

OMEGA HEALTHCARE INVESTORS INC  
Form 424B4  
March 29, 2007

**PROSPECTUS**

**Filed Pursuant to Rule 424(b)(4)  
Registration No. 333-141242**

**6,200,000 Shares**

**OMEGA HEALTHCARE INVESTORS, INC.**  
**Common Stock**

We are offering for sale 6,200,000 shares of our common stock to be sold in this offering. We will receive all of the net proceeds from the sale of such common stock.

Our common stock is listed on the New York Stock Exchange, or NYSE, under the symbol "OHI." On March 28, 2007, the last reported sale price of our common stock on the NYSE was \$17.03 per share.

**Investing in our common stock involves a high degree of risk. Before buying any shares, you should read the discussion of material risks of investing in our common stock in "Risk factors" beginning on page 9 of this prospectus.**

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.**

	<b>Per Share</b>	<b>Total</b>
Public offering price	\$ 16.75	\$ 103,850,000
Underwriting discounts and commissions	\$ 0.84	\$ 5,192,500
Proceeds, before expenses, to us	\$ 15.91	\$ 98,657,500

The underwriters may also purchase up to an additional 930,000 shares of common stock from us at the public offering price, less underwriting discounts and commissions payable by us, to cover over-allotments, if any, within 30 days from the date of this prospectus. If the underwriters exercise the option in full, the total underwriting discounts and commissions will be \$5,971,375, and the total proceeds, before expenses, to us will be \$113,456,125.

The underwriters are offering the shares of our common stock as set forth under "Underwriting." Delivery of the shares of common stock will be made on or about April 3, 2007.

*Sole Book Running Manager*  
**UBS Investment Bank**

*Co-Managers*

Banc of America Securities LLC

Deutsche Bank Securities

Stifel Nicolaus

The date of this prospectus is March 28, 2007.

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You should rely only on the information contained in this prospectus. We have not, and the underwriters have not, authorized anyone to provide you with additional information or information different from that contained in this prospectus. We are offering to sell, and seeking offers to buy, shares of our common stock only in jurisdictions where offers and sales are permitted. The information contained in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or of any sale of shares of common stock.

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and adversely affect our business and financial condition.

We rely on external sources of capital to fund future capital needs, and if we encounter difficulty in obtaining such capital, we may not be able to make future investments necessary to grow our business or meet maturing commitments. 15

Our ability to raise capital through sales of equity is dependent, in part, on the market price of our common stock, and our failure to meet market expectations with respect to our business could negatively impact the market price of our common stock and limit our ability to sell equity. 15

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*This prospectus includes market share, industry data and forecasts that we obtained from the United States Census Bureau and the Centers for Medicare and Medicaid Services, or CMS. In this prospectus, we refer to additional information regarding market data obtained from internal sources, market research, publicly available information and industry publications. Although we believe the information is reliable, we cannot guarantee the accuracy or completeness of the information and have not independently verified it.*

## **ABOUT THIS PROSPECTUS**

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission, or the SEC, on Form S-11 to register the shares offered by this prospectus. This prospectus does not include all of the information contained in the registration statement. For further information about us and the common stock offered in this prospectus, you should review the registration statement. You should read this prospectus together with additional information described under the heading “Available Information.”

All references to “you” in this prospectus refer to those persons who invest in the common stock being offered by this prospectus, and all references to “we,” “us” and “our” in this prospectus refer to Omega Healthcare Investors, Inc., a Maryland corporation, and its subsidiaries.



**Prospectus summary**

*The following summary may not contain all the information that may be important to you. You should read the entire prospectus and the documents we have filed with the SEC before making a decision to invest in our common stock.*

**OUR COMPANY**

We are a self-administered real estate investment trust, or REIT, investing in income-producing healthcare facilities, principally long-term care facilities located in the United States. We provide lease or mortgage financing to qualified operators of skilled nursing facilities, or SNFs, and, to a lesser extent, assisted living facilities, or ALFs and rehabilitation and acute care facilities. We have historically financed investments through borrowings under our revolving credit facilities, private placements or public offerings of debt or equity securities, the assumption of secured indebtedness, or a combination of these methods.

