

NATIONWIDE HEALTH PROPERTIES INC

Form 10-Q

August 03, 2005

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended June 30, 2005.

OR

.. **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 1-9028

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**NATIONWIDE HEALTH PROPERTIES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Maryland**  
(State or Other Jurisdiction of Incorporation  
or Organization)

**95-3997619**  
(I.R.S. Employer  
Identification Number)

**610 Newport Center Drive, Suite 1150**

**Newport Beach, California 92660**

(Address of Principal Executive Offices)

**(949) 718-4400**

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the 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  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Shares of registrant's common stock, \$0.10 par value, outstanding at July 31, 2005: 67,410,655

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**NATIONWIDE HEALTH PROPERTIES, INC.**

**FORM 10-Q**

**JUNE 30, 2005**

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**Table of Contents****Part I. Financial Information****Item 1. Financial Statements****NATIONWIDE HEALTH PROPERTIES, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | <b>June 30,<br/>2005</b>      | <b>December 31,<br/>2004</b> |
|---|-------------------------------|------------------------------|
|   | <b>(Unaudited)</b>            |                              |
|   | <b>(Dollars in thousands)</b> |                              |
| <b>ASSETS</b>   |                               |                              |
| Investments in real estate  |                               |                              |
| Real estate properties:   |                               |                              |
| Land  | \$ 210,041                    | \$ 187,666                   |
| Buildings and improvements  | 1,868,341                     | 1,665,290                    |
|   | <u>2,078,382</u>              | <u>1,852,956</u>             |
| Less accumulated depreciation   | (327,863)                     | (303,766)                    |
|   | <u>1,750,519</u>              | <u>1,549,190</u>             |
| Mortgage loans receivable, net  | 78,082                        | 75,453                       |
| Investment in unconsolidated joint venture  |                               | 12,747                       |
|   | <u>1,828,601</u>              | <u>1,637,390</u>             |
| Cash and cash equivalents   | 12,979                        | 8,473                        |
| Receivables   | 7,252                         | 7,470                        |
| Assets held for sale  | 4,443                         | 3,050                        |
| Other assets  | 55,713                        | 53,728                       |
|   | <u>\$ 1,908,988</u>           | <u>\$ 1,710,111</u>          |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                               |                              |
| Borrowings under unsecured revolving credit facility  | \$ 96,000                     | \$ 186,000                   |
| Senior unsecured notes due 2006-2038  | 702,000                       | 470,000                      |
| Notes and bonds payable   | 254,207                       | 187,409                      |
| Accounts payable and accrued liabilities  | 53,996                        | 50,876                       |
| Commitments and contingencies   |                               |                              |
| Stockholders' equity:   |                               |                              |
| Preferred stock \$1.00 par value; 5,000,000 shares authorized;  |                               |                              |
| Series A, 1,000,000 shares issued and outstanding at June 30, 2005 and December 31, 2004, stated at liquidation preference of \$100 per share                       | 100,000                       | 100,000                      |
| Series B, 1,064,500 shares issued and outstanding at June 30, 2005 and December 31, 2004, stated at liquidation preference of \$100 per share                       | 106,450                       | 106,450                      |
| Common stock \$0.10 par value; 100,000,000 shares authorized; 67,409,107 and 66,805,959 issued and outstanding at June 30, 2005 and December 31, 2004, respectively | 6,741                         | 6,681                        |

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|                                |                             |                             |
|--------------------------------|-----------------------------|-----------------------------|
| Capital in excess of par value | 879,620                     | 868,091                     |
| Cumulative net income          | 842,118                     | 808,775                     |
| Cumulative dividends           | (1,132,144)                 | (1,074,171)                 |
|                                | <u>                    </u> | <u>                    </u> |
| Total stockholders' equity     | 802,785                     | 815,826                     |
|                                | <u>                    </u> | <u>                    </u> |
|                                | \$ 1,908,988                | \$ 1,710,111                |
|                                | <u>                    </u> | <u>                    </u> |

See accompanying notes.

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## NATIONWIDE HEALTH PROPERTIES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

|  | Three Months Ended<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|--|--------------------------------|------------------|------------------------------|------------------|
|  | 2005                           | 2004             | 2005                         | 2004             |
| (In thousands, except per share amounts)                           |                                |                  |                              |                  |
| <b>Revenues:</b>   |                                |                  |                              |                  |
| Rental income  | \$ 52,507                      | \$ 43,083        | \$ 100,804                   | \$ 80,208        |
| Interest and other income  | 2,475                          | 3,231            | 4,970                        | 6,408            |
|  | <u>54,982</u>                  | <u>46,314</u>    | <u>105,774</u>               | <u>86,616</u>    |
| <b>Expenses:</b>   |                                |                  |                              |                  |
| Interest and amortization of deferred financing costs              | 17,034                         | 14,646           | 31,620                       | 27,268           |
| Depreciation and amortization                                      | 14,219                         | 11,880           | 27,381                       | 22,125           |
| General and administrative   | 3,213                          | 3,348            | 7,114                        | 7,215            |
| Impairment of assets   |                                |                  | 310                          |                  |
|  | <u>34,466</u>                  | <u>29,874</u>    | <u>66,425</u>                | <u>56,608</u>    |
| Income before unconsolidated joint venture                         | 20,516                         | 16,440           | 39,349                       | 30,008           |
| Income (loss) from unconsolidated joint venture                    | (158)                          | 518              | 689                          | 930              |
| Income from continuing operations                                  | <u>20,358</u>                  | <u>16,958</u>    | <u>40,038</u>                | <u>30,938</u>    |
| <b>Discontinued operations</b>                                     |                                |                  |                              |                  |
| Gain (loss) on sale of facilities, net                             |                                | (204)            | 33                           | (204)            |
| Income (loss) from discontinued operations                         | (376)                          | 618              | (6,728)                      | 1,194            |
|  | <u>(376)</u>                   | <u>414</u>       | <u>(6,695)</u>               | <u>990</u>       |
| Net income   | 19,982                         | 17,372           | 33,343                       | 31,928           |
| Preferred stock dividends  | (3,981)                        | (1,919)          | (7,963)                      | (3,839)          |
| Income available to common stockholders                            | <u>\$ 16,001</u>               | <u>\$ 15,453</u> | <u>\$ 25,380</u>             | <u>\$ 28,089</u> |
| <b>Basic/diluted per share amounts:</b>                            |                                |                  |                              |                  |
| Income from continuing operations available to common stockholders | <u>\$ 0.24</u>                 | <u>\$ 0.23</u>   | <u>\$ 0.48</u>               | <u>\$ 0.41</u>   |
| Income (loss) from discontinued operations                         | <u>\$</u>                      | <u>\$</u>        | <u>\$ (0.10)</u>             | <u>\$ 0.02</u>   |
| Income available to common stockholders                            | <u>\$ 0.24</u>                 | <u>\$ 0.23</u>   | <u>\$ 0.38</u>               | <u>\$ 0.43</u>   |
| Dividends paid per common share                                    | \$ 0.37                        | \$ 0.37          | \$ 0.74                      | \$ 0.74          |

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|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Diluted weighted average common shares outstanding | 67,336 | 66,561 | 67,183 | 65,679 |
|--|--------|--------|--------|--------|

See accompanying notes.

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## NATIONWIDE HEALTH PROPERTIES, INC.

## CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(Unaudited)

(In thousands)

|                               | Preferred stock |            | Common stock |          | Capital in<br>excess of<br>par value | Cumulative<br>net income | Cumulative<br>dividends | Total<br>stockholders<br>equity |
|-------------------------------|-----------------|------------|--------------|----------|--------------------------------------|--------------------------|-------------------------|---------------------------------|
|                               | Shares          | Amount     | Shares       | Amount   |                                      |                          |                         |                                 |
| Balances at December 31, 2004 | 2,065           | \$ 206,450 | 66,806       | \$ 6,681 | \$ 868,091                           | \$ 808,775               | \$ (1,074,171)          | \$ 815,826                      |
| Issuance of common stock      |                 |            | 603          | 60       | 11,342                               |                          |                         | 11,402                          |
| Stock option amortization     |                 |            |              |          | 187                                  |                          |                         | 187                             |
| Net income                    |                 |            |              |          |                                      | 33,343                   |                         | 33,343                          |
| Preferred dividends           |                 |            |              |          |                                      |                          | (7,963)                 | (7,963)                         |
| Common dividends              |                 |            |              |          |                                      |                          | (50,010)                | (50,010)                        |
| Balances at June 30, 2005     | 2,065           | \$ 206,450 | 67,409       | \$ 6,741 | \$ 879,620                           | \$ 842,118               | \$ (1,132,144)          | \$ 802,785                      |

See accompanying notes.



**Table of Contents****NATIONWIDE HEALTH PROPERTIES, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|   | <b>Six Months Ended</b> |                  |
|---|-------------------------|------------------|
|   | <b>June 30,</b>         |                  |
|   | <b>2005</b>             | <b>2004</b>      |
|   | <b>(In thousands)</b>   |                  |
| <b>Cash flows from operating activities:</b>  |                         |                  |
| Net income  | \$ 33,343               | \$ 31,928        |
| <b>Non-cash adjustments to reconcile net income to cash provided by operating activities:</b> |                         |                  |
| Depreciation and amortization   | 27,381                  | 22,125           |
| Depreciation and amortization in discontinued operations                                      | 304                     | 477              |
| Gain on sale of facilities, net   | (33)                    | 204              |
| Impairment of assets  | 8,062                   |                  |
| Amortization of deferred financing costs  | 929                     | 764              |
| Mortgage loan discount accretion  |                         | (499)            |
| Equity in earnings from unconsolidated joint venture  | (565)                   | (743)            |
| Cash distribution from unconsolidated joint venture   | 901                     | 1,200            |
| <b>Changes in operating assets and liabilities:</b>   |                         |                  |
| Receivables   | 218                     | (2,088)          |
| Other assets  | 2,009                   | (6,654)          |
| Accounts payable and accrued liabilities  | 3,254                   | 1,432            |
| <b>Net cash provided by operating activities</b>  | <b>75,803</b>           | <b>48,146</b>    |
| <b>Cash flows from investing activities:</b>  |                         |                  |
| Investment in real estate   | (156,038)               | (231,364)        |
| Disposition of real estate  | 2,126                   | 146              |
| Return of investment from unconsolidated joint venture  | 875                     | 594              |
| Investment in mortgage loans receivable   | (3,250)                 |                  |
| Principal payments on mortgage loans receivable   | 621                     | 10,214           |
| <b>Net cash used in investing activities</b>  | <b>(155,666)</b>        | <b>(220,410)</b> |
| <b>Cash flows from financing activities:</b>  |                         |                  |
| Borrowings under unsecured revolving credit facility  | 229,000                 | 274,000          |
| Repayment of borrowings under unsecured revolving credit facility                             | (319,000)               | (161,000)        |
| Issuance of common stock, net   | 11,403                  | 140,307          |
| Issuance of senior unsecured debt   | 250,000                 |                  |
| Repayments of senior unsecured debt   | (18,000)                | (26,750)         |
| Principal payments on notes and bonds payable   | (3,708)                 | (1,356)          |
| Dividends paid  | (57,973)                | (53,964)         |
| Deferred financing costs  | (7,353)                 | (16)             |
| <b>Net cash provided by financing activities</b>  | <b>84,369</b>           | <b>171,221</b>   |

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|  |                   |                   |
|--|-------------------|-------------------|
| Increase (decrease) in cash and cash equivalents | 4,506             | (1,043)           |
| Cash and cash equivalents, beginning of period   | 8,473             | 10,726            |
|  | <u>          </u> | <u>          </u> |
| Cash and cash equivalents, end of period         | \$ 12,979         | \$ 9,683          |
|  | <u>          </u> | <u>          </u> |

See accompanying notes.

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**NATIONWIDE HEALTH PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2005**

**(Unaudited)**

**1. Organization**

Nationwide Health Properties, Inc., a Maryland corporation, is a real estate investment trust (REIT) specializing in investments in health care related senior housing and long-term care properties. Whenever we refer herein to NHP or to us or use the terms we or our, we are referring to Nationwide Health Properties, Inc. and its subsidiaries.

We primarily make our investments by acquiring an ownership interest in facilities and leasing them to unaffiliated operators under triple-net master leases that pass *all* facility operating costs (insurance, property taxes, utilities, maintenance, capital improvements, etc.) through to the tenant operator. In addition, but intentionally to a much lesser extent because we view the risks of this activity to be greater, from time to time we extend mortgage loans and other financing to operators. Currently, about 96% of our revenues are derived from our leases, with the remaining 4% from our mortgage loans and other financing.

We believe we have operated in such a manner as to qualify as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended. We intend to continue to qualify as such and therefore to distribute at least ninety percent (90%) of our REIT taxable income to our stockholders. If we qualify for taxation as a REIT, and we distribute 100% of our taxable income to our stockholders, we will generally not be subject to federal income taxes on our income that is distributed to stockholders. Accordingly, no provision has been made for federal income taxes.

At June 30, 2005, we had investments in 426 health care facilities located in 39 states, consisting of:

194 skilled nursing facilities;

216 assisted and independent living facilities;

7 continuing care retirement communities;

7 specialty hospitals; and

2 assets held for sale.

Our facilities are operated by 72 different operators, including the following publicly traded companies:

|                                 | <b>Number of<br/>Facilities<br/>Operated</b> |
|---------------------------------|--|
| American Retirement Corporation | 16   |
| Beverly Enterprises, Inc.       | 20   |
| Emeritus Corporation            | 23   |
| Extendicare, Inc.               | 5  |
| Genesis Healthcare              | 4  |
| HEALTHSOUTH Corporation         | 2  |
| Kindred Healthcare, Inc.        | 1  |
| Sun Healthcare Group, Inc.      | 4  |

One operator of our facilities accounted for 10% or more of our revenues at June 30, 2005, as follows:

|                                |     |
|--------------------------------|-----|
| Alterra Healthcare Corporation | 16% |
|--------------------------------|-----|

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**NATIONWIDE HEALTH PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. Summary of Significant Accounting Policies**

*Basis of Presentation*

We have prepared the condensed consolidated financial statements included herein without audit. These financial statements include all adjustments that are, in the opinion of management, necessary for a fair presentation of the results of operations for the three-month and six-month periods ended June 30, 2005 and 2004 pursuant to the rules and regulations of the Securities and Exchange Commission. All such adjustments are of a normal recurring nature. Certain items in prior period financial statements have been reclassified to conform to current year presentation, including those required by Statement of Financial Accounting Standards (SFAS) No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to these rules and regulations. Although we believe that the disclosures in the financial statements included herein are adequate to make the information presented not misleading, these condensed consolidated financial statements should be read in conjunction with our financial statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2004 filed with the Securities and Exchange Commission. The results of operations for the three-month and six-month periods ending June 30, 2005 and 2004 are not necessarily indicative of the results for a full year.

*Principles of Consolidation*

The condensed consolidated financial statements include our accounts and the accounts of our wholly owned and majority owned subsidiaries. All material intercompany accounts and transactions have been eliminated.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could materially differ from those estimates.

*Revenue Recognition*

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Rental income from operating leases is accrued as earned over the life of the lease agreements in accordance with accounting principles generally accepted in the United States. The majority of our leases do not contain step rent provisions. Interest income on real estate mortgages is recognized using the effective interest method based upon the expected payments over the lives of the mortgages. Additional rent, included in the caption Rental income, and additional interest, included in the caption Interest and other income, are generally computed as a percentage of facility net revenues in excess of base amounts or as a percentage of the increase in the Consumer Price Index. Additional rent and interest are generally calculated and payable monthly or quarterly, and the majority of our leases contain provisions such that total rent cannot decrease from one year to the next. While the calculations and payments are generally made on a quarterly basis, SEC Staff Accounting Bulletin No. 101 *Revenue Recognition in Financial Statements* (SAB No. 101) does not allow for the recognition of such revenue until all possible contingencies have been eliminated. Most of our leases with additional rent contingent upon facility net patient revenues in excess of base amounts are structured as quarterly calculations so that all contingencies for revenue recognition have been eliminated at each of our quarterly reporting dates.

