter (see *Tax Valuation Allowance* in our Critical Accounting Policies Update above).

New Accounting Standard

In December 2004, the FASB issued SFAS No. 123R which eliminates the intrinsic value method as an alternative method of accounting for stock-based awards. SFAS No. 123R also revises the fair value-based method of accounting for share-based payment liabilities, forfeitures and modifications of stock-based awards and clarifies guidance surrounding measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. In addition, SFAS No. 123R amends SFAS No. 95 to require that excess tax benefits be reported as

a financing cash inflow rather than as a reduction of taxes paid, which is included within operating cash flows.

In the first quarter of 2005, the SEC issued Staff Accounting Bulletin No. 107, which provided further clarification on the implementation of SFAS No. 123R and provided alternative phase-in methods. The SEC announced in the second quarter of 2005 that it is extending the phase-in period, which will extend our effective date for implementation of SFAS No. 123R to January 1, 2006. We expect to use the modified

BEVERLY ENTERPRISES, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

version of prospective application when we implement SFAS No. 123R. Based on the estimated value of unvested stock options, we expect wages and related expenses to increase $469,000 in 2006.

Liquidity and Capital Resources

At March 31, 2005, we had $233.8 million in cash and cash equivalents and $3.0 million of investments with maturities between three and six months. We anticipate that $74.3 million of this cash balance, while not legally restricted, will be utilized primarily to fund certain general and professional liabilities and workers compensation claims and expenses. In addition, at March 31, 2005, we had approximately $16.0 million in funds that are restricted for the payment of insured claims and are included in Prepaid expenses and other on our condensed consolidated balance sheet. At March 31, 2005, we had positive working capital of $188.0 million reflected on our condensed consolidated balance sheet, an increase of 7% from year-end 2004. At March 31, 2005, we had $90.0 million of unused commitments under our revolving credit facility and $15.7 million of unused commitments under our letter of credit facility.

Cash Flows. Our cash flows consisted of the following for the three months ended March 31 (in thousands):

	2005	2004
Net cash provided by (used for):		
Operating activities	$ 34,770	$ (36,572)
Investing activities	(18,220)	11,726
Financing activities	1,595	(3,742)
Net increase (decrease) in cash and cash equivalents	$ 18,145	$ (28,588)

Net cash provided by (used for) operating activities, under the direct method, for the three months ended March 31, consists of the following (in thousands):

	2005	2004
Cash received from patients and third-party payors	$ 551,958	$ 473,874
Interest received	2,066	1,568
Cash paid to suppliers and employees	(516,699)	(504,346)
Interest paid	(4,681)	(5,218)
Income tax (paid) refunds received	2,126	(2,450)
Net cash provided (used for) by operating activities	$ 34,770	$ (36,572)

The $34.8 million of net cash provided by operating activities was primarily used to fund capital expenditures of $20.7 million for the three months ended March 31, 2005. For the three months ended March 31, 2004, the $36.6 million net cash used for operating activities was not caused by operational issues, but was primarily due to a $55.9 million increase in accounts receivable resulting from the termination of daily purchases of receivables by Beverly Funding Corporation (BFC) from Beverly Health and Rehabilitation Services (BHRS) on March 1, 2004. With the termination of daily purchases of receivables by BFC from BHRS, our accounts receivable increased and resulted in a use of cash from operating activities on our condensed consolidated statement of cash flows for the first quarter of 2004.

Divestitures. During February 2005, we sold 10 outpatient clinics for $4.6 million consisting of $710,000 cash and $3.9 million of notes receivable. The purchase price is subject to adjustment based on a working capital settlement, which is expected to be finalized by the third quarter of 2005. As of March 31, 2005, we

BEVERLY ENTERPRISES, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

had 22 nursing facilities classified as held for sale that met the appropriate criteria set forth in SFAS No. 144 and we expect to dispose of them within the next three to six months.

Sale of the Company. Our results of operations, financial condition, cash flows and liquidity may be adversely impacted by the ongoing sales process. To date we have incurred various costs as a result of the expression of interest, the proxy contest and the sales process including legal, investment banking advisory fees and other related costs. During the three months ended March 31, 2005, we recorded $18.7 million of these costs of which $807,000 was paid and $17.9 million remains accrued as of March 31, 2005. In addition, the sale process may impact our ability to attract and retain customers, management and employees and will result in the incurrence of significant additional advisory fees, legal fees and other expenses; however the amount and impact of these potential additional expenses cannot be reasonably estimated at this time.

Summary. We currently anticipate that cash on hand, cash flows from operations and availability under our banking arrangements will be adequate to repay our debts due within one year of $12.2 million, to make capital additions and improvements of approximately $100.0 million, to make operating lease and other contractual obligation payments, to make selective acquisitions, including the purchase of previously leased facilities and to meet working capital requirements for the twelve months ending March 31, 2006.