Our portfolio of investments, as of December 31, 2006, consisted of 239 healthcare facilities, located in 27 states and operated by 32 third-party operators. This portfolio is made up of:

- 228 long-term healthcare facilities and two rehabilitation hospitals owned and leased to third parties; and
- fixed rate mortgages on nine long-term healthcare facilities.

As of December 31, 2006, our gross investments in these facilities, net of impairments and before reserve for uncollectible loans, totaled approximately \$1.3 billion. In addition, we also held miscellaneous investments of approximately \$22 million at December 31, 2006, consisting primarily of secured loans to third-party operators of our facilities.

For the year ended December 31, 2006, we generated operating revenue of \$135.7 million, net income of \$55.7 million, and \$76.7 million of funds from operations, or FFO. FFO is not a financial measure recognized under generally accepted accounting principles in the United States of America, or GAAP, and, therefore, should not be considered a measure of liquidity, an alternative to net income or an indicator of any other performance measure determined in accordance with GAAP. For more information with respect to FFO and a reconciliation of FFO to GAAP net income, see footnote 2 in the section entitled "Summary Historical Financial Information."

**OUR PROPERTY INVESTMENTS**

We own a diversified portfolio of assets. The following table summarizes our property investments as of December 31, 2006:

Investment Structure/Operator	Number of Beds <sup>(1)</sup>	Number of Facilities	Occupancy Percentage (1)	Gross Investment (in thousands)
<b>Purchase/Leaseback<sup>(2)</sup></b>				
Sun Healthcare Group, Inc.	4,523	38	86%	\$ 210,222
CommuniCare Health Services, Inc.	2,781	18	89	185,821
Haven Healthcare	1,787	15	91	117,230
HQM of Floyd County, Inc	1,466	13	87	98,368
Advocat Inc	2,925	28	78	94,432
Guardian LTC Management, Inc. <sup>(4)</sup>	1,308	17	83	85,981



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Nexion Health Inc	2,412	20	78	80,211
Essex Health Care Corporation	1,388	13	78	79,354
Seacrest Healthcare	720	6	92	44,223

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<b>Investment Structure/Operator</b>	<b>Number of Beds</b>	<b>Number of Facilities</b>	<b>Occupancy Percentage (1)</b>	<b>Gross Investment (in thousands)</b>
Senior Management	1,413	8	70	35,243
Mark Ide Limited Liability Company	832	8	77	25,595
Harborside Healthcare Corporation	465	4	92	23,393
StoneGate Senior Care LP	664	6	87	21,781
Infinia Properties of Arizona, LLC	378	4	63	19,289
USA Healthcare, Inc	489	5	65	15,703
Rest Haven Nursing Center, Inc	200	1	90	14,400
Conifer Care Communities, Inc.	204	3	89	14,367
Washington N&R, LLC	286	2	75	12,152
Triad Health Management of Georgia II, LLC	304	2	98	10,000
Ensign Group, Inc	271	3	92	9,656
Lakeland Investors, LLC	300	1	73	8,893
Hickory Creek Healthcare Foundation, Inc.	138	2	85	7,250
Liberty Assisted Living Centers, LP	120	1	85	5,997
Emeritus Corporation	52	1	66	5,674
Longwood Management Corporation <sup>(5)</sup>	185	2	91	5,425
Generations Healthcare, Inc.	60	1	84	3,007
Skilled Healthcare <sup>(6)</sup>	59	1	92	2,012
Healthcare Management Services <sup>(6)</sup>	98	1	48	1,486
	25,828	224	83	1,237,165
<b>Assets Held for Sale</b>				
Active Facilities <sup>(7)</sup>	354	5	58	3,443
Closed Facility	—	1	—	125
	354	6	58	3,568
<b>Fixed Rate Mortgages<sup>(3)</sup></b>				
Advocat Inc	423	4	82	12,587
Parthenon Healthcare, Inc	300	2	73	10,730
CommuniCare Health Services, Inc.	150	1	91	6,454
Texas Health Enterprises/HEA Mgmt. Group, Inc.	147	1	68	1,230
Evergreen Healthcare	100	1	67	885
	1,120	9	80	31,886
<b>Total</b>	<b>27,302</b>	<b>239</b>	<b>82</b>	<b>\$ 1,272,619</b>

(1) Represents the most recent data provided by our operators.