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**NATIONWIDE HEALTH PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

We have historically deferred the payment of rent for the first few months on leases for certain buildings we have constructed. In addition, we have occasionally deferred the payment of a portion or all of the monthly rent for the first few months on leases we have restructured with new operators. Also, certain leases we entered into, primarily with regard to facilities returned to us by operators in bankruptcy, have had reduced or free rent in the early months of the lease or fixed increases in future years. These deferred amounts are repaid over the remainder of the lease term. Although the payment of cash rent is deferred, rental income is recorded on a straight-line basis over the life of the lease. We received \$652,000 of cash in excess of revenues recorded during the six months ended June 30, 2005 and received \$231,000 of cash in excess of revenues recorded during the six months ended June 30, 2004. There was \$8,900,000 at June 30, 2005 and \$9,281,000 at December 31, 2004 of deferred rent receivables, net of reserves, recorded under the caption "Other assets" on the balance sheet. We evaluate the collectibility of the deferred rent balances on an ongoing basis and provide reserves against receivables we believe may not be fully recoverable. The ultimate amount of deferred rent we realize could be less than amounts currently recorded.

*Gain on sale of facilities*

We recognize sales of facilities only upon closing. Payments received from purchasers prior to closing are recorded as deposits. Gains on facilities sold are recognized using the full accrual method upon closing when the collectibility of the sales price is reasonably assured, we have received an adequate initial investment from the buyer, we are not obligated to perform significant activities after the sale to earn the gain and other profit recognition criteria have been satisfied. Gains may be deferred in whole or in part until the sales satisfy the requirements of gain recognition for sales of real estate under SFAS No. 66 *Accounting for Sales of Real Estate*.

*Asset Impairment*

We review our long-lived assets individually on a quarterly basis to determine if there are indicators of impairment in accordance with SFAS No. 144. Indicators may include, among others, the tenant's inability to make rent payments, operating losses or negative operating trends at the facility level, notification by the tenant that it will not renew its lease, a decision to dispose of an asset or changes in the market value of the property. For operating assets, if indicators of impairment exist, we compare the future estimated undiscounted cash flows from the expected use of the property to its net book value to determine if impairment exists. If the sum of the future estimated undiscounted cash flows is higher than the current net book value, in accordance with SFAS No. 144, we conclude no impairment exists. If the sum of the future estimated undiscounted cash flows is lower than the current net book value, we recognize an impairment loss for the difference between the net book value of the asset and its estimated fair market value. To the extent we decide to sell an asset, we recognize an impairment loss if the current net book value of the asset exceeds its fair value less costs to sell. The above analyses require us to determine whether there are indicators of impairment for individual assets, to estimate the most likely stream of cash flows from operating assets and to determine the fair value of assets that are impaired or held for sale. If our assumptions, projections or estimates regarding an asset change in the future, we may have to record an impairment charge to reduce or further reduce the net book value of the asset.

*Collectibility of Receivables*

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We evaluate the collectibility of our mortgage loans and other receivables on a regular basis based on factors including, among others, payment history, the financial strength of the borrower and any guarantors, the value of the underlying collateral, the operations and operating trends of the underlying collateral, if any, and current economic conditions. If our evaluation of these factors indicates we may not recover the full value of the receivable, we provide a reserve against the portion of the receivable that we estimate will not be recovered. This



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**NATIONWIDE HEALTH PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

analysis requires us to determine whether there are factors indicating a receivable may not be fully collectible and to estimate the amount of the receivable that will not be collected. If our assumptions or estimates regarding the collectibility of a receivable change in the future, we may have to record a reserve to reduce the carrying value of the receivable.

*Accounting for Stock-Based Compensation*

In 1999, we adopted the accounting provisions of SFAS No. 123 *Accounting for Stock-Based Compensation* (SFAS No. 123). In 2005 we adopted SFAS No. 123 (revised 2004) *Share-Based Payment* (SFAS No. 123R). SFAS No. 123 and SFAS No. 123R established a fair value based method of accounting for stock-based compensation. Accounting for stock-based compensation under SFAS No. 123 and SFAS No. 123R causes the fair value of stock options granted to be amortized as an expense over the vesting period of the options and causes any dividend equivalents earned to be treated as dividends for financial reporting purposes. Restricted stock grants are valued at the market price on the date of grant and amortized as an expense over the vesting period of the stock grants. Net income includes stock-based compensation expense of \$443,000 and \$774,000 for the three-month and six-month periods ended June 30, 2005, respectively, and \$78,000 and \$150,000 for the three-month and six-month periods ended June 30, 2004, respectively.

*Land, Buildings and Improvements*

We record properties at cost and use the straight-line method of depreciation for buildings and improvements over their estimated remaining useful lives of up to 40 years, generally 30 to 40 years. We review and adjust useful lives periodically. Depreciation expense was \$13,965,000 and \$26,868,000 for the three months and six months ended June 30, 2005, respectively, and \$11,576,000 and \$21,574,000 for the three months and six months ended June 30, 2004, respectively. We allocate the purchase price of a property based on management's estimate of its fair value between land, building and, if applicable, equipment as if the property were vacant. Historically, we have generally acquired properties and simultaneously entered into a new market rate lease for the entire property with one tenant. In certain instances we have acquired facilities subject to an in-place lease. Accordingly, in certain instances, we may allocate a portion of purchase prices to in-place leases. The costs to execute a lease at the time of the acquisition of a property is recorded as an intangible asset and amortized over the initial term of the lease.

*Impact of New Accounting Pronouncements*

In December 2004, the FASB released SFAS No. 123R, which we adopted in 2005. In 1999 we adopted the original SFAS No. 123 and have recognized all stock-based compensation in our income statement since that time. The effect of this pronouncement on our financial statements was not material.

**3. Real Estate Properties**

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As of June 30, 2005, we had direct ownership of 180 skilled nursing facilities, 215 assisted and independent living facilities, six continuing care retirement communities and seven specialty hospitals. We lease our owned facilities to single tenants under triple-net leases that are accounted for as operating leases. The leases generally have initial terms ranging from five to 21 years, and generally have two or more multiple-year renewal options. Approximately 82% of our facilities are leased under master leases. In addition, the majority of our leases contain cross-collateralization and cross-default provisions tied to other leases with the same tenant, as

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**NATIONWIDE HEALTH PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

well as grouped lease renewals and grouped purchase options. Leases covering 338 facilities are backed by security deposits consisting of irrevocable letters of credit or cash, most of which cover from three to six months of initial monthly minimum rents. Under the terms of the leases, the tenant is responsible for all maintenance, repairs, taxes, insurance and capital expenditures on the leased properties. No individual property held by us is material to us as a whole.

During the six months ended June 30, 2005, we acquired 14 skilled nursing facilities and 50 assisted and independent living facilities in seven separate transactions for an aggregate investment of \$204,504,000, including the assumption of \$70,506,000 of mortgage financing. These amounts include our acquisition of JER Senior Housing, LLC's ( JER ) 75% interest in our joint venture. For more information about this transaction, see Note 5. In addition, we exchanged two facilities plus \$1,500,000 for two different facilities owned by American Retirement Corporation. We also funded \$5,245,000 in earnouts, expansions, construction and capital improvements at certain facilities in accordance with existing lease provisions. Such expansions, construction and capital improvements generally result in an increase in the minimum rents earned by us on these facilities either at the time of funding or upon completion of the project. At June 30, 2005, we have committed to fund additional expansions, construction and capital improvements of approximately \$20,000,000.