Our ability to make payments on, and to refinance, our indebtedness, as well as to fund planned capital expenditures, including strategic acquisitions, and research and development efforts, will depend on our ability to generate cash in the future. This, to a certain extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. However, based on our current level of operations and anticipated cost savings and operating improvements, we believe our cash flows from operations, current cash and cash equivalents and available borrowings will be adequate to meet our future liquidity needs.

We cannot assure you, however, that our business will generate sufficient cash flows from operations, that currently anticipated cost savings and operating improvements will be realized on schedule or that future borrowings will be available to us in an amount sufficient to enable us to pay our indebtedness or to fund our other liquidity needs. We also cannot assure you as to what the potential impact of the sales process will ultimately be on our business and our operations. We may need to refinance all or a portion of our indebtedness on or before maturity. We cannot assure you that we will be able to refinance any of our indebtedness on commercially reasonable terms or at all. If cash flows from operations or availability under our existing banking arrangements fall below expectations, we may be required to utilize cash on hand, delay capital expenditures, dispose of certain assets, issue additional debt securities, or consider other alternatives to improve liquidity.

Obligations and Commitments

There have been no material changes in the information related to obligations and commitments provided in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004 under Item 7.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

There have been no material changes in the information provided in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004 under Item 7A.

ITEM 4. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures, which are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, 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.

As required by SEC Rule 13a-15(b), we have carried out an evaluation as of March 31, 2005, the end of the period covered by this report, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon their evaluation and subject to the foregoing, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II
BEVERLY ENTERPRISES, INC.
OTHER INFORMATION
March 31, 2005
(Unaudited)

ITEM 1. LEGAL PROCEEDINGS.

There have been no material developments to the information presented under Item 3. Legal Proceedings in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

ITEM 5. OTHER INFORMATION.

(b) The information contained in Item 8.01 of our Current Report on Form 8-K filed March 23, 2005, and Item 8.01 of our Current Report on Form 8-K filed April 7, 2005, is hereby incorporated by reference. These items pertain to the procedures adopted by our Board of Directors to enable the beneficial owners of not less than 20 percent of our outstanding common stock to cause us to call a special meeting of stockholders to remove and replace the Board and the nomination of individuals for election as directors at the special meeting, if held.

ITEM 6. EXHIBITS.

Exhibit Number	
3.1	Form of Restated Certificate of Incorporation of New Beverly Holdings, Inc. (incorporated by reference to Exhibit 3.1 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1997)
3.2	Form of Certificate of Amendment of Certificate of Incorporation of New Beverly Holdings, Inc., changing its name to Beverly Enterprises, Inc. (incorporated by reference to Exhibit 3.2 to Beverly Enterprises, Inc. s Annual Report on Form 10-K for the year ended December 31, 1997)
3.3	By-Laws of Beverly Enterprises, Inc. (incorporated by reference to Exhibit 3.4 to Beverly Enterprises, Inc. s Registration Statement on Form S-1 filed on June 4, 1997 (File No. 333-28521))
4.1	Rights agreement, dated as of January 26, 2005, between Beverly Enterprises, Inc. and the Bank of New York, as Rights Agent, which includes the form of Certificate of Designations of the Series A Junior Participating Preferred Stock of Beverly Enterprises, Inc. as Exhibit A, the form of Right Certificate as Exhibit B and the Summary of Rights to Purchase Preferred Shares as Exhibit C (incorporated by reference to Exhibit 4.1 to Beverly Enterprises, Inc. s Current Report on Form 10-K filed January 28, 2005)
4.2	Amendment to Rights Agreement, dated April 7, 2005, between Beverly Enterprises, Inc. and the Bank of New York, as Rights Agent (incorporated by reference to Exhibit 4.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed April 7, 2005)
10.1	Settlement Agreement, dated April 11, 2005, between Beverly Enterprises, Inc. and Arnold Whitman, Appaloosa Management L.P., Formation Capital LLC, Franklin Mutual Advisers, LLC and Northbrook NBV, LLC (incorporated by reference to Exhibit 10.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed April 13, 2005)

Table of Contents

BEVERLY ENTERPRISES, INC.
OTHER INFORMATION (Continued)
March 31, 2005
(Unaudited)

Exhibit Number	
10.2	Summary of Executive Compensation for 2005.
15	Acknowledgement Letter of Ernst & Young LLP re: Unaudited Condensed Consolidated Interim Financial Statements
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.1	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer
99.1	Resolution of the Beverly Enterprises, Inc. Board of Directors (incorporated by reference to Exhibit 99.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed March 23, 2005)
99.2	Resolution of the Beverly Enterprises, Inc. Board of Directors (incorporated by reference to Exhibit 99.1 to Beverly Enterprises, Inc. s Current Report on Form 8-K filed April 7, 2005)

Table of Contents

SIGNATURE

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

Beverly Enterprises, Inc.
Registrant

By: /s/ Pamela H. Daniels

Pamela H. Daniels
Senior Vice President, Controller and Chief Accounting Officer

Dated: May 4, 2005

34