

NATIONAL HEALTH INVESTORS INC  
Form 10-Q  
November 06, 2006

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

**FORM 10-Q**

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

For the quarterly period ended September 30, 2006

Commission file number 001-10822

**NATIONAL HEALTH INVESTORS, INC.**

(Exact name of registrant as specified in its Charter)

Maryland

(State or other jurisdiction

of incorporation or organization)

62-1470956

(I.R.S. Employer Identification No.)

100 Vine Street

Murfreesboro, TN

37130

(Address of principal executive offices)

(Zip Code)

(615) 890-9100

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer.

See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

There were 27,752,239 shares of common stock outstanding as of November 3, 2006.

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

NATIONAL HEALTH INVESTORS, INC.

INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

Sept. 30,

December 31,

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	<u>2006</u>	<u>2005</u>
	(unaudited)	
<b>ASSETS</b>		
Real estate properties:		
Land	\$ 30,078	\$ 31,647
Buildings and improvements	345,270	362,907
Construction in progress	<u>360</u>	<u>359</u>
	375,708	394,913
Less accumulated depreciation	<u>(138,424)</u>	<u>(131,784)</u>
Real estate properties, net	237,284	263,129
Mortgage and other notes receivable, net	112,936	118,800
Investment in preferred stock	38,132	38,132
Cash and cash equivalents	155,231	132,469
Marketable securities	22,487	19,553
Accounts receivable, net	5,282	5,581
Deferred costs and other assets	<u>13,018</u>	<u>10,268</u>
Total Assets	\$584,370	\$587,932
<b>LIABILITIES</b>		
Unsecured public notes	\$100,000	\$100,000
Debt	14,946	17,252
Convertible subordinated debentures	--	201
Accounts payable and other accrued expenses	20,889	26,471
Accrued interest	1,546	3,374
Dividends payable	13,320	12,524
Deferred income	<u>2,968</u>	<u>3,142</u>
Total Liabilities	<u>153,669</u>	<u>162,964</u>
Commitments, Guarantees and Contingencies		
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, \$.01 par value; 40,000,000 shares authorized; 27,749,239 and 27,830,439 shares, respectively, issued and outstanding	278	278
Capital in excess of par value	461,431	464,389
Cumulative net income	658,987	613,208
Cumulative dividends	(704,751)	(664,729)
Unrealized gains on marketable securities, net	<u>14,756</u>	<u>11,822</u>
Total Stockholders' Equity	<u>430,701</u>	<u>424,968</u>
Total Liabilities and Stockholders' Equity	\$584,370	\$587,932

The accompanying notes to interim condensed consolidated financial statements are an integral part of these financial statements. The condensed balance sheet at December 31, 2005 is taken from the audited financial statements at that date.

NATIONAL HEALTH INVESTORS, INC.  
INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

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Three Months Ended  
September 30  
2006

2005

2006

2005

REVENUES:

(in thousands, except share amounts)

Mortgage interest income\$ 3,380\$ 6,710\$ 11,246\$ 14,541 Rental income11,37710,85234,56433,018 Facility operating revenue22,45421,296 65,950  
63,49337,21138,858111,760111,052EXPENSES: Interest2,0342,1016,1046,500 Depreciation2,9283,0398,7929,072 Amortization of loan costs3434101140 Legal expense16645392367 Franchise, excise and other taxes53102187387 General and administrative1,1591,0343,4763,205 Loan and realty impairment losses--2,852--11,402 Facility operating expense20,62819,74661,60159,34027,00228,95380,65390,413INCOME BEFORE NON-OPERATING INCOME10,2099,90531,10720,639 Non-operating income (investments and other) 3,170 2,287 8,39419,831INCOME FROM CONTINUING OPERATIONS13,37912,19239,50140,470Discontinued Operations Operating income from discontinued operations--323464906 Net gain on sale of real estate -- 25 5,814 773 -- 348 6,278 1,679NET INCOME\$13,379\$12,540\$45,779\$42,149Earnings per share: Basic: Income from continuing operations\$ .48\$ .44\$ 1.42\$ 1.46 Discontinued operations -- .01 .23 .06 Net income\$ .48\$ .45\$ 1.65\$ 1.52 Diluted: Income from continuing operations\$ .48\$ .44\$ 1.42\$ 1.46 Discontinued operations -- .01 .23 .06 Net income\$ .48\$ .45\$ 1.65\$ 1.52WEIGHTED AVERAGE COMMON SHARES OUTSTANDING: Basic27,699,23927,741,42427,760,24727,676,367 Diluted27,723,57027,860,17727,778,98327,829,214

The accompanying notes to interim condensed consolidated financial statements are an integral part of these financial statements.

NATIONAL HEALTH INVESTORS, INC.

INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended	
	<u>September 30</u>	
	<u>2006</u>	<u>2005</u>
	(in thousands)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 45,779	\$ 42,149
Depreciation	8,972	9,573
Loan and realty impairment losses	--	8,550
Net gain on sale of real estate	(5,814)	(2,646)
Amortization of loan costs	101	140
Realized gain and recovery on sale of marketable securities	--	(9,072)
Deferred income	--	109
Amortization of deferred income	(174)	(197)
Share based compensation	214	--
Decrease (increase) in accounts receivable	299	(465)
Increase in deferred costs and other assets	(2,852)	(2,585)
Increase (decrease) in accounts payable and other accrued expenses	(5,581)	5,997

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Decrease in accrued interest payable	<u>(1,828)</u>	<u>(1,830)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>39,116</u>	<u>49,723</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment in mortgage and other notes receivable	(10,928)	(22,022)
Collection of mortgage and other notes receivable	5,244	8,635
Prepayment of mortgage notes receivable	11,548	--
Acquisition of property and equipment	(1,527)	(11,772)
Proceeds from disposition of property and equipment	24,214	14,452
Sale of marketable securities	=	<u>10,308</u>
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	<u>28,551</u>	<u>(399)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments on debt	(2,306)	(35,987)
Redemption of subordinated convertible debentures	(201)	--
Stock options exercised	357	2,130
Repurchase of common stock	(3,529)	--
Dividends paid to stockholders	<u>(39,226)</u>	<u>(40,767)</u>
NET CASH USED IN FINANCING ACTIVITIES	<u>(44,905)</u>	<u>(74,624)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	22,762	(25,300)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	<u>132,469</u>	<u>161,215</u>
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$155,231	\$135,915

(continued)

NATIONAL HEALTH INVESTORS, INC.

INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Nine Months Ended	
	<u>September 30</u>	
	<u>2006</u>	<u>2005</u>
	<i>(in thousands)</i>	
Supplemental Information:		
Cash payments for interest expense	\$ 7,351	\$ 7,416
During the nine months ended September 30, 2005, \$534,000 of Senior Subordinated Convertible Debentures were converted into 76,278 shares of NHI's common stock:		
Senior subordinated convertible debentures	--	\$ (534)
Accrued interest	--	(3)
Common stock	--	1
Capital in excess of par value	--	536

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The accompanying notes to interim condensed consolidated financial statements are an integral part of these financial statements.