During the six-month period ended June 30, 2005, we sold one skilled nursing facility for net cash proceeds of \$2,126,000. This sale resulted in a gain of \$33,000 that is included in gain on sale of facilities in discontinued operations.

**4. Mortgage Loans Receivable**

As of June 30, 2005, we held 12 mortgage loans receivable secured by 14 skilled nursing facilities, one assisted living facility and one continuing care retirement community. In addition, we held one mortgage loan receivable secured by the skilled nursing portion of a continuing care retirement community that for facility count purposes is accounted for in the real estate properties above as a continuing care retirement community and therefore is not counted as a separate facility here. As of June 30, 2005, the mortgage loans receivable had a net book value of \$78,082,000 with individual outstanding balances ranging from \$111,000 to \$10,563,000 and maturities ranging from 2005 to 2031.

During the six months ended June 30, 2005, we funded one mortgage loan secured by one skilled nursing facility in the amount of \$3,250,000.

**5. Investment in Unconsolidated Joint Venture**

On May 3, 2005, we acquired JER's 75% interest in our joint venture, JER/NHP Senior Housing, LLC, for approximately \$121,000,000. As part of this transaction, we assumed the secured debt the joint venture had in place of approximately \$60,000,000, approximately \$45,000,000 of which represented JER's share, resulting in a payment to JER Senior Housing, LLC of approximately \$75,000,000, net of other costs and fees related to buying out their interest of approximately \$1,000,000. As a result of this acquisition, we now own 100% of the 46 assisted living

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facilities in 12 states that are leased to Alterra Healthcare Corporation under two cross-defaulted master leases with initial terms expiring in 2020. From the transaction date forward, the operations of JER/NHP Senior Housing, LLC have been consolidated with our existing operations.

During the six months ended June 30, 2005, prior to our acquisition of JER's interest, the joint venture sold one facility for net cash proceeds of \$3,500,000 resulting in a gain of \$1,320,000 included in discontinued operations of the joint venture.

**Table of Contents****NATIONWIDE HEALTH PROPERTIES, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Prior to May 3, 2005, in addition to our 25% share of the income from the joint venture, we received a management fee of 2.5% of the joint venture revenues. This fee is included in our income from unconsolidated joint venture and in the general and administrative expenses on the joint venture's income statement. Management fees earned by us were \$31,000 and \$124,000 during the three months and six months ended June 30, 2005, respectively, and were \$93,000 and \$187,000 during the three months and six months ended June 30, 2004, respectively.

The income statement for the joint venture below presents its results of operations for the three-month and six-month periods ended June 30, 2005, and three-month and six-month periods ended June 30, 2004 in thousands. The activity in the second quarter represents only the activity for the month of April as the operations were 100% owned by us and therefore consolidated beginning in May. Included in interest and amortization of deferred financing costs is a \$595,000 prepayment fee and the write-off of \$751,000 of deferred financing costs related to the prepayment/refinancing of approximately \$59,500,000 of secured debt held by the joint venture prior to our acquisition that was refinanced with a five year term loan at 5.56% subsequent to our acquisition.

**INCOME STATEMENT****(Unaudited)**

|   | <b>Three Months Ended</b> |                 | <b>Six Months Ended</b> |                 |
|---|---------------------------|-----------------|-------------------------|-----------------|
|   | <b>June 30,</b>           |                 | <b>June 30,</b>         |                 |
|   | <b>2005</b>               | <b>2004</b>     | <b>2005</b>             | <b>2004</b>     |
| Rental income   | \$ 1,227                  | \$ 3,726        | \$ 4,908                | \$ 7,453        |
| Expenses:   |                           |                 |                         |                 |
| Interest and amortization of deferred financing costs | 1,722                     | 1,094           | 2,819                   | 2,299           |
| Depreciation and amortization                         | 240                       | 739             | 979                     | 1,478           |
| General and administrative                            | 26                        | 193             | 195                     | 426             |
|   | <u>1,988</u>              | <u>2,026</u>    | <u>3,993</u>            | <u>4,203</u>    |
| Income from continuing operations                     | (761)                     | 1,700           | 915                     | 3,250           |
| Discontinued operations                               |                           |                 |                         |                 |
| Gain (loss) on sale                                   |                           |                 | 1,320                   | (307)           |
| Income from discontinued operations                   |                           |                 | 20                      | 29              |
|   |                           |                 | <u>1,340</u>            | <u>(278)</u>    |
| Net income (loss)                                     | <u>\$ (761)</u>           | <u>\$ 1,700</u> | <u>\$ 2,255</u>         | <u>\$ 2,972</u> |

**6. Assets Held for Sale**

During the six months ended June 30, 2005, we transferred two buildings to assets held for sale and we reclassified a land parcel valued at \$752,000 from assets held for sale to investment in land. A skilled nursing facility is to be constructed on the site, and we will acquire that facility upon completion. In addition, we recognized an impairment of \$893,000 on one of the two facilities transferred to assets held for sale, recorded an impairment on the other during the first quarter, \$6,709,000 of which is now reported in discontinued operations and recorded an impairment of \$150,000 related to one land parcel to write it down to its estimated fair value less costs to sell based on an offer received.

During the six months ended June 30, 2004, we sold one asset held for sale resulting in a loss of \$204,000.

At June 30, 2005 two buildings and two land parcels remained in assets held for sale. At December 31, 2004 three land parcels remained in assets held for sale.

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**NATIONWIDE HEALTH PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**7. Unsecured Revolving Credit Facility**

At June 30, 2005, we had \$96,000,000 outstanding on our \$400,000,000 unsecured credit agreement with several banks that matures on April 15, 2007, which we may extend for an additional year. At our option, borrowings under the agreement bear interest at prime (6.25% at June 30, 2005) or LIBOR plus 1.075% (4.45% at June 30, 2005). We pay a facility fee of 0.3% per annum on the total commitment under the agreement.

**8. Senior Unsecured Notes**

On May 18, 2005, we issued \$250,000,000 of senior notes due May 20, 2015 at a fixed rate of 6.0% resulting in net proceeds of approximately \$243,000,000. The proceeds were used primarily for the repayment of amounts outstanding under our revolving credit facility.

**9. Common Stock**

During 2003, we adopted a dividend reinvestment and stock purchase plan. This plan enables existing stockholders to purchase additional shares of common stock by automatically reinvesting all or part of the cash dividends paid on their shares of common stock. The plan also allows investors to acquire shares of our common stock, subject to certain limitations, including a maximum monthly investment of \$10,000, at a discount ranging from 0% to 5%, determined by us from time to time in accordance with the plan. The discount at June 30, 2005 was 2%. During the six months ended June 30, 2005, we issued approximately 406,000 shares of common stock resulting in net proceeds of \$8,683,000.

**10. Earnings Per Share (EPS)**

Basic EPS is computed by dividing income from continuing operations available to common stockholders by the weighted average common shares outstanding. Income from continuing operations available to common stockholders is calculated by deducting dividends declared on preferred stock from income from continuing operations. Diluted EPS includes the effect of any potential shares outstanding, which for us is only comprised of dilutive stock options. The calculation below excludes 138,000 of stock options with option prices that would not be dilutive for the three months and six months ended June 30, 2005, and 417,000 of stock options with option prices that would not be dilutive for the three months and six months ended June 30, 2004. The table below details the components of the basic and diluted EPS from continuing operations available to common stockholders calculations:

**Three Months Ended June 30,**

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|                                       | 2005           |        | 2004      |        |
|---------------------------------------|----------------|--------|-----------|--------|
|                                       | Income         | Shares | Income    | Shares |
|                                       | (In thousands) |        |           |        |
| Income from continuing operations     | \$ 20,358      |        | \$ 16,958 |        |
| Less: preferred stock dividends       | (3,981)        |        | (1,919)   |        |
| Amounts used to calculate Basic EPS   | 16,377         | 67,201 | 15,039    | 66,481 |
| Effect of dilutive securities:        |                |        |           |        |
| Stock options                         |                | 135    |           | 80     |
| Amounts used to calculate Diluted EPS | \$ 16,377      | 67,336 | \$ 15,039 | 66,561 |