(2) Certain of our lease agreements contain purchase options that permit the lessees to purchase the underlying properties from us. Some of these purchase options could result in us receiving less than fair market value for such facility. As of the date of this prospectus, leases applicable to approximately 9.16% of our total gross investments contain purchase options. The purchase options relating to .16% are currently exercisable, the purchase options relating to .70% are exercisable at specified times during the next four years, and the purchase options relating to 8.30% are exercisable in ten years.

(3) In general, many of our mortgages contain prepayment provisions that permit prepayment of the outstanding principal amounts thereunder.

(4) All 17 facilities are subject to a purchase option on September 1, 2015.

(5) Both facilities are subject to a purchase option on November 1, 2007.

- (6) The facility is subject to a purchase option on November 1, 2007.
- (7) Two facilities representing \$1.9 million were purchased on January 31, 2007 pursuant to a purchase option.
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## OUR COMPETITIVE STRENGTHS

**Geographically Diverse Property Portfolio.** Our portfolio of properties is broadly diversified by geographic location. We have healthcare facilities located in 27 states. Only two states comprised more than 10% of our rental and mortgage income in 2006. In addition, the majority of our 2006 rental and mortgage income was derived from facilities in states that require state approval for development and expansion of healthcare facilities. We believe that such state approvals may limit competition for our operators and enhance the value of our properties.

**Large Number of Tenants.** Our facilities are operated by 32 different public and private healthcare providers. Except for Sun Healthcare Group, Inc., or Sun, and CommuniCare Health Services, Inc., or CommuniCare, which together hold approximately 32% of our portfolio (by gross investment value), no single tenant holds greater than 10% of our portfolio (by gross investment value).

**Significant Number of Long-term Leases and Mortgage Loans.** A large portion of the properties in our core portfolio are subject to long-term lease and mortgage agreements. At December 31, 2006, approximately 94% of our leases and mortgages had primary terms that expire in 2010 or later. Our leased real estate properties are leased under provisions of single facility leases or master leases with initial terms typically ranging from 5 to 15 years, plus renewal options. Substantially all of the leases and master leases provide for minimum annual rentals that are subject to annual increases based upon increases in the Consumer Price Index, or CPI, or increases in revenues of the underlying properties, with certain limits. Under the terms of the leases, the lessee is responsible for all maintenance, repairs, taxes and insurance on the leased properties.

**Experienced Management Team.** The top four members of our executive team average over 19 years of experience in the long-term healthcare industry. We believe that the long, accomplished tenure of our management team helps to distinguish us from our competitors in the long-term healthcare industry.

## OUR STRATEGY

In making investments in properties, we generally have focused on established, creditworthy, middle-market healthcare operators that meet our standards for quality and experience of management. We have sought to diversify our investments in terms of geographic locations and operators. In evaluating potential investments, we consider such factors as:

- the quality and experience of management and the creditworthiness of the operator of the facility;
- the facility's historical and forecasted cash flow and its ability to meet operational needs, capital expenditure requirements and lease or debt service obligations, providing a competitive return on our investment;
  - the construction quality, condition and design of the facility;
  - the geographic area of the facility;
- the tax, growth, regulatory and reimbursement environment of the jurisdiction in which the facility is located;
  - the effect of an investment in such facility on our ability to qualify as a REIT;
- the occupancy and demand for similar healthcare facilities in the same or nearby communities; and
  - the payor mix of private, Medicare and Medicaid patients.

We prefer to invest in equity ownership of properties. Due to regulatory, tax or other considerations, we sometimes pursue alternative investment structures that can achieve returns comparable to equity investments.

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## OUR INDUSTRY

We are a REIT that invests in income-producing healthcare facilities, principally long-term care facilities located in the United States. Within the long-term care industry, we focus specifically on the approximately \$122 billion United States nursing home market by providing lease or mortgage financing to operators of SNFs and, to a lesser extent, assisted living and acute care facilities. According to Centers for Medicare and Medicaid Services, or CMS, as of December 2006, there were approximately 16,000 nursing homes with approximately 1.7 million total beds certified to provide Medicare and/or Medicaid services in the United States. The nursing home industry is highly fragmented. As of May 2003, the ten largest for-profit chains combined control approximately 16% of the industry's beds, with the largest company operating just under 3% of the industry's beds.