NATIONAL HEALTH INVESTORS, INC.  
 INTERIM CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
 FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005  
*(in thousands, except share amounts)*

	<u>Common Stock</u>		Capital in	Cumulative	Cumulative	Unrealized	Total
	<u>Shares</u>	<u>Amount</u>	Excess of <u>Par Value</u>	<u>Net Income</u>	<u>Dividends</u>	(Losses) on <u>Securities</u>	Stock- <u>holders' Equity</u>
BALANCE AT 12/31/05	27,830,439	\$278	\$464,389	\$613,208	\$(664,729)	\$11,822	\$424,968
Net income	--	--	--	45,779	--	--	45,779
Unrealized gains on securities	--	--	--	--	--	2,934	<u>2,934</u>
Total Comprehensive Income							<u>48,713</u>
Stock options exercised	15,000	--	357	--	--	--	357
Shares repurchased	(146,200)	(1)	(3,528)	--	--	--	(3,529)
Restricted stock issued	50,000	1	(1)	--	--	--	--
Share based compensation	--	--	214	--	--	--	214
Dividends to common stockholders	=	=	=	=	(40,022)	=	(40,022)
BALANCE AT 9/30/06	27,749,239	\$278	\$461,431	\$658,987	\$(704,751)	\$14,756	\$430,701
BALANCE AT 12/31/04	27,545,018	\$275	\$461,119	\$558,800	\$(614,785)	\$20,130	\$425,539
Net income	--	--	--	42,149	--	--	42,149
Unrealized losses on securities	--	--	--	--	--	(7,975)	<u>(7,975)</u>
Total Comprehensive Income							<u>34,174</u>
Stock options exercised	139,729	2	2,128	--	--	--	2,130
Shares issued in conversion of convertible debentures to common stock	76,278	1	536	--	--	--	537
Dividends to common stockholders	=	=	=	=	(37,421)	=	(37,421)
BALANCE AT 9/30/05	27,761,025	\$278	\$463,783	\$600,949	\$(652,206)	\$12,155	\$424,959

The accompanying notes to interim condensed consolidated financial statements are an integral part of these financial statements.

**Note 1. SIGNIFICANT ACCOUNTING POLICIES:**

We, the management of National Health Investors, Inc., believe that the unaudited condensed consolidated financial statements to which these notes are attached include all normal, recurring adjustments which are necessary to fairly present the financial position, results of operations and cash flows of National Health Investors, Inc. ("NHI" or the "Company") in all material respects. We assume that users of these interim financial statements have read or have access to the audited December 31, 2005 consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnotes and other disclosures which would substantially duplicate the disclosure contained in our most recent annual report to stockholders on Form 10-K for the year ended December 31, 2005 have been omitted. This interim consolidated financial information is not necessarily indicative of the results that may be expected for a full year for a

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variety of reasons including, but not limited to, acquisitions and dispositions, changes in interest rates, rents and the timing of debt and equity financings. Our audited December 31, 2005 financial statements are available at our web site: [www.nhinvestors.com](http://www.nhinvestors.com).

### **Note 2. NEW ACCOUNTING PRONOUNCEMENTS:**

In December 2004, the FASB has issued FASB Statement No. 123 (Revised 2004), *Share-Based Payment* ("Statement 123R"). The new FASB rule requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost is measured based on the fair value of the equity or liability instruments issued. The Company adopted Statement 123R beginning January 1, 2006. The scope of Statement 123R includes a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The adoption of Statement 123R has not had a significant impact on our condensed consolidated financial statements other than the recording of compensation charges for option holders and restricted shares.

In May 2005, the FASB issued FASB Statement No. 154, *Accounting for Changes and Error Corrections* ("Statement 154"). This new standard replaces APB Opinion No. 20, *Accounting Changes* and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. Statement 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. Statement 154 also provides that (1) a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a "restatement". The new standard is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. The adoption of this pronouncement has not had an impact on the Company's financial statements.

In February 2006, the FASB issued FAS No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment to FASB Statements No. 133 and 140" (FAS 155). FAS 155 simplifies the accounting for certain hybrid financial instruments containing embedded derivatives. FAS 155 allows fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation under FAS 133. In addition, it amends FAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The Company will adopt the provisions of FAS 155 beginning in fiscal 2007. The implementation of FAS 155 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140." This Statement amends FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement clarifies when servicing rights should be separately accounted for, requires companies to account for separately recognized servicing rights initially at fair value, and gives companies the option of subsequently accounting for those servicing rights at either fair value or under the amortization method. SFAS 156 is effective for fiscal years beginning after September 15, 2006. The implementation of FAS 156 is not expected to have a material impact on the Company's consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109." FIN 48 prescribes a recognition threshold and measurement attribute for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 will require that the financial statements reflect expected future tax consequences of such positions presuming the taxing authorities' full knowledge of the position and all relevant facts, but without considering time values. FIN 48 is effective for annual periods beginning after December 15, 2006. We are currently evaluating the impact of adopting FIN 48 on our consolidated financial statements. Upon adoption, the cumulative effect of applying the provision of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year.

### **Note 3. SHARE-BASED COMPENSATION**

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" ("SFAS 123(R)"), using the modified prospective application transition method. Under this method, compensation cost is recognized, beginning January 1, 2006, based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date, and based on Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), for all awards granted to employees prior to January 1, 2006 that remain unvested on the effective date. Prior to January 1, 2006, we applied Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations in accounting for our employee stock benefit plans. Accordingly, no compensation cost was recognized for stock options granted under the plans because the exercise prices for options granted were equal to the quoted market prices on the option grant dates and all option grants were to employees or directors. Results for prior periods have not been restated.

#### Share Based Compensation Plans

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The Compensation Committee of the Board of Directors ("the Committee") has the authority to select the participants to be granted options; to designate whether the option granted is an incentive stock option ("ISO"), a non-qualified option, or a stock appreciation right; to establish the number of shares of common stock that may be issued upon exercise of the option; to establish the vesting provision for any award; and to establish the term any award may be outstanding. The exercise price of any ISO's granted will not be less than 100% of the fair market value of the shares of common stock on the date granted and the term of an ISO may not be any more than ten years. The exercise price of any non-qualified options granted will not be less than 100% of the fair market value of the shares of common stock on the date granted unless so determined by the Committee.

In May 2005, our shareholders approved the 2005 Stock Option, Restricted Stock and Stock Appreciation Rights Plan ("the 2005 Plan") pursuant to which 1,500,000 shares of our common stock are available to grant as share-based payments to employees, officers, directors or consultants. Options for 86,000 shares and Restricted Stock for 53,000 shares have been granted under the 2005 Plan during the nine months ended September 30, 2006, leaving 1,361,000 shares available for future grants. The restricted stock granted vests over five years and the options granted vest over three to five years. The term of the options outstanding under the 2005 Plan is five years.