**Table of Contents****NATIONWIDE HEALTH PROPERTIES, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

|                                       | <b>Six Months Ended June 30,</b> |               |               |               |
|---------------------------------------|----------------------------------|---------------|---------------|---------------|
|                                       | <b>2005</b>                      |               | <b>2004</b>   |               |
|                                       | <b>Income</b>                    | <b>Shares</b> | <b>Income</b> | <b>Shares</b> |
|                                       | <b>(In thousands)</b>            |               |               |               |
| Income from continuing operations     | \$ 40,038                        |               | \$ 30,938     |               |
| Less: preferred stock dividends       | (7,963)                          |               | (3,839)       |               |
| Amounts used to calculate Basic EPS   | 32,075                           | 67,068        | 27,099        | 65,583        |
| Effect of dilutive securities:        |                                  |               |               |               |
| Stock options                         |                                  | 115           |               | 96            |
| Amounts used to calculate Diluted EPS | \$ 32,075                        | 67,183        | \$ 27,099     | 65,679        |

**11. Impairment of Assets**

During the six months ended June 30, 2005, we recognized impairment of assets charges of \$893,000 related to one skilled nursing facility and \$7,019,000 related to one facility that will no longer be operated as a skilled nursing facility, which includes the write-down of the facility to its estimated fair value less costs to sell, a reserve against a receivable from the operator of the facility and the write off of certain capitalized lease costs. In addition, we had an impairment of \$150,000 against one land parcel in assets held for sale to write it down to its estimated fair value less costs to sell. There were no asset impairments during the six months ended June 30, 2004.

**12. Pension Plan**

During 1991, we adopted an unfunded pension plan covering the current non-employee members of our Board of Directors. The benefits, limited to the number of years of service on the Board, are based upon the then current annual retainer in effect. The service cost for the plan was \$54,000 for the six months ended June 30, 2005 and was \$42,000 for the six months ended June 30, 2004. The interest cost for the plan was \$35,000 for the six months ended June 30, 2005 and \$36,000 for the six months ended June 30, 2004. We made \$50,000 of contributions to the plan for the six months ended June 30, 2005 and 2004 and expect to make \$50,000 of contributions during the remainder of 2005.

**13. Discontinued Operations**

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SFAS No. 144 requires the operating results of any assets with their own identifiable cash flows that are disposed of or held for sale be removed from income from continuing operations and reported as discontinued operations. The operating results for any such assets for any prior periods presented must also be reclassified as discontinued operations. See Note 3, Note 6 and Note 11 for more detail regarding the facilities sold and classified as held for sale during 2005. The following table details the amounts reclassified to discontinued operations for the periods presented:

|  | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |          |
|--|--------------------------------|--------|------------------------------|----------|
|  | 2005                           | 2004   | 2005                         | 2004     |
|  | (In thousands)                 |        | (In thousands)               |          |
| Rental income                              | \$ 531                         | \$ 890 | \$ 1,249                     | \$ 1,777 |
| Depreciation and amortization              | 120                            | 235    | 304                          | 477      |
| General and administrative                 | (106)                          | 37     | (79)                         | 106      |
| Impairment of assets                       | 893                            |        | 7,752                        |          |
|  | 907                            | 272    | 7,977                        | 583      |
| Income (loss) from discontinued operations | \$ (376)                       | \$ 618 | \$ (6,728)                   | \$ 1,194 |

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**NATIONWIDE HEALTH PROPERTIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**14. Litigation**

On October 5, 2004, we were served with a complaint for wrongful death in connection with a fire at the Greenwood Healthcare Center on February 26, 2003. At the time of the fire, the Greenwood Healthcare Center was owned by us and leased to and operated by Lexington Healthcare Group. Approximately fourteen additional complaints have been filed by families of patients who were either killed or injured in the fire. The lawsuits seek unspecified monetary damages. The complaints allege that the fire was set by a resident who had previously been diagnosed with depression. The complaints allege theories of negligent operation and premises liability against Lexington Healthcare, as operator, and the Company as owner. Lexington Healthcare has filed for bankruptcy. The matters have been consolidated into one action and are in the early stages of discovery and pleading.

The Company is being defended in the matter by its commercial general liability carrier. The Company believes that it has substantial defenses to the claims and that it has adequate insurance to cover the risks, should liability nonetheless be imposed. However, because the litigation is in the early stages, it is not possible to predict the ultimate outcome of these claims.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Critical Accounting Policies**

Our financial statements have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. On an ongoing basis, we evaluate our estimates and assumptions, including those that impact our most critical accounting policies. We base our estimates and assumptions on historical experience and on various other factors that we believe are reasonable under the circumstances. Actual results may differ from these estimates. We believe the following are our most critical accounting policies.

*Revenue Recognition*

Our rental revenue is accounted for in accordance with Statement of Financial Accounting Standards (SFAS) No. 13 *Accounting for Leases* (SFAS No. 13) and SEC Staff Accounting Bulletin No. 101 *Revenue Recognition in Financial Statements* (SAB No. 101) among other authoritative pronouncements. These pronouncements require us to account for the rental income on a straight-line basis unless a more appropriate method exists. We believe that the method most reflective of the use of a healthcare facility with fixed rate increases is the straight-line method. Straight-line accounting requires us to calculate the total fixed rent to be paid over the life of the lease and recognize that revenue evenly over that life. In a situation where a lease calls for fixed rental increases during the life of a lease or there is a period of free rent at the beginning of a lease, rental income recorded in the early years of a lease is higher than the actual cash rent received which creates an asset on the balance sheet called deferred rent receivable. At some point during the lease, depending on the rent levels and terms, this reverses and the cash rent payments received during the later years of the lease are higher than the rental income recognized, which reduces the deferred rent receivable balance to zero by the end of the lease. The majority of our leases do not contain fixed increases or provide for free or reduced rent at the beginning of the lease term. However, certain leases for facilities we have constructed have had free rent for the first three to six months and certain leases we entered into, primarily with regard to facilities returned to us by operators in bankruptcy have had reduced or free rent in the early months of the lease or fixed increases in future years. We record the rent for these facilities on a straight-line basis in accordance with SFAS No. 13. However, we also assess the collectibility of the deferred portion of the rent that is to be collected in a future period in accordance with SAB No. 101. This assessment is based on several factors, including the financial strength of the lessee and any guarantors, the historical operations and operating trends of the facility, the historical payment pattern of the facility and whether we intend to continue to lease the facility to the current operator, among others. If our evaluation of these factors indicates we may not receive the rent payments due in the future, we provide a reserve against the current rental income as an offset to revenue, and depending on the circumstances, we may provide a reserve against the existing deferred rent balance for the portion, up to its full value, that we estimate will not be recovered. This assessment requires us to determine whether there are factors indicating the future rent payments may not be fully collectible and to estimate the amount of the rent that will not be collected. If our assumptions or estimates regarding a lease change in the future, we may have to record a reserve to reduce or further reduce the rental revenue recognized and/or deferred rent receivable balance. We received \$652,000 of cash in excess of revenues recorded during the six months ended June 30, 2005 and received \$231,000 of cash in excess of revenues recorded during the six months ended June 30, 2004. There is \$8,900,000 at June 30, 2005 and \$9,281,000 at December 31, 2004 of deferred rent receivables, net of reserves, recorded under the caption "Other assets" on the balance sheet. We evaluate the collectibility of the deferred rent balances on an ongoing basis and provide reserves against receivables we believe may not be fully recoverable. The ultimate amount of deferred rent we realize could be less than amounts recorded.