The aging population and increased life expectancies are the primary growth drivers for long-term care facilities. According to the United States Census Bureau, in 2005, there were approximately 35 million Americans aged 65 or older, comprising approximately 12% of the total United States population. The number of Americans aged 65 or older is expected to climb to approximately 40.2 million by 2010 and to approximately 54.6 million by 2020. In addition to positive demographic trends, the demand for the services provided by operators of long-term care facilities is expected to increase substantially during the next decade due primarily to the impact of cost containment measures by government and private-pay sources resulting in higher acuity patients being transferred more quickly from hospitals to less expensive care settings such as SNFs. According to CMS, national nursing home expenditures are expected to grow from \$122 billion in 2005 to \$211 billion in 2016, representing a 5.1% compounded annual growth rate. We believe that these trends will support a growing demand for the services provided by nursing and assisted living facility operators, which in turn will support a growing demand for our properties.

In recent years, Congress has enacted three significant laws that have dramatically altered payments to operators of SNFs under Medicare. Beginning with the enactment of the Balanced Budget Act of 1997, or Balanced Budget Act, payments for Medicare services were reduced and extensive changes in the Medicare and Medicaid programs were made. Congress twice enacted legislation intended to mitigate temporarily the reduction in Medicare reimbursement rates for SNFs caused by the Balanced Budget Act. These bills were the Medicare, Medicaid, and SCHIP Balanced Budget Refinement Act of 1999, or Balanced Budget Refinement Act, and the Medicare, Medicaid and SCHIP Benefits Improvement and Protection Act of 2000, or Benefits Improvement and Protection Act. These acts implemented several temporary payment increases for services provided under Medicare in SNFs.

On August 4, 2005, CMS published a final rule, effective October 1, 2005, establishing Medicare payments for SNFs under the prospective payment system for federal fiscal year 2006, thereby triggering the elimination of the remaining temporary payment increases arising from the Balanced Budget Refinement Act and the Benefits Improvement and Protection Act. CMS estimated that the increases in Medicare reimbursements to SNFs arising from refinements to the prospective payment system under the final rule would offset the reductions stemming from the elimination of the temporary increases during federal fiscal year 2006 (October 1, 2005 through September 30, 2006), resulting in an overall increase in Medicare payments to SNFs of \$20 million in fiscal year 2006 compared to 2005. We cannot accurately predict what effect, if any, these changes will have on individual operators, and as a result, our business in 2007 and beyond.

Furthermore, Medicaid programs, which are administered at the state level and are a significant source of revenues for our operators, are impacted by fluctuations in state budgets. The recent economic climate has had a detrimental effect on state revenues in most regions of the United States. Given that Medicaid outlays are a significant component of state budgets, we expect continuing cost containment pressures on Medicaid outlays for skilled nursing services in the states in which we maintain facilities.

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In large part as a result of the 1997 changes in Medicare reimbursement of services provided by SNFs and reimbursement cuts imposed under state Medicaid programs, a number of operators of our properties have encountered significant financial difficulties in recent years. Some of these operators, including Sun and Integrated Health Services, or IHS, who is no longer one of our operators, filed for bankruptcy protection. Other operators were required to undertake significant restructuring efforts. We have restructured our arrangements with many of our operators by renegotiating lease and mortgage terms, re-leasing properties to new operators and closing and/or disposing of properties.

## **RECENT DEVELOPMENTS**

### **Increase in our Credit Facility**

Pursuant to Section 2.01 of our credit agreement, dated as of March 31, 2006, as amended, by and among OHI Asset, LLC, a Delaware limited liability company, OHI Asset (ID), LLC, a Delaware limited liability company, OHI Asset (LA), LLC, a Delaware limited liability company, OHI Asset (TX), LLC, a Delaware limited liability company, OHI Asset (CA), LLC, a Delaware limited liability company, Delta Investors I, LLC a Maryland limited liability company, Delta Investors II, LLC, a Maryland limited liability company and Texas Lessor - Stonegate, LP, a Maryland limited partnership, the Lenders identified therein, and Bank of America, N.A., as Administrative Agent, we are permitted under certain circumstances to increase our available borrowing base under our revolving secured credit facility, or Credit Facility, from \$200 million up to an aggregate of \$300 million. Effective as of February 22, 2007, we exercised our right to increase our available revolving commitment under Section 2.01 of the credit agreement from \$200 million to \$255 million and we consented to the addition of 18 of our properties to the borrowing base assets under our Credit Facility. For additional information regarding our Credit Facility, see Management's discussion and analysis of financial condition and results of operations - Liquidity and capital resources - *Financing activities and borrowing arrangements*.