The NHI 1997 Stock Option Plan ("the 1997 Plan") provides for the granting of options to key employees and directors of NHI to purchase shares of common stock at a price no less than the market value of the stock on the date the option is granted. Options for 60,000 shares have been granted under the 1997 Plan during the nine months ended September 30, 2006, leaving 57,800 shares available for future grants. Options to purchase 180,000 shares are currently outstanding to the Board of Directors under the 1997 Stock Option Plan. All of the currently outstanding options under the 1997 stock option plan vested immediately upon grant and may be exercised at any time prior to expiration. The term of the options outstanding under the 1997 stock option plan is five years.

The compensation expense reported for share-based compensation related to the 2005 Plan and the 1997 Plan totaled \$214,000 for the nine months ended September 30, 2006, consisting of \$61,000 for restricted stock and \$153,000 for stock options which is included in general and administrative expense in the condensed consolidated statements of income.

### Determining Fair Value Under SFAS No. 123(R)

The fair value of each option award was estimated on the grant date, using the Black-Scholes option valuation model with the weighted average assumptions indicated in the following table. Generally, awards are subject to cliff vesting. Each grant is valued as a single award with an expected term based upon expected employee and termination behavior. Compensation cost is recognized on the straight-line attribution method. The straight-line attribution method requires that compensation expense is recognized at least equal to the portion of the grant-date fair value that is vested at that date. The expected volatility is derived using daily historical data for periods preceding the date of grant. The risk-free interest rate is the approximate yield on the United States Treasury Strips having a life equal to the expected option life on the date of grant. The expected life is an estimate of the number of year an option will be held before it is exercised.

The weighted average fair value per share of options granted was \$1.95 and \$2.51 for 2006 and 2005, respectively. For purposes of pro forma disclosures of net income and earnings per share as required by SFAS 123, as amended, the estimated fair value of the options is amortized to expense over the requisite service period. The fair value of each grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2006 and 2005:

	Nine Months Ended	
	<u>September 30,</u>	
	<u>2006</u>	<u>2005</u>
Dividend yield	8.71%	8.80%
Expected volatility	22.93%	21.69%
Expected lives	2.7 years	5 years
Risk-free interest rate	4.83%	3.81%
Expected forfeiture rate	0.00%	0.00%

### Stock Option Activity

The following table summarizes option activity:

Number <u>of Shares</u>	Weighted Average <u>Exercise Price</u>	Weighted Average Remaining <u>Contractual Life (Years)</u>	Aggregate <u>Intrinsic Value</u>
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(in thousands)

Outstanding December 31, 2005	135,000	\$23.502		
Options granted under 2005 Plan	86,000	25.318		
Options granted under 1997 Plan	60,000	23.790		
Options exercised under 1997 Plan	<u>(15,000)</u>	23.790		
Outstanding September 30, 2006	266,000	24.138	3.684	\$1,115
Exercisable September 30, 2006	180,000	23.574	3.278	857

Grant Date	Options Outstanding	Exercise Price	Remaining Contractual Life in Years
4/24/03	30,000	\$16.35	1.583
4/20/04	45,000	23.90	2.583
5/3/05	60,000	26.78	3.667
3/9/06	50,000	26.10	4.417
5/1/06	11,000	23.62	4.583
5/2/06	45,000	23.79	4.583
7/21/06	<u>25,000</u>	24.50	4.750
	266,000		

The weighted average remaining contractual life of all options outstanding at September 30, 2006 is 3.684 years. NHI's Board of Directors has authorized an additional 1,684,800 shares of common stock that may be issued under the share-based payments plans.

Options exercised during the nine months ended September 30, 2006 included 15,000 shares at a weighted average exercise price of \$23.79, a quoted market price of the stock of \$26.32 on the exercise date and an intrinsic value of \$2.53 per share. The closing market price of our common stock at September 30, 2006 was \$28.33 per share. The intrinsic value of total options outstanding at September 30, 2006 was \$4.19 per share. The intrinsic value of options exercisable at September 30, 2006 was \$4.76 per share.

The weighted average fair values of stock options granted during the nine months ended September 30, 2006 and 2005 were \$1.95 and \$2.51 per share, respectively. At September 30, 2006, we had unvested options to purchase 86,000 shares with a weighted average grant date fair value of \$1.53 per share. As of September 30, 2006, we had \$132,000 of total unrecognized compensation cost related to unvested options, net of expected forfeitures, which is expected to be recognized over the following periods:

(in thousands)

2006	\$ 21
2007	60
2008	36
2009	11
2010	3
2011	<u>1</u>
	\$132

At September 30, 2006, we had \$1,244,000 of total unrecognized compensation cost related to unvested restricted stock issued which is expected to be recognized over the following periods:

(in thousands)



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2006	\$ 26
2007	104
2008	104
2009	104
2010	757
2011	<u>149</u>
	\$1,244

Prior Period Pro Forma Presentations

Prior to 2006, our share-based compensation plan was accounted for using the intrinsic value method prescribed in APB No. 25 and related Interpretations. No share-based compensation was reflected in net income in the three month and nine month periods ended September 30, 2005, as all stock options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. Had compensation cost for the plan been determined based on the fair value at the grant dates for awards under the plan consistent with the method of SFAS No. 123R, our net income and basic and diluted net income per share would have been changed to the pro forma amounts indicated below.

	Three Months Ended <u>9/30/05</u>	Nine Months Ended <u>9/30/05</u>
<i>(dollars in thousands, except per share amounts)</i>		
Net income - as reported	\$12,540	\$42,149
Less compensation cost that would be recognized under fair value method	<u>1</u>	<u>153</u>
Net income - pro forma	\$12,539	\$41,996
Net earnings per share - as reported		
Basic	\$ .45	\$ 1.52
Diluted	\$ .45	\$ 1.52
Net earnings per share - pro forma		
Basic	\$ .45	\$ 1.51
Diluted	\$ .45	\$ 1.51

**Note 4. REAL ESTATE PROPERTIES:**

The following table summarizes NHI's real estate properties by facilities that we lease to others and facilities that are operated by others:

*(Dollars in thousands)*

	<u>September 30, 2006</u>			<u>December 31, 2005</u>		
	<u>Leased</u>	<u>Operating</u>	<u>Total</u>	<u>Leased</u>	<u>Operating</u>	<u>Total</u>
Land	\$ 26,502	\$ 3,576	\$ 30,078	\$ 27,598	\$ 4,049	\$ 31,647
Buildings and improvements	283,638	61,632	345,270	295,416	67,491	362,907
Construction in progress	<u>123</u>	<u>237</u>	<u>360</u>	=	<u>359</u>	<u>359</u>
	310,263	65,445	375,708	323,014	71,899	394,913
Less accumulated depreciation	<u>(111,664)</u>	<u>(26,760)</u>	<u>(138,424)</u>	<u>(106,398)</u>	<u>(25,386)</u>	<u>(131,784)</u>
Real estate properties, net	\$198,599	\$ 38,685	\$237,284	\$216,616	\$ 46,513	\$ 263,129

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### Foreclosure Properties

*New England Properties* - During 1999, we took over the operations of seven New England facilities. During 2001, we sold the properties to a not-for-profit entity and provided 100% financing consisting of 6.9% first mortgage proceeds totaling \$40,526,000, maturing August, 2011. For financial reporting purposes, we have not recorded the sale of the assets and continue to record the results of operations of these properties each period. For tax reporting purposes, the sale has been recorded with gain on sale to be recorded under the installment method as cash payments are received. For financial reporting purposes, sale proceeds received from the buyer will be reported as a deposit until the down payment and continuing investment criteria of Statement of Financial Accounting Standards No. 66, "Accounting for Sales of Real Estate" ("SFAS 66") are met, at which time we will report the sale under the full accrual method. Management believes that the carrying amount of these real estate properties at September 30, 2006 of \$24,735,000 is recoverable.