Additional rents are generally computed as a percentage of facility revenues in excess of base amounts or as a percentage of the increase in the Consumer Price Index. We do not straight-line rent contingent on revenue increases or increases in the Consumer Price Index. Additional rents are generally calculated and payable

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monthly or quarterly, and most of our leases contain provisions such that total rent cannot decrease from one year to the next. While the calculations and payments of additional rents contingent upon revenue are generally made on a quarterly basis, SAB No. 101 does not allow for the recognition of this revenue until all possible contingencies have been eliminated. Most of our leases with additional rents contingent upon revenue are structured as quarterly calculations so that all contingencies for revenue recognition have been eliminated at each of our quarterly reporting dates.

### *Depreciation and Useful Lives of Assets*

We calculate depreciation on our buildings and improvements using the straight-line method based on estimated useful lives ranging up to 40 years, generally from 30 to 40 years. A significant portion of the cost of each property is allocated to building (generally approximately 90%). The allocation of the cost between land and building, and the determination of the useful life of a property, are based on management's estimates. We calculate depreciation and amortization on equipment and lease costs using the straight-line method based on estimated useful lives of up to five years or the lease term, whichever is appropriate. We review and adjust useful lives periodically. If we do not allocate appropriately between land and building or we incorrectly estimate the useful lives of our assets, our computation of depreciation and amortization will not appropriately reflect the usage of the assets over future periods. If we overestimate the useful life of an asset, the depreciation expense related to the asset will be understated, which could result in a loss if the asset is sold in the future.

### *Asset Impairment*

We review our long-lived assets individually on a quarterly basis to determine if there are indicators of impairment in accordance with SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144). Indicators may include, among others, the tenant's inability to make rent payments, operating losses or negative operating trends at the facility level, notification by the tenant that it will not renew its lease, a decision to dispose of an asset or changes in the market value of the property. For operating assets, if indicators of impairment exist, we compare the undiscounted cash flows from the expected use of the property to its net book value to determine if impairment exists. If the sum of the future estimated undiscounted cash flows is higher than the current net book value, in accordance with SFAS No. 144, we conclude no impairment exists. If the sum of the future estimated undiscounted cash flows is lower than the current net book value, we recognize an impairment loss for the difference between the net book value of the asset and its estimated fair market value. To the extent we decide to sell an asset, we recognize an impairment loss if the current net book value of the asset exceeds its fair value less costs to sell. The above analyses require us to determine whether there are indicators of impairment for individual assets, to estimate the most likely stream of cash flows from operating assets and to determine the fair value of assets that are impaired or held for sale. If our assumptions, projections or estimates regarding an asset change in the future, we may have to record an impairment charge to reduce or further reduce the net book value of such asset. During the six months ended June 30, 2005, we recognized impairment of assets charges of \$8,062,000, \$893,000 of which related to one skilled nursing facility and \$7,019,000 related to one facility that will no longer be operated as a skilled nursing facility, which includes the write-down of the facility to its estimated fair value less costs to sell, a reserve against a receivable from the operator of the facility and the write off of certain capitalized lease costs. In addition, we had an impairment of \$150,000 against one land parcel in assets held for sale to write it down to its estimated fair value less costs to sell.

### *Collectibility of Receivables*

We evaluate the collectibility of our mortgage loans and other receivables on a regular basis. We evaluate the collectibility of receivables based on factors including, among others, payment history, the financial strength of the borrower and any guarantors, the value of the underlying collateral, the operations and operating trends of the underlying collateral, if any, and current economic conditions. If our evaluation of these factors indicates we may not recover the full value of the receivable, we provide a reserve against the portion of the receivable that we estimate will not be recovered. This analysis requires us to determine whether there are factors indicating a



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receivable may not be fully collectible and to estimate the amount of the receivable that will not be collected. If our assumptions or estimates regarding the collectibility of a receivable change in the future, we may have to record a reserve to reduce or further reduce the carrying value of the receivable.

### *Impact of New Accounting Pronouncements*

In December 2004, the FASB released SFAS No. 123 (revised 2004) *Share-Based Payment*. In 2005 we adopted SFAS No. 123 (revised 2004) *Share-Based Payment* (SFAS No. 123R). In 1999 we adopted the original SFAS No. 123 *Accounting for Stock-Based Compensation* and have recognized all stock-based compensation in our income statement since that time. The effect of this pronouncement on our financial statements was not material.

## **Operating Results**

### *Six-Month Period Ended June 30, 2005 vs. Six-Month Period Ended June 30, 2004*

Rental income increased \$20,596,000, or 26%, over the same period in 2004. The increase was primarily due to rental income from 63 facilities acquired in 2005, 12 facilities acquired during the last two quarters of 2004 and rent increases at existing facilities. Interest and other income decreased \$1,438,000, or 22%, over the same period in 2004. The decrease was due to the payoff of ten mortgage loans during 2004, partially offset by one new mortgage loan receivable funded during 2005.

Interest and amortization of deferred financing costs increased \$4,352,000, or 16%, over the same period in 2004. The increase was primarily due to the assumption of \$70,506,000 of secured debt during the first half of 2005 and \$66,725,000 during 2004, an increase in the interest rates on our floating rate debt, an increase in the average balance on our unsecured revolving credit facility and interest on the \$250,000,000 of senior notes issued in May 2005, partially offset by the repayment of \$44,000,000 of senior notes during third quarter 2004 and \$18,000,000 of senior notes during first quarter 2005. During the six months ended June 30, 2005, we recognized an impairment of assets charge of \$310,000 in continuing operations. The impairment related to a receivable from the operator of a facility that was impaired for an additional \$6,709,000 in 2005, which portion is now reported in discontinued operations because we transferred the building to assets held for sale.

Prior to our acquisition of JER Senior Housing, LLC's (JER) 75% interest in our joint venture, income from unconsolidated joint venture represents our 25% share of the income generated by the joint venture and our management fee of 2.5% of the revenues of the unconsolidated joint venture. The decrease of \$241,000, or 26%, from the same period in 2004 is due to the recognition of only four months of income in 2005 prior to our acquisition and the recognition of our share, equal to \$330,000, of a gain on the sale of one of the joint venture's facilities of \$1,320,000 partially offset by charges related to the refinance of the joint venture's debt, consisting of the write off of deferred finance charges, our share of which was \$188,000, and a prepayment fee, our share of which was \$149,000 compared to six months of income in 2004. Please see the caption Investment in Unconsolidated Joint Venture below for more information regarding the formerly unconsolidated joint venture.

Discontinued operations decreased \$7,685,000, or 776%, versus the same period in 2004. The loss for the six months ended June 30, 2005 is comprised of an impairment charge of \$7,752,000 and depreciation of \$304,000, partially offset by rent revenue of \$1,249,000, other income of \$79,000 and gain on sale of \$33,000. The income for the six months ended June 30, 2004 is comprised of \$1,777,000 of rental income partially offset by \$477,000 of depreciation and amortization, a loss on sale of \$204,000 and \$106,000 of general and administrative expenses. The

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difference in the composition of the loss from discontinued operations was primarily caused by the impairments in 2005 and the fact that the facilities sold in 2004 had income in 2004, but do not have income in 2005, while the assets held for sale generate expenses, but generally do not produce income. Any future income or loss in discontinued operations would result from future sales of facilities or reclassifications of facilities to assets held for sale.



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*Three-Month Period Ended June 30, 2005 vs. Three-Month Period Ended June 30, 2004*

Rental income increased \$9,424,000, or 22%, over the same period in 2004. The increase was primarily due to rental income from 63 facilities acquired in 2005, 12 facilities acquired during the last two quarters of 2004 and rent increases at existing facilities. Interest and other income decreased \$756,000, or 23%, over the same period in 2004. The decrease was due to the payoff of ten mortgage loans during 2004.

Interest and amortization of deferred financing costs increased \$2,388,000, or 16%, over the same period in 2004. The increase was primarily due to the assumption of \$70,506,000 of secured debt during 2005 and \$66,725,000 during 2004, an increase in the interest rates on our floating rate debt, an increase in the average balance on our unsecured revolving credit facility and interest on the \$250,000,000 of senior notes issued in May 2005, partially offset by the repayment of \$44,000,000 of senior notes during third quarter 2004 and \$18,000,000 of senior notes during first quarter 2005. General and administrative expenses decreased \$135,000, or 4%, over the same period in 2004. The decrease was primarily due to a \$745,000 charge related to the lease-up of a restructured skilled nursing facility in 2004, partially offset by the amortization of restricted stock grants and increases in other general corporate expenses.