### **Restatement**

In December 2006, we filed an amended Annual Report on Form 10-K/A to correct our previously issued historical consolidated financial statements as of December 31, 2005 and 2004, and for each of the three years in the period ended December 31, 2005, for errors in previously reported amounts related to income tax matters and asset values, as well as the recording of straight-line rental income. Please see the sections of this prospectus entitled "Certain federal income tax consequences - Taxation of Omega" and "Risk Factors - Tax Risks" for additional information.

## **CORPORATE INFORMATION**

We were incorporated in the State of Maryland on March 31, 1992. Our principal executive offices are located at 9690 Deereco Road, Suite 100, Timonium, Maryland 21093, and our telephone number is (410) 427-1700.

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**The offering**

Common stock we are offering           6,200,000 shares.

Common stock to be outstanding  
immediately after the offering       66,300,859 shares.

New York Stock Exchange symbol   OHI

Use of proceeds                       We intend to use all of the net proceeds of this offering to repay indebtedness outstanding under our Credit Facility. If and to the extent there are net proceeds remaining after we have repaid all indebtedness under our Credit Facility, we will use these proceeds for working capital and general corporate purposes. See "Use of Proceeds."

Risk factors                         This investment involves a high degree of risk. See the section entitled "Risk Factors" beginning on page 9 of this prospectus for a discussion of certain factors you should consider before deciding to invest in our common stock.

The number of shares of our common stock outstanding after this offering is based on approximately 60,100,859 shares outstanding as of March 26, 2007 and excludes:

- 47,244 shares of our common stock issuable upon exercise of options outstanding as of December 31, 2006 at a weighted average exercise price of \$12.70 per share;
- 1,516,428 shares of our common stock available for issuance under our dividend reinvestment and common stock purchase plan as of December 31, 2006;
- 2,891,980 shares of our common stock available for future grant under our 2000 Stock Incentive Plan and our 2004 Stock Incentive Plan; and
- 930,000 shares of our common stock that may be purchased by underwriters to cover over-allotments, if any.

Unless otherwise stated, all information in this prospectus supplement assumes that the underwriters do not exercise their over-allotment option.

**Summary historical financial information**

The following table sets forth summary consolidated financial data as of the dates and for the periods presented. The operating data and other financial data as of, and for each of the years during the three-year period ended, December 31, 2006 have been derived from, and should be read in conjunction with, our audited consolidated financial statements and the related notes included elsewhere in this prospectus. The operating data and other financial data as of and for each of the years ended December 31, 2002 and 2003 are derived from our audited consolidated financial statements.

	<b>Year ended December 31,</b>				
	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
	<b>(in thousands)</b>				
<b>Operating data:</b>					
Revenues:					
Core operations	\$ 80,572	\$ 76,803	\$ 86,972	\$ 109,644	\$ 135,693
Nursing home operations	42,203	4,395	—	—	—
Total revenues	122,775	81,198	86,972	109,644	135,693
Interest expense	27,381	20,802	24,902	32,021	44,126
(Loss) income from continuing operations	(2,561)	27,770	13,371	37,355	56,042
Net (loss) income available to common shareholders	(32,801)	3,516	(36,715)	25,355	45,774
<b>Other financial data:</b>					
Depreciation and amortization <sup>(1)</sup>	17,495	18,129	18,842	23,856	32,113
Funds from operations <sup>(2)</sup>	(15,025)	25,091	(18,474)	42,663	76,683

	<b>Twelve months ended</b>	
	<b>December 31, 2006</b>	
	<b>Actual</b>	<b>As adjusted<sup>(3)</sup></b>
	<b>(in thousands)</b>	
<b>Balance sheet data:</b>		
Cash	\$ 729	729
Gross investment	1,294,697	1,294,697
Total assets	1,175,370	1,175,370
Total debt <sup>(4)</sup>	676,141	577,983
Stockholders' equity	465,454	563,612