Amounts included in the condensed consolidated financial statements applicable to the New England facilities are summarized as follows: (*in thousands*)

	Nine Months Ended	
	September 30	
<b>Income Statement:</b>	<u>2006</u>	<u>2005</u>
Facility operating revenue	\$41,688	\$40,001
Facility operating expenses	38,182	36,604
Interest expense	7	6
Depreciation	1,960	1,864
Total Expenses	40,149	38,474
Net income	\$ 1,539	\$ 1,527
<b>Balance Sheet:</b>	<u>Sept. 30,</u>	<u>Dec. 31,</u>
	<u>2006</u>	<u>2005</u>
Real estate properties, net	\$24,735	\$25,969
Cash	2,730	3,045
Accounts receivable	3,662	3,241
Other assets	11,074	9,157
Accounts payable and other accrued expenses	6,618	6,689

The operating results of these properties and the asset or liability generated from the cumulative net income (loss) have been considered in our assessment that the carrying amount of these properties at September 30, 2006 is recoverable. The asset or liability generated from the cumulative net income (loss) associated with these properties will be recognized, along with the deferred gain, as a gain or a loss at the time the sale is recorded. Our continuing involvement with these properties is as a creditor.

*Kansas and Missouri Properties* - In July 2001 we took over the operations of nine nursing homes in Kansas and Missouri and have included the operating results of these facilities in our condensed consolidated financial statements since that date. During 2004, we sold the properties to a not-for-profit entity for \$33,585,000 and provided 100% financing. Proceeds consisted of an 8.5% note for \$20,585,000 maturing December 31, 2014, and a note for \$13,000,000 with interest at 3% through December 31, 2007 and at prime plus 1% thereafter, maturing December 31, 2014. For financial reporting purposes, we have not recorded the sale of the assets and continue to record the results of operations of these properties each period. For tax purposes, the sale has been recorded as an installment sale. For financial reporting purposes, sale proceeds received from the buyer will be reported as a deposit until the down payment and continuing investment criteria of SFAS 66 are met, at which time we will account for the sale under the full accrual method.

During the nine months ended September 30, 2006, we received \$5,482,000 in cash from the sale by the not-for-profit entity of the nursing facility in Town & Country, Missouri. The carrying amount of this facility was \$5,358,000 composed of net realty of \$6,520,000, reduced by net liabilities of \$1,162,000. This property was sold in December 2004 to a not-for-profit entity and we provided 100% financing. As a result of having received final proceeds related to this facility, we have recognized the December 2004 sale of this property and recognized a \$124,000 gain in the first quarter of 2006.

Management believes that the carrying amount of the remaining Kansas and Missouri properties at September 30, 2006 of \$13,950,000 is recoverable.

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Amounts included in the condensed consolidated financial statements applicable to the Kansas and Missouri facilities are summarized as follows: *(in thousands)*

	Nine Months Ended	
	September 30	
<b>Income Statement:</b>	<u>2006</u>	<u>2005</u>
Facility operating revenue	\$24,263	\$23,493
Facility operating expenses	23,421	22,735
Interest (income) expense	(5)	245
Depreciation	<u>558</u>	<u>625</u>
Total expenses	<u>23,974</u>	<u>23,605</u>
Net income (loss)	\$ 289	\$ (112)
<b>Balance Sheet:</b>	<u>Sept. 30,</u>	<u>Dec. 31,</u>
	<u>2006</u>	<u>2005</u>
Real estate properties, net	\$13,950	\$20,544
Cash	4,366	3,422
Accounts receivable	2,041	2,946
Other assets	576	492
Accounts payable and other accrued expenses	8,343	9,579

The operating results of these properties and the asset or liability generated from the cumulative net income (loss) have been considered in our assessment that the carrying amount of these properties at September 30, 2006 is recoverable. The asset or liability generated from the cumulative net income (loss) associated with these properties will be recognized, along with the deferred gain, as a gain or a loss at the time the sale is recorded. Our continuing involvement with these properties is as a creditor.

*Midwest Nursing Home Investors, Inc. ("Midwest")* - An \$8,735,000 first mortgage loan was secured by two nursing homes in Kansas and one in Wisconsin. Management's analysis of the future expected cash flows consistent with SFAS 114, historical occupancy and operating income of the project resulted in the recording of a \$2,000,000 writedown of this mortgage loan value during 2002 and an additional writedown of \$2,000,000 during 2003. Payments to NHI were past due and the properties were foreclosed on in October 2004, resulting in our recording of real estate with a carrying value of \$4,324,000. The remaining carrying value of \$4,025,000 at September 30, 2006, is believed by management to be recoverable. The average recorded investment in these properties was \$4,075,000 and \$4,242,000 for the nine months ended September 30, 2006 and 2005, respectively. Rental income of \$391,000 and \$370,000 was recognized on the Midwest Kansas properties for the nine months ended September 30, 2006 and 2005, respectively. Lease Terminations and Sales of Property

*Regal and Royal Healthgate* - In May 2006, two New Jersey nursing facilities were sold generating net cash proceeds of \$17,570,000 and a gain of \$5,690,000 which is included in discontinued operations.

*Manor House of Charlotte* - In January 2005, this facility was sold generating net proceeds of \$3,571,000, and a gain of \$1,624,000, which is included in discontinued operations as well as the operating results of this facility for all periods presented.

*Marriott Senior Living Services* - In July 2003, we reached an agreement with Marriott Senior Living Services ("Marriott") to terminate their leases with us on four assisted living facilities, two of which are located in Florida, one in Texas and one in New Jersey. The four facilities were leased to new operators.

Based on our impairment analysis, as a result of further defaults of covenants in the facility leases and continued deferred maintenance of the facilities, we recorded an impairment of \$2,550,000 during the first quarter of 2005 on the two Florida facilities. Further maintenance analysis resulted in the recording of an additional \$2,852,000 of accrued maintenance expense in the third quarter of 2005 on the two Florida facilities attributable to mold remediation. We had previously recorded an impairment of \$5,400,000 during the third quarter of 2003 on one of the Florida facilities.