Prior to our acquisition of JER's 75% interest in our joint venture, income from unconsolidated joint venture represented our 25% share of the income generated by the joint venture and our management fee of 2.5% of the revenues of the unconsolidated joint venture. The decrease of \$676,000, or 131%, from the same period in 2004 is due to the recognition of only one month of income in 2005 prior to our acquisition, partially offset by charges related to the refinance of the joint venture's debt, consisting of the write off of deferred finance charges, our share of which was \$188,000, and a prepayment fee, our share of which was \$149,000, partially offset by increases in revenues from the joint venture owned facilities. Please see the caption "Investment in Unconsolidated Joint Venture" below for more information regarding the formerly unconsolidated joint venture.

Discontinued operations decreased \$790,000, or 191%, over the same period in 2004. The loss for the three months ended June 30, 2005 is comprised of an impairment charge of \$893,000 and depreciation of \$120,000, partially offset by rent revenue of \$531,000 and other income of \$106,000. The income for the three months ended June 30, 2004 is comprised of \$890,000 of rental income partially offset by \$235,000 of depreciation and amortization, a loss on sale of \$204,000, and \$37,000 of general and administrative expenses. The difference in the composition of the loss from discontinued operations was primarily caused by the impairments in 2005 and the fact that the facilities sold in 2004 had income in 2004, but do not have income in 2005, while the assets held for sale generate expenses, but generally do not produce income. Any future income or loss in discontinued operations would result from future sales of facilities or reclassifications of facilities to assets held for sale.

We expect to receive increased rent and interest at individual facilities because our leases and mortgages generally contain provisions under which rents or interest income increase with increases in facility revenues and/or increases in the Consumer Price Index. If revenues at our facilities and/or the Consumer Price Index do not increase, our revenues may not continue to increase. Sales of facilities or repayments of mortgage loans receivable would serve to offset revenue increases, and if sales and repayments exceed additional investments this could actually reduce revenues. Our leases could renew below or above the aggregate existing rent level, so the impact of lease renewals may cause a decrease or an increase in the total rent we receive. We currently have leases covering six facilities expiring in 2005. The exercise of purchase options by tenants would also cause a decrease in the total rent we receive. We believe our tenants may exercise purchase options on assets totaling between \$50,000,000 to \$90,000,000 during 2005. However, we do not have any control over whether our tenants will choose to exercise any available purchase options. Additional investments in healthcare facilities would increase rental and/or interest income. At this time we expect to make additional acquisitions during 2005, although the quantity and timing of any such acquisitions cannot be accurately forecast. As additional investments in facilities are made, depreciation and/or interest expense will also increase. We expect any such increases to be at least partially offset by rent or interest income associated with the investments.



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### **Investment in Unconsolidated Joint Venture**

During 2001, we entered into a joint venture with JER Senior Housing, LLC, a wholly-owned subsidiary of JER Partners, an institutional investor. The joint venture was established to invest up to \$130,000,000, of which over \$127,000,000 was invested in healthcare facilities similar to those already owned by us. The financial statements of the joint venture were not consolidated with our financial statements and our investment was accounted for using the equity method.

On May 3, 2005, we acquired JER's 75% interest in our joint venture, JER/NHP Senior Housing, LLC, for approximately \$121,000,000. As part of this transaction, we assumed the secured debt the joint venture had in place of approximately \$60,000,000, approximately \$45,000,000 of which represented JER's share, resulting in a payment to JER Senior Housing, LLC of approximately \$75,000,000, net of other costs and fees related to buying out their interest of approximately \$1,000,000. As a result of this acquisition, we now own 100% of the 46 assisted living facilities in 12 states that are leased to Alterra Healthcare Corporation under two cross-defaulted master leases with initial terms expiring in 2020. From the transaction date forward, the operations of JER/NHP Senior Housing, LLC have been consolidated with our other operations.

During the six months ended June 30, 2005, prior to our acquisition of JER's interest, the joint venture sold one facility for cash proceeds of \$3,500,000 resulting in a gain of \$1,320,000 included in discontinued operations of the joint venture.

### **Liquidity and Capital Resources**

#### *Operating Activities*

Cash provided by operating activities increased \$27,657,000, or 57%, over the same period in 2004. This was primarily due to increased income prior to non-cash impairment charges and changes in the balances of operating assets and liabilities. There have been no significant changes in the underlying sources and uses of cash provided by operating activities.

#### *Investing Activities*

During the six months ended June 30, 2005, we acquired 14 skilled nursing facilities and 50 assisted and independent living facilities in seven separate transactions for an aggregate investment of \$204,504,000, including the assumption of \$70,506,000 of mortgage financing. In addition, we exchanged two facilities plus \$1,500,000 for two different facilities owned by American Retirement Corporation. We also funded \$5,245,000 in earnouts, expansions, construction and capital improvements at certain facilities in accordance with existing lease provisions. Such expansions, construction and capital improvements generally result in an increase in the minimum rents earned by us on these facilities. The acquisitions, earnouts, expansions, construction and capital improvements were funded by borrowings on our unsecured revolving credit facility and by cash on hand. At June 30, 2005, we had committed to fund additional expansions, construction and capital improvements of approximately \$20,000,000.

During the six months ended June 30, 2005, we funded one mortgage loan secured by one skilled nursing facility in the amount of \$3,250,000.

*Financing Activities*

During the six-month period ended June 30, 2005, we issued \$250,000,000 of 6.0% fixed rate notes that will mature on May 20, 2015 and bear interest from May 18, 2005 that resulted in net proceeds of approximately \$243,000,000.

As part of the joint venture acquisition, we assumed secured debt of approximately \$60,000,000 with a floating rate equal to LIBOR plus 4.0%, of which approximately \$45,000,000 represented JER's share. This debt

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was subsequently refinanced with a five year term loan at a fixed rate of 5.56%. In addition, we repaid \$18,000,000 of fixed rate medium-term notes that bore interest at a weighted average rate of 8.7%. The repayments were funded by borrowings on our unsecured revolving credit facility and by cash on hand.

We anticipate repaying medium-term notes at maturity with a combination of proceeds from borrowings on our unsecured revolving credit facility and cash on hand; however, there are no medium-term notes currently maturing until November 2006. Borrowings on our unsecured revolving credit facility could be repaid by potential asset sales or mortgage loans receivable payoffs, the potential issuance of debt or equity securities under the shelf registration statements discussed below or cash from operations. Our medium-term notes have been investment grade rated since 1994. Our current credit ratings are Baa3 from Moody's Investors Service, BBB- from Standard & Poor's Ratings Services and BBB- from Fitch Ratings.

During 2003, we adopted a dividend reinvestment and stock purchase plan. This plan enables existing stockholders to purchase additional shares of common stock by automatically reinvesting all or part of the cash dividends paid on their shares of common stock. The plan also allows investors to acquire shares of our common stock, subject to certain limitations, including a maximum monthly investment of \$10,000, at a discount ranging from 0% to 5%, determined by us from time to time in accordance with the plan. The discount at June 30, 2005 is 2%. During the six months ended June 30, 2005, we issued approximately 406,000 shares of common stock resulting in net proceeds of \$8,683,000 that were primarily used to repay borrowings on our unsecured revolving credit facility and for other general corporate purposes.

At June 30, 2005, we had \$304,000,000 available under our \$400,000,000 unsecured revolving credit facility that expires on April 15, 2007.

At June 30, 2005, we had shelf registration statements on file with the Securities and Exchange Commission under which we may issue (a) up to \$66,000,000 in aggregate principal amount of medium-term notes and (b) up to approximately \$246,068,000 of securities including debt, convertible debt, common and preferred stock. In addition, at June 30, 2005, we had approximately 4,087,000 shares available for issuance under our dividend reinvestment and stock purchase plan.