(1) Excludes amounts included in discontinued operations

(2) We consider funds from operations, or FFO, to be a key measure of a REIT's performance which should be considered along with, but not as an alternative to, net income and cash flow as a measure of operating performance

*and liquidity. We calculate and report FFO in accordance with the definition and interpretive guidelines issued by the National Association of Real Estate Investment Trusts, or NAREIT, and, consequently, FFO is defined as net income available to common stockholders, adjusted for the effects of asset dispositions and certain non-cash items, primarily depreciation and amortization. We believe that FFO is an important supplemental measure of our operating performance. Because the historical cost accounting convention used for real estate assets requires depreciation (except on land), such accounting presentation implies that the value of real estate assets diminishes predictably over time, while real estate values instead have historically risen or fallen with market conditions. The term FFO was designed by the real estate industry to address this issue. FFO herein is not necessarily comparable to FFO of other REITs that do not use the same definition of implementation guidelines or interpret the standards differently from us.*

*We use FFO as one of several criteria to measure operating performance of our business. We further believe that by excluding the effect of depreciation, amortization and gains or losses from sales of real estate, all of which are based on historical costs and which may be of limited relevance in evaluating current performance, FFO can facilitate comparisons of operating performance between periods and between other REITs. We offer this measure to assist the users of our financial performance under GAAP and FFO should not be considered a measure of liquidity, an alternative to net income or an indicator of any other performance measure determined in accordance with GAAP. Investor and potential investors in our securities should not rely on this measure as a substitute for any GAAP measure, including net income.*

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In February 2004, NAREIT informed its member companies that it was adopting the position of the SEC with respect to asset impairment charges and would no longer recommend that impairment write-downs be excluded from FFO. In the table included below, we have applied this interpretation and have not excluded asset impairment charges in calculating our FFO. As a result, our FFO may not be comparable to similar measures reported in previous disclosures. According to NAREIT, there is inconsistency among NAREIT member companies as to the adoption of this interpretation of FFO. Therefore, a comparison of our FFO results to another company's FFO results may not be meaningful.

The following table is a reconciliation of net income (loss) available to common shareholders to FFO:

	Year ended December 31,				
	2002	2003	2004	2005	2006
	(in thousands)				
Net income (loss) available to common shareholders	(32,801)	3,516	(36,715)	25,355	45,774
(Deduct gain) add back loss from real estate dispositions <sup>(a)</sup>	(2,548)	149	(3,310)	(7,969)	(1,354)
	(35,349)	3,665	(40,025)	17,386	44,420
Elimination of non-cash items included in net income (loss):					
Depreciation and amortization <sup>(b)</sup>	21,270	21,426	21,551	25,277	32,263
Adjustments of derivatives to fair market value	(946)	—	—	—	—
<b>FFO</b>	<b>(15,025)</b>	<b>25,091</b>	<b>(18,474)</b>	<b>42,663</b>	<b>76,683</b>

(a) The add back of loss/deduction of gain from real estate dispositions includes the facilities classified as discontinued operations in our audited consolidated financial statements included in our Annual Reports on Form 10-K for the three year period ended December 31, 2006.

(b) The add back of depreciation and amortization includes the facilities classified as discontinued operations in our audited consolidated financial statements included in our Annual Reports on Form 10-K for the three year period ended December 31, 2006. The 2002, 2003, 2004, 2005 and 2006 includes depreciation of \$3.8 million, \$3.3 million, \$2.7 million, \$1.4 million, and \$0.2 million, respectively, related to facilities classified as discontinued operations.

(3) As adjusted basis giving effect to our sale of the common stock in this offering at an offering price of \$16.75 per share and the receipt of the estimated net proceeds of this sale of \$98.2 million, (after deducting underwriting discounts and commissions and other expenses of this offering), and the assumed application of the approximately \$98.2 million of net proceeds to repay a portion of our outstanding borrowings under our Credit Facility.

(4) Total debt includes long-term debt and current maturities of long-term debt.

## **Risk factors**

*You should carefully consider the risks described below. These risks are not the only ones that we may face. Additional risks and uncertainties that we are unaware of, or that we currently deem immaterial, also may become important factors that affect us. If any of the following risks occurs, our business, financial condition or results of operations could be materially and adversely affected.*

### **RISKS RELATED TO THE OPERATORS OF OUR FACILITIES**

Our financial position could be weakened and our ability to fulfill our obligations under our indebtedness could be limited if any of our major operators were unable to meet their obligations to us or failed to renew or extend their relationship with us as their lease terms expire, or if we were unable to lease or re-lease our facilities or make mortgage loans on economically favorable terms. These adverse developments could arise due to a number of factors, including those listed below.