Lease income of \$1,131,000 and \$1,256,000 was recognized on these four facilities for the nine months ended September 30, 2006 and 2005, respectively. In February 2005, the facility in Dallas, Texas was sold for cash proceeds of \$7,911,000 and a loss of \$851,000, which is included in discontinued operations as well as the operating results of this facility for all periods presented. We believe that the carrying amount of these remaining three properties at September 30, 2006 of \$24,624,000 is recoverable.

**Note 5. MORTGAGE AND OTHER NOTES RECEIVABLE:**

*American Medical Associates, Inc. ("AMA")* - On May 1, 2004, NHI financed the purchase of three Florida-based nursing homes formerly owned by American Medical Associates, Inc. and previously financed by NHI. The amount of the new mortgage loans total \$14,500,000 and the notes mature May 14, 2009.

Management's analysis of the future expected cash flows consistent with SFAS 114, historical occupancy and operating income of the project resulted in the recording of a \$2,000,000 writedown of these mortgage loans in the second quarter of 2005. The notes were recorded net of the \$5,200,000 recorded loss on notes to AMA in 2002. Management believes that the remaining carrying amount of \$5,723,000 at September 30, 2006 is realizable. The average recorded investment in the loans was \$5,827,000, and \$7,106,000 for the nine months ended September 30, 2006 and 2005, respectively. The related amount of interest income recognized on the loans was \$1,201,000, and \$806,000 for the nine months ended September 30, 2006 and 2005, respectively.

Subsequent to the balance sheet date, on October 2, 2006, the borrower who replaced American Medical Associates, Inc. in May 2004 prepaid the mortgage loans on two of the three facilities. As a result, we received \$8,116,000, representing the full principal balances on the notes in cash resulting in a gain of \$5,950,000 which will be recognized in the fourth quarter of 2006. The remaining property located in Ocoee, Florida has a principal balance of \$5,736,000 and has a carrying amount of \$3,557,000 at September 30, 2006.

*Miracle Hill Nursing and Convalescent Center ("Miracle Hill")* - In September 1996, NHI provided financing to Miracle Hill. Management's analysis of the future expected cash flows consistent with SFAS 114, past, current and anticipated operating income of the project and liquidity of the facility, resulted in the recording of a \$2,000,000 writedown of this mortgage loan in the second quarter of 2005. Management believes that the remaining carrying amount of \$2,577,000 at September 30, 2006 is supported by the value of the underlying collateral. The average recorded investment in the Miracle Hill loan was \$2,646,000, and \$3,824,000 for the nine months ended September 30, 2006 and 2005, respectively. The related amount of interest income recognized (representing cash received) on the loan was \$371,000, and \$381,000 for the nine months ended September 30, 2006 and 2005, respectively.

*Allgood HealthCare, Inc. ("Allgood")* - We had two loans secured by five Georgia nursing home properties that were operated by Allgood. In January 2003, the borrowers filed for bankruptcy protection. We reported a \$2,000,000 writedown of this mortgage loan in the first quarter of 2005 to adjust the loan to its estimated net realizable value. Estate proceeds of \$1,247,000 received in August 2006 were applied to the loan.

In December 2005, two of these facilities were sold by the Bankruptcy Trustee pursuant to a plan of liquidation. Prior to the sale, NHI assigned its right to credit bid its mortgages to a third party operator who was the successful purchaser of these facilities. NHI provided the purchaser with \$4,000,000 of first mortgage financing and agreed to loan up to a total of \$800,000 of working capital. NHI had a first lien on all assets of the borrowers, including accounts receivable.

Effective July 1, 2006, two of the remaining three properties were sold to affiliates of the purchaser of the first two properties. NHI provided the purchaser with long-term first mortgage financing totaling \$12,162,000 secured by all four facilities. The Note bears interest at 9% and matures July 1, 2016. The \$800,000 commitment to loan working capital remains in place (working capital balance is \$122,000 at September 30, 2006) and can be used by any of the four facilities. The carrying amount of this note is \$9,921,000 at September 30, 2006, which management believes is supported by the value of the collateral.

On July 1, 2006, the remaining property was sold to a third party operator by the Bankruptcy Trustee with NHI consenting to such sale. NHI provided the purchaser with short-term first mortgage financing totaling \$5,692,000. The note bears interest at 9% and matures December 31, 2006. The carrying amount of this note is \$3,618,000 at September 30, 2006, which management believes is supported by the value of the collateral.

*National Health Realty, Inc.* - We purchased by assignment on February 3, 2006, a \$10,450,000 bank term loan, owed by National Health Realty, Inc. The assigned loan as amended requires monthly interest payments at the interest rate of 30 days LIBOR plus 1.00% (6.33% at September 30, 2006). Principal of \$1,275,000 was paid during the nine months. The unpaid principal (\$9,175,000 at September 30, 2006) is due at maturity (January 2, 2008).

**Note 6. INVESTMENTS IN MARKETABLE SECURITIES**

Our investments in marketable securities include available for sale securities. Unrealized gains and losses on available for sale securities are recorded in stockholders' equity in accordance with SFAS 115 "Accounting for Certain Investments in Debt and Equity Securities". Realized gains and losses from securities sales are determined based upon specific identification of the securities.

Marketable securities consist of the following:

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(in thousands)

	<u>9/30/06</u>		<u>12/31/05</u>	
	<u>Cost</u>	Fair <u>Value</u>	<u>Cost</u>	Fair <u>Value</u>
Available for sale	\$7,731	\$22,487	\$7,731	\$19,553

Gross unrealized gains and gross unrealized losses related to available for sale securities are as follows:

(in thousands)	<u>9/30/06</u>	<u>12/31/05</u>
Gross unrealized gains	\$14,853	\$11,941
Gross unrealized losses	<u>(97)</u>	<u>(119)</u>
	\$14,756	\$11,822

Our available for sale marketable securities consist of the common stock of other publicly traded REITs. None of these available for sale marketable securities have stated maturity dates.

During the nine months ended September 30, 2006 and 2005, we received and recognized \$3,459,000 and \$3,371,000, respectively, of dividend income from our marketable securities. Such income is included in non-operating income in the condensed consolidated statements of income.

Proceeds from the sale of investments in available for sale securities during the nine months ended September 30, 2005 were \$10,308,000. Gross investment gains of \$9,072,000 were realized on these sales during the nine months ended September 30, 2005 which is included in non-operating income in the consolidated statements of income described as \$5,022,000 of security recoveries and \$4,050,000 of realized gains.

**Note 7. DEBT**

Because of the maturity in one year of the \$100,000 million 7.3% unsecured public notes on July 16, 2007, we received a waiver in the covenants related to this debt with the understanding that we will maintain at least \$100 million of cash and marketable securities until the debt is paid.

Early payoff of debt in January 2005 included a non-recourse mortgage bank note of \$25,637,000 with a weighted average interest rate of 6.0% that was to mature in 2007, and first mortgage notes totaling \$8,224,000 with a weighted average interest rate of 5.0% and that were to mature in 2006 and 2021.