Financing for future investments and for the repayment at or prior to maturity of the obligations and commitments noted above may be provided by borrowings under our unsecured revolving credit facility discussed above, private placements or public offerings of debt or equity either under the shelf registration statements discussed above or under new registration statements, potential asset sales or mortgage loans receivable payoffs, the assumption of secured indebtedness, obtaining mortgage financing on a portion of our owned portfolio or through joint ventures.

We anticipate the possible sale of certain facilities, primarily due to purchase option exercises, and the potential repayment of certain mortgage loans receivable during 2005. In the event that there are facility sales or mortgage loan receivable repayments in excess of new investments, revenues may decrease. We anticipate using the proceeds from any facility sales or mortgage loans receivable repayments to provide capital for future investments, to reduce the outstanding balance on our unsecured revolving credit facility or to repay other borrowings as they mature. Any such reduction in debt levels would result in reduced interest expense that we believe would partially offset any decrease in revenues. We believe the combination of the available balance on our \$400,000,000 unsecured revolving credit facility and the availability under the shelf registration statements provides sufficient liquidity and financing capability to finance anticipated future investments, maintain our current dividend level and repay borrowings at or prior to their maturity, for at least the next 12 months.

## **Off-Balance Sheet Arrangements**

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Subsequent to our acquisition of JER's interest in our joint venture we did not utilize any other off-balance sheet financing arrangements or have any unconsolidated subsidiaries.

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**Statement Regarding Forward-Looking Disclosure**

Certain information contained in this report includes statements that may be deemed to be forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include statements regarding our expectations, beliefs, intentions, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements which are other than statements of historical facts. These statements may be identified, without limitation, by the use of forward looking terminology such as may, will, anticipates, expects, believes, intends, should or comparable terms or the negative thereof. All forward-looking statements included report are based on information available to us on the date hereof. These statements speak only as of the date hereof and we assume no obligation to update such forward-looking statements. These statements involve risks and uncertainties that could cause actual results to differ materially from those described in the statements. These risks and uncertainties include (without limitation) the following:

general distress of the healthcare industry;

the effect of economic and market conditions and changes in interest rates;

access to the capital markets and the cost of capital;

increasing competition adversely impacting the availability, amount and yield of any additional investments;

deterioration of the operating results, occupancy levels or financial condition, including bankruptcies, of our tenants;

lost revenues from purchase option exercises, loan repayments, lease expirations and restructurings;

changes in the ratings of our debt securities;

government regulations, including changes in the reimbursement levels under the Medicare and Medicaid programs;

the ability of our operators to repay deferred rent or loans in future periods;

the ability of our operators to obtain and maintain adequate liability and other insurance;

our ability to attract new operators for certain facilities;

our ability to sell certain facilities for their book value;

changes in or inadvertent violations of tax laws and regulations and other factors that can affect real estate investment trusts and our status as a real estate investment trust; and

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the risk factors set forth under the caption Risk Factors in our annual report on Form 10-K for the year ended December 31, 2004.



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

This market risk exposure discussion is an update of material changes to the Item 7A. Quantitative and Qualitative Disclosures About Market Risk discussion included in our annual report on Form 10-K for the year ended December 31, 2004 and should be read in conjunction with that discussion. Readers are cautioned that many of the statements contained in this Quantitative and Qualitative Disclosures About Market Risk discussion are forward looking and should be read in conjunction with our disclosures under the heading Statement Regarding Forward-Looking Disclosure set forth above.

We are exposed to market risks related to fluctuations in interest rates on our mortgage loans receivable and debt. We do not utilize interest rate swaps, forward or option contracts on foreign currencies or commodities or other types of derivative financial instruments.

We provide mortgage loans to operators of healthcare facilities as part of our normal operations. The majority of the loans have fixed rates. Four of our mortgage loans have adjustable rates; however, the rates adjust only once or twice over the term of the loans and the minimum adjusted rates are equal to the then current rates. Therefore, all mortgage loans receivable are treated as fixed rate notes.

We utilize debt financing primarily for the purpose of making additional investments in healthcare facilities. Historically, we have made short-term borrowings on our variable rate unsecured revolving credit facility to fund our acquisitions until market conditions were appropriate, based on management's judgment, to issue stock or fixed rate debt to provide long-term financing.

During the six months ended June 30, 2005, the borrowings under our unsecured revolving credit facility decreased from \$186,000,000 to \$96,000,000.

For fixed rate debt, changes in interest rates generally affect the fair market value, but do not impact earnings or cash flows. Conversely, for variable rate debt, changes in interest rates generally do not impact fair market value, but do affect the future earnings and cash flows. We generally cannot prepay fixed rate debt prior to maturity. Therefore, interest rate risk and changes in fair market value should not have a significant impact on the fixed rate debt until we would be required to refinance such debt. Holding the variable rate debt balance constant, and including the bank borrowings as variable rate debt due to its nature, each one percentage point increase in interest rates would result in an increase in interest expense for the remaining six months of 2005 of approximately \$597,000.

Decreases in interest rates prior to early 2004 resulted in a decrease in interest expense related to our unsecured revolving credit facility; however, rates have been steadily increasing since the middle of 2004. Any future interest rate increases will increase the cost of borrowings on our unsecured revolving credit facility and any borrowings to refinance long-term debt as it matures or to finance future acquisitions.

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

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial & Portfolio Officer, of the effectiveness of our disclosure controls and procedures. Disclosure controls and procedures are designed to ensure that information required to be disclosed in our periodic reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Based upon that evaluation, our Chief Executive Officer and Chief Financial & Portfolio Officer concluded that our disclosure controls

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and procedures were effective as of the end of the quarterly period covered by this report. No change in our internal control over financial reporting occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

On October 5, 2004, we were served with a complaint for wrongful death in connection with a fire at the Greenwood Healthcare Center on February 26, 2003. At the time of the fire, the Greenwood Healthcare Center was owned by us and leased to and operated by Lexington Healthcare Group. Approximately fourteen additional complaints have been filed by families of patients who were either killed or injured in the fire. The lawsuits seek unspecified monetary damages. The complaints allege that the fire was set by a resident who had previously been diagnosed with depression. The complaints allege theories of negligent operation and premises liability against Lexington Healthcare, as operator, and the Company as owner. Lexington Healthcare has filed for bankruptcy. The matters have been consolidated into one action and are in the early stages of discovery and pleading.

The Company is being defended in the matter by its commercial general liability carrier. The Company believes that it has substantial defenses to the claims and that it has adequate insurance to cover the risks, should liability nonetheless be imposed. However, because the litigation is in the early stages, it is not possible to predict the ultimate outcome of these claims.

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

The Annual Meeting of Stockholders was held on April 27, 2005 ( Annual Meeting ). At the Annual Meeting, R. Bruce Andrews and Charles D. Miller were elected as directors to serve for a three-year term until the 2008 Annual Meeting of Stockholders. The other directors whose term of office continued after the meeting are David R. Banks, William K. Doyle, Douglas M. Pasquale, Robert D. Paulson, Keith P. Russell and Jack D. Samuelson. Also, the proposal to approve the Company's 2005 Performance Stock Plan was approved by the stockholders of the Company.

Voting at the Annual Meeting was as follows:

| Matter  | Votes Cast For | Votes Cast Against | Abstentions and Broker<br>Non-votes |
|---|----------------|--------------------|-------------------------------------|
| Election of R. Bruce Andrews                                      | 63,267,967     | 358,763            |                                     |
| Election of Charles D. Miller                                     | 63,197,675     | 429,055            |                                     |
| Proposal to approve the Company's 2005 Performance Incentive Plan | 44,107,333     | 3,683,244          | 281,508                             |

**Item 6. Exhibits**

Exhibit 31 Rule 13a-14(a)/15d-14(c) Certifications of chief executive officer and principal financial officer.

Exhibit 32 Section 1350 Certifications of chief executive officer and principal financial officer.