#### **The bankruptcy, insolvency or financial deterioration of our operators could delay or limit our ability to collect, in full or at all, unpaid rents or require us to find new operators for rejected facilities.**

We are exposed to the risk that our operators may not be able to meet their obligations, which may result in their bankruptcy or insolvency. Although our leases and loans provide us the right to terminate an investment, evict an operator, demand immediate repayment and other remedies, title 11 of the United States Code, 11 U.S.C. §§ 101-1330, as amended and supplemented, or the Bankruptcy Code, affords certain protections to a party that has filed for bankruptcy that would probably render certain of these remedies unenforceable, or, at the very least, delay our ability to pursue such remedies. In addition, an operator in bankruptcy may be able to restrict our ability to collect unpaid rent or mortgage payments during the bankruptcy case.

Furthermore, the receipt of liquidation proceeds or the replacement of an operator that has defaulted on its lease or loan could be delayed by the approval process of any federal, state or local agency necessary for the transfer of the property or the replacement of the operator licensed to manage the facility. In addition, some significant expenditures associated with real estate investment, such as real estate taxes and maintenance costs, are generally not reduced when circumstances cause a reduction in income from the investment. In order to protect our investments, we may take possession of a property or even become licensed as an operator, which might expose us to successor liability under government programs (or otherwise) or require us to indemnify subsequent operators to whom we might transfer the operating rights and licenses. Third-party payors may also suspend payments to us following foreclosure until we receive the required licenses to operate the facilities. Should such events occur, our income and cash flow from operations would be adversely affected.

#### **A debtor may have the right to assume or reject a lease with us under bankruptcy law and his or her decision could delay or limit our ability to collect rents thereunder.**

If one or more of our lessees files bankruptcy relief, the Bankruptcy Code provides that a debtor has the option to assume or reject the unexpired lease within a certain period of time. However, our lease arrangements with operators that operate more than one of our facilities are generally made pursuant to a single master lease covering all of that operator's facilities leased from us, and consequently, it is possible that in bankruptcy the debtor-lessee may be required to assume or reject the master lease as a whole, rather than making the decision on a facility by facility basis, thereby preventing the debtor-lessee from assuming only the better performing facilities and terminating the leasing arrangement with respect to the poorer performing facilities. The Bankruptcy Code generally requires that a debtor must assume or reject a contract in its entirety. Thus, a debtor cannot choose to keep the beneficial provisions of a contract

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## Risk Factors

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while rejecting the burdensome ones; the contract must be assumed or rejected as a whole. However, where under applicable law a contract (even though it is contained in a single document) is determined to be divisible or severable into different agreements, or similarly where a collection of documents are determined to constitute separate agreements instead of a single, integrated contract, then in those circumstances a debtor/trustee may be allowed to assume some of the divisible or separate agreements while rejecting the others. Whether a master lease agreement would be determined to be a single contract or a divisible agreement, and hence whether a bankruptcy court would require a master lease agreement to be assumed or rejected as a whole, would depend on a number of factors some of which may include, but may not necessarily be limited to, the following:

- applicable state law;
- the parties' intent;
- whether the master lease agreement and related documents were executed contemporaneously;
  - the nature and purpose of the relevant documents;
  - whether the obligations in various documents are independent;
    - whether the leases are coterminous;
    - whether a single check is paid for all properties;
    - whether rent is apportioned among the leases;
  - whether termination of one lease constitutes termination of all;
    - whether the leases may be separately assigned or sublet;
    - whether separate consideration exists for each lease; and
    - whether there are cross-default provisions.