**Note 8. COMMITMENTS, GUARANTEES AND CONTINGENCIES:**

At September 30, 2006, we were committed, subject to due diligence and financial performance goals, to fund approximately \$1,674,000 in health care real estate projects, all of which are expected to be funded within the next 12 months. The commitments include additional mortgage investments for three long-term health care centers and one assisted living facility, all at an interest rate of prime plus 2.0%.

As described in Note 5 for Allgood HealthCare, Inc., two of the previous Allgood properties were purchased by new operators using NHI financing. As a part of these transactions, NHI agreed to contingently guarantee up to \$113,000 of Utility Deposit Bonds and Resident Trust Fund Bonds.

We believe that we have operated our business so as to qualify as a REIT under Section 856 through 860 of the Internal Revenue Code of 1986, as amended (the "Code") and we intend to continue to operate in such a manner, but no assurance can be given that we will be able to qualify at all times. If we qualify as a REIT, we will generally not be subject to federal corporate income taxes on our net income that is currently distributed to our stockholders. This treatment substantially eliminates the "double taxation" (at the corporate and stockholder levels) that typically applies to corporate dividends. Our failure to continue to qualify under the applicable REIT qualification rules and regulations would cause us to owe state and federal income taxes and would have a material adverse impact on our financial position, results of operations and cash flows.

**Note 9. EARNINGS PER COMMON SHARE:**

Basic earnings per share is based on the weighted average number of common shares outstanding during the reporting period.

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Diluted earnings per share assumes, if dilutive, the conversion of convertible subordinated debentures (fully retired in 2006) and the exercise of stock options using the treasury stock method. Net income is increased for interest expense on the convertible subordinated debentures, if dilutive.

The following table summarizes the average number of common shares and the net income used in the calculation of basic and diluted earnings per share.

	Three Months Ended		Nine Months Ended	
	<u>September 30</u>		<u>September 30</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
<b>BASIC:</b>				
Weighted average common shares	27,699,239	27,741,424	27,760,247	27,676,367
Income from continuing operations	\$13,379,000	\$12,192,000	\$39,501,000	\$40,470,000
Discontinued operations	=	<u>348,000</u>	<u>6,278,000</u>	<u>1,679,000</u>
Net income	\$13,379,000	\$12,540,000	\$45,779,000	\$42,149,000
Income from continuing operations per common share	\$ .48	\$ .44	\$ 1.42	\$ 1.46
Discontinued operations per common share	=	<u>.01</u>	<u>.23</u>	<u>.06</u>
Net income per common share	\$ .48	\$ .45	\$ 1.65	\$ 1.52
<b>DILUTED:</b>				
Weighted average common shares	27,699,239	27,741,424	27,760,247	27,676,367
Stock options	21,360	32,327	17,746	33,827
Restricted shares	2,971	--	990	--
Convertible subordinated debentures	=	<u>86,426</u>	=	<u>119,020</u>
Average common shares outstanding	27,723,570	27,860,177	27,778,983	27,829,214
Income from continuing operations	\$13,379,000	\$12,192,000	\$39,501,000	\$40,470,000
Interest on convertible subordinated debentures	=	<u>17,000</u>	=	<u>66,000</u>
Income from continuing operations	13,379,000	12,209,000	39,501,000	40,536,000
Discontinued operations	=	<u>348,000</u>	<u>6,278,000</u>	<u>1,679,000</u>
Net income assuming conversion of convertible subordinated debentures to common stock, if dilutive	\$13,379,000	\$12,557,000	\$45,779,000	\$42,215,000
Income from continuing operations per common share	\$ .48	\$ .44	\$ 1.42	\$ 1.46
Discontinued operations per common share	=	<u>.01</u>	<u>.23</u>	<u>.06</u>
Net income per common share	\$ .48	\$ .45	\$ 1.65	\$ 1.52
<b>Incremental Shares Excluded Since Anti-dilutive:</b>				
Options	110,000	--	135,000	--

In accordance with Statement of Financial Accounting Standards No. 128, "Earnings per Share", the above incremental shares were excluded from the computation of diluted earnings per share, since inclusion of these incremental shares in the calculation would have been anti-dilutive.

### **Note 10. NON-OPERATING INCOME**

Non-operating income is outlined in the table below:

	Three Months		Nine Months	
	Ended		Ended	
	<u>September 30</u>		<u>September 30</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
<i>(in thousands)</i>				
Dividends	\$1,156	\$1,132	\$3,459	\$ 3,371

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Equity in losses - investees	--	--	(26)	--
Recovery of securities	--	--	--	5,022
Realized gains on securities	--	--	--	4,050
Interest income	1,945	1,051	4,788	2,664
Gain on disposal of assets	--	--	--	1,871
Insurance proceeds	--	--	--	2,654
Other	<u>69</u>	<u>104</u>	<u>173</u>	<u>199</u>
	\$3,170	\$2,287	\$8,394	\$19,831

**Note 11. DISCONTINUED OPERATIONS**

In May 2006, two New Jersey nursing facilities were sold generating net cash proceeds of \$17,570,000 and a gain of \$5,690,000 which is included in discontinued operations.

In March 2006, we received \$5,482,000 from the sale by the current owner of a nursing facility in Town & Country, Missouri. The carrying amount of this facility was \$5,358,000 composed of net realty of \$6,520,000, reduced by net liabilities of \$1,162,000. This property was sold in December 2004 to a not-for-profit entity and we provided 100% financing. As a result of having received final proceeds related to this facility, we have recognized the December 2004 sale of this property and recognized a \$124,000 gain.

During the nine months ended September 30, 2005, we sold two assisted living facilities with carrying amounts totaling \$10,709,000 for proceeds of \$11,482,000. We recognized a gain of \$773,000 on the sale of these facilities.

For the nine months ended September 30, 2006 and 2005, we have reclassified the operations, including the net gain on the sale of these facilities, as discontinued operations in accordance with SFAS 144.

Income from discontinued operations related to these facilities are as follows:

<i>(in thousands, except per share amounts)</i>	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Revenues:				
Rental income	\$ --	\$ 446	\$ 662	\$1,339
Facility operating revenue	=	<u>2,229</u>	<u>2,067</u>	<u>6,528</u>
		<u>2,675</u>	<u>2,729</u>	<u>7,867</u>
Expenses:				
Depreciation	--	146	181	501
Facility operating expenses	=	<u>2,206</u>	<u>2,084</u>	<u>6,460</u>
		<u>2,352</u>	<u>2,265</u>	<u>6,961</u>
Operating income	--	323	464	906
Gain on sale of assets	=	<u>25</u>	<u>5,814</u>	<u>773</u>
Total discontinued operations	\$ --	\$ 348	\$6,278	\$1,679
Discontinued operations per common share:				
Basic	\$ --	\$ .01	\$ .23	\$ .06
Diluted	\$ --	\$ .01	\$ .23	\$ .06

**Note 12. SUBSEQUENT EVENTS**

*Early Mortgage Payoff* - On October 2, 2006, the borrower who replaced American Medical Associates, Inc. in May, 2004 prepaid the mortgages on two of the three Florida-based facilities. As a result, we received \$8,116,000, representing the full principal balances of the notes, resulting in a gain of \$5,950,000 which will be recognized in the fourth quarter. (See Note 5)

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*Acquisition Offer* - On October 5, 2006, we received an offer from W. Andrew Adams, our Chairman and CEO, a significant shareholder and President of Management Advisory Source, LLC, NHI's management advisor, to acquire all of our outstanding shares of common stock for \$30.00 per share. The offer is subject to certain conditions and contingencies. The Board of Directors formed a Special Committee of independent directors for the purpose of evaluating strategic alternatives to enhance shareholder value. Additionally, the Special Committee hired The Blackstone Group L.P. as its financial advisor to assist in evaluating this or any other proposed transactions.

The Special Committee has informed Mr. Adams that it considers his proposal to be inadequate and that the Special Committee desires more particular information about the proposal. The Special Committee will review and assess the details of the proposal when provided in order to determine the appropriate course of action that will serve the best interests of our shareholders.

On October 13, 2006, a lawsuit was filed in Chancery Court for the State of Tennessee, Rutherford County, against the individual directors serving on the Special Committee alleging breach of fiduciary duty and improper action in connection with the offer by Mr. Adams. The directors intend to vigorously defend the allegations in the complaint. NHI has previously indemnified all members of the Board of Directors for all actions related to NHI, including serving on the Special Committee. NHI expects that indemnification to cover the expenses incurred by the directors in the defense of this action.

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

#### Executive Overview

National Health Investors, Inc. ("NHI" or the "Company"), a Maryland corporation, is a real estate investment trust ("REIT") that invests primarily in income producing health care properties with emphasis on the long-term care sector. As of September 30, 2006, we had interests in real estate owned, and investments in mortgages, preferred stock and marketable securities resulting in total invested assets of \$410,839,000. Founded in 1991, our mission is to invest in health care real estate which generates current income that will be distributed to stockholders. We have pursued this mission by making mortgage loans and acquiring properties to lease nationwide primarily in the long-term health care industry.

#### *Portfolio*

As of September 30, 2006, we had investments in 143 health care facilities located in 18 states consisting of 101 long-term care facilities, one acute care hospital, four medical office buildings, 14 assisted living facilities, six retirement centers and 17 residential projects for the developmentally disabled. These investments consisted of approximately \$103,761,000 aggregate carrying value amount of loans to 17 borrowers and \$237,284,000 of real estate investments with 15 lessees. Of these 143 facilities, 16 were acquired through foreclosure and are operated by us. These 16 facilities have been sold, but we have not yet met the accounting criteria to record the sales.

Our largest customer is National HealthCare Corporation ("NHC"). Of our 143 facilities, 41 are leased to NHC. These 41 facilities include four centers leased to other parties, the lease payments of which are guaranteed to us by NHC. Also, the 16 properties operated by us are managed by subsidiaries of NHC. NHC was our investment advisor until November 1, 2004. Consistent with our strategy of diversification, we have increased our portfolio so that the portion of our portfolio operated by NHC has been reduced from 100% of our total portfolio on October 17, 1991 (the date we began operations) to 11.8% of total portfolio on September 30, 2006, based on the net book value of these properties. In 1991, these assets were transferred by NHC to NHI at their then current net book value, in a non-taxable exchange. Many of these assets were substantially depreciated as a result of having been carried on NHC's books for as many as 20 years. As a result, we believe that the fair market value of these assets is significantly in excess of their net book value. To illustrate, rental income in 2005 from these facilities was \$33,328,000 or approximately 66% of our net book value. Therefore, NHC properties represent a smaller percentage of the portfolio. Subsequent additions to the portfolio related to non-NHC investments reflect their higher value based on existing costs at the date the investment was made.

As with all assets in our portfolio, we monitor the financial and operating results of each of these properties on a quarterly basis. In addition to reviewing the consolidated financial results of NHC, the individual center financial results are reviewed including their occupancy, patient mix, state survey results and other relevant information.

At September 30, 2006, 26.8% of the total invested assets of the health care facilities were operated by publicly-traded operators, 60.5% by regional operators, and 12.7% by small operators.

The following tables summarize our portfolio as of September 30, 2006:

#### **Portfolio Statistics**

	<u>Properties</u>	<u>Investment</u>	<u>Investment</u> <u>Percentage</u>
Real Estate Properties	90	\$237,284,000	70%



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Mortgages and Notes Receivable	<u>53</u>	<u>103,761,000</u>	<u>30%</u>
Total Real Estate Portfolio	143	\$341,045,000	100%
<b>Real Estate Properties</b>	<u>Properties</u>	<u>Beds</u>	<u>Investments</u>
Nursing Homes	66	8,557	\$151,532,000
Assisted Living	14	1,161	58,650,000
Medical Office Buildings	4	124,427 sq. ft.	10,092,000
Retirement Homes	5	560	10,024,000
Hospitals	<u>1</u>	55	<u>6,986,000</u>
Total Real Estate Properties	<u>90</u>		<u>\$237,284,000</u>
<b>Mortgages and Notes Receivable</b>			
Nursing Homes	35	3,941	\$ 97,639,000
Retirement Homes	1	60	1,949,000
Developmentally Disabled	<u>17</u>	108	<u>4,173,000</u>
Total Mortgages and Notes Receivable	<u>53</u>		<u>103,761,000</u>
Total Real Estate Portfolio	143		\$341,045,000
<b>Summary of Facilities by Type</b>		Percentage of	Total
	<u>Properties</u>	<u>Total Dollars</u>	<u>Dollars</u>
Nursing Homes	101	73.06%	\$249,171,000
Assisted Living	14	17.20%	58,650,000
Medical Office Buildings	4	2.96%	10,092,000
Retirement Homes	6	3.51%	11,973,000
Hospitals	1	2.05%	6,986,000
Developmentally Disabled	<u>17</u>	<u>1.22%</u>	<u>4,173,000</u>
Total Real Estate Portfolio	143	100.00%	\$341,045,000
<b>Portfolio by Operator Type:</b>			
Public	62	26.81%	\$ 91,441,000
Regional	67	60.49%	206,306,000
Small Operator	<u>14</u>	<u>12.70%</u>	<u>43,298,000</u>
Total Real Estate Portfolio	143	100.00%	\$341,045,000
<b>Public Operators</b>		Percentage of	Dollar
		Total Real Estate	Portfolio
National HealthCare Corp.		14.24%	\$48,563,000
Sunrise Senior Living Services		3.82%	13,011,000
Community Health Systems, Inc.		3.81%	13,008,000
Sun Healthcare		2.53%	8,616,000
Res-Care, Inc.		1.22%	4,173,000
HCA - The Healthcare Company		<u>1.19%</u>	<u>4,070,000</u>
Total Public Operators		26.81%	\$91,441,000

Operators who collectively operate more than 3% of our total real estate investments are as follows: NHC, THI of Baltimore, Inc., Sunrise Senior Living Services, Inc., Health Services Management, Inc., Community Health Systems, Inc., ElderTrust of Florida, Inc., RGL Development, LLC, American HealthCare, LLC, SeniorTrust of Florida, Inc., and Senior Living Management Corporation.