The Bankruptcy Code provides that a debtor has the power and the option to assume, assume and assign to a third party, or reject the unexpired lease. In the event that the unexpired lease is assumed on behalf of the debtor-lessee, obligations under the lease generally would be entitled to administrative priority over other unsecured pre-bankruptcy claims. If the debtor chooses to assume the lease (or assume and assign the lease), then the debtor is required to cure all monetary defaults, or provide adequate assurance that it will promptly cure such defaults. However, the debtor-lessee may not have to cure historical non-monetary defaults under the lease to the extent that they have not resulted in an actual pecuniary loss, but the debtor-lessee must cure non-monetary defaults under the lease from the time of assumption going forward. A debtor must generally pay all rent payments coming due under the lease after the bankruptcy filing but before the assumption or rejection of the lease. The Bankruptcy Code provides that the debtor-lessee must make the decision regarding assumption, assignment or rejection within a certain period of time. For cases filed on or after October 17, 2005, the time period to make the decision is 120 days, subject to one extension "for cause." A bankruptcy court may only further extend this period for 90 days unless the lessor consents in writing.

If a tenant rejects a lease under the Bankruptcy Code, it is deemed to be a pre-petition breach of the lease, and the lessor's claim arising therefrom may be limited to any unpaid rent already due plus an amount equal to the rent reserved under the lease, without acceleration, for the greater of one year, and 15%, not to exceed three years, of the remaining term of such lease, following the earlier of the petition date and repossession or surrender of the leased property. If the debtor rejects the lease, the facility would be returned to us. In that event, if we were unable to re-lease the facility to a new operator on favorable terms or only after a significant delay, we could lose some or all of the associated revenue from that facility for an extended period of time.

## Risk Factors

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### **With respect to our mortgage loans, the imposition of an automatic stay under bankruptcy law could negatively impact our ability to foreclose or seek other remedies against a mortgagor.**

Generally, with respect to our mortgage loans, the imposition of an automatic stay under the Bankruptcy Code precludes us from exercising foreclosure or other remedies against the debtor without first obtaining stay relief from the bankruptcy court. Pre-petition creditors generally do not have rights to the cash flows from the properties underlying the mortgages unless their security interest in the property includes such cash flows. Mortgagees may, however, receive periodic payments from the debtor/mortgagors. Such payments are referred to as adequate protection payments. The timing of adequate protection payments and whether the mortgagees are entitled to such payments depends on negotiating an acceptable settlement with the mortgagor (subject to approval of the bankruptcy court) or on the order of the bankruptcy court in the event a negotiated settlement cannot be achieved.

A mortgagee also is treated differently from a landlord in three key respects. First, the mortgage loan is not subject to assumption, assumption and assignment, or rejection. Second, the mortgagee's loan may be divided into a secured claim for the portion of the mortgage debt that does not exceed the value of the property securing the debt and a general unsecured claim for the portion of the mortgage debt that exceeds the value of the property. A secured creditor such as our company is entitled to the recovery of interest and reasonable fees, costs and charges provided for under the agreement under which such claim arose only if, and to the extent that, the value of the collateral exceeds the amount owed. If the value of the collateral exceeds the amount of the debt, interest as well as reasonable fees, costs, and charges are not necessarily required to be paid during the progress of the bankruptcy case, but they will accrue until confirmation of a plan of reorganization/liquidation and are generally paid at confirmation or such other time as the court orders unless the debtor voluntarily makes a payment. If the value of the collateral held by a secured creditor is less than the secured debt (including such creditor's secured debt and the secured debt of any creditor with a more senior security interest in the collateral), interest on the loan for the time period between the filing of the case and confirmation may be disallowed. Finally, while a lease generally would either be assumed, assumed and assigned, or rejected with all of its benefits and burdens intact, the terms of a mortgage, including the rate of interest and the timing of principal payments, may be modified under certain circumstances if the debtor is able to effect a "cram down" under the Bankruptcy Code. Before such a "cram down" is allowed, the Bankruptcy Court must conclude that the treatment of the secured creditor's claim is "fair and equitable."

### **If an operator files bankruptcy, our leases with the operator could be recharacterized as a financing agreement, which could negatively impact our rights under the lease.**

Another risk regarding our leases is that in an operator's bankruptcy the leases could be re-characterized as a financing agreement. In making such a determination, a bankruptcy court may consider certain factors, which may include, but are not necessarily limited to, the following:

- whether rent is calculated to provide a return on investment rather than to compensate the lessor for loss, use and possession of the property;
- whether the property is purchased specifically for the lessee's use or whether the lessee selected, inspected, contracted for, and received the property;
  - whether the transaction is structured solely