*Areas of Focus*

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We have focused on lowering our debt for the past five years. Our debt to capitalization ratio on September 30, 2006 was 21.1%, the lowest level in our 14 year history. Our liquidity is also strong with cash and marketable securities of \$177,718,000 exceeding our total debt outstanding of \$114,946,000 at September 30, 2006.

On December 27, 2005, we reached an agreement with NHC to extend through December 31, 2021 our current lease on 41 of our real estate properties. These 41 facilities include four centers leased to other parties, and three retirement centers. This extension assures an ongoing relationship with our largest customer.

As a result of our strong liquidity, we anticipated making new investments during 2006. Although we evaluated a number of potential investments during the year, no new investments were closed. At this time, we are continuing to cautiously evaluate new investments but we are concerned that the current prices being offered for health care assets exceed our risk tolerance.

Recently we received an offer from our Chairman and CEO to acquire all of our outstanding shares of common stock for \$30 per share in cash or in equity in a new company. The offer is subject to certain conditions and contingencies. Our Board of Directors formed a Special Committee of independent directors for the purpose of evaluating this proposal or other strategic alternatives to enhance stockholder value. Although the Special Committee rejected the offer as inadequate, the Special Committee has hired The Blackstone Group L.P. as its financial advisor to assist in evaluating this or any other proposed transactions.

### Critical Accounting Policies

We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. These accounting principles require 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 period. Actual results could differ from those estimates and cause our reported net income to vary significantly from period to period. If actual experience differs from the assumptions and other considerations used in estimating amounts reflected in our consolidated financial statements, the resulting changes could have a material adverse effect on our consolidated results of operations, liquidity and/or financial condition.

We consider an accounting estimate or assumption critical if:

- the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
- the impact of the estimates and assumptions on financial condition or operating performance is material.

Our significant accounting policies and the associated estimates, judgments and the issues which impact these estimates are as follows:

1) Valuations and impairments to our investments - The majority of our tenants and borrowers are in the long-term health care industry and derive their revenues primarily from Medicare, Medicaid and other government programs. Amounts paid under these government programs are subject to legislative and government budget constraints. From time to time, there may be material changes in government reimbursement. In the past, the long-term health care industry has at times experienced material reductions in government reimbursement.

The long-term health care industry has also experienced a dramatic increase in professional liability claims and in the cost of insurance to cover such claims. These factors have combined to cause a number of bankruptcy filings, bankruptcy court rulings and court judgments about refinancing for our lessees and mortgagees. We have determined that impairment of certain of our investments have occurred as the result of these events.

Decisions about valuations and impairments of our investments require significant judgments and estimates on the part of management. For real estate properties, the need to recognize an impairment is evaluated on a property by property basis in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment and Disposal of Long-Lived Assets" ("SFAS 144"). Recognition of an impairment is based upon estimated undiscounted future cash flows from a property compared to the carrying amount of the property and may be affected by management's plans, if any, to dispose of the property.

For notes receivable, impairment recognition is based upon an evaluation of the estimated collectibility of loan payments and general economic conditions on a specific loan basis in accordance with Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan - An Amendment of FASB Statements No. 5 and 15" ("SFAS 114"). On a quarterly basis, NHI reviews its notes receivable for realizability when events or circumstances, including the non-receipt of principal and interest payments, significant deteriorations of the financial condition of the borrower and significant adverse changes in general economic conditions, indicate that the carrying amount of the note receivable may not be recoverable. If necessary, an impairment is measured as the amount by which the carrying amount exceeds the discounted cash flows expected to be received under the note receivable or, if

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foreclosure is probable, the fair value of the collateral securing the note receivable.

We evaluate our marketable securities for other-than-temporary impairments consistent with the provisions of Statement of Financial Accountant Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115") as amended by EITF 03-01 "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments". An impairment of a marketable security would be considered "other-than-temporary" unless we have the ability and intent to hold the investment for a period of time sufficient for a forecasted market price recovery up to (or beyond) the cost of the investment and evidence indicates the cost of the investment is recoverable within a reasonable period of time.

While we believe that the carrying amounts of our properties are recoverable and our notes receivable, marketable securities and other investments are realizable, it is possible that future events could require us to make significant adjustments or revisions to these estimates.

2) Revenue recognition - mortgage interest and rental income - We collect interest and rent from our customers. Generally our policy is to recognize revenues on an accrual basis as earned. However, there are certain of our customers for which we have determined, based on insufficient historical collections and the lack of expected future collections, that revenue for interest or rent is not realizable. For these nonperforming investments, our policy is to recognize interest or rental income when assured, which we consider to be the period the amounts are collected. We identify investments as nonperforming if a required payment is not received within 30 days of the date it is due. This policy could cause our revenues to vary significantly from period to period. Revenue from minimum lease payments under our leases is recognized on a straight-line basis as required under SFAS 13 "Accounting for Leases" to the extent that future lease payments are considered collectible. Lease payments that depend on a factor directly related to future use of the property, such as an increase in annual revenues over a base year revenues, are considered to be contingent rentals and are excluded from minimum lease payments in accordance with SFAS 13.

3) REIT status and taxes - We believe that we have operated our business so as to qualify as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the "Code") and we intend to continue to operate in such a manner, but no assurance can be given that we will be able to qualify at all times. If we qualify as a REIT, we will generally not be subject to federal corporate income taxes on our net income that is currently distributed to our stockholders. This treatment substantially eliminates the "double taxation" (at the corporate and stockholder levels) that typically applies to corporate dividends. Our failure to continue to qualify under the applicable REIT qualification rules and regulations would cause us to owe state and federal income taxes and would have a material adverse impact on our financial position, results of operations and cash flows.

4) Revenue recognition - third party payors - Approximately two-thirds of our facility operating revenues are derived from Medicare, Medicaid, and other government programs. Amounts earned under these programs are subject to review by the third party payors. In our opinion, adequate provision has been made for any adjustments that may result from these reviews. Any differences between our estimates of settlements and final determinations are reflected in operations in the year finalized.

### Liquidity and Capital Resources

#### *Sources and Uses of Funds*

Our primary sources of cash include rent and interest receipts, the revenues of facilities we operate, proceeds from the sales of real property and principal payments on loans receivable. Our primary uses of cash include dividend distributions, the expenses of facilities we operate, debt service payments (including principal and interest), real property acquisitions and general and administrative expenses. These sources and uses of cash are reflected in our Consolidated Statements of Cash Flows and are discussed in further detail below. The following is a summary of our sources and uses of cash flows (dollars in thousands):

	Nine Months Ended		Nine Month Change	
	<u>September 30</u>		<u>\$</u>	<u>%</u>
	<u>2006</u>	<u>2005</u>		
Cash and cash equivalents at beginning of period	\$132,469	\$161,215	\$(28,746)	(18%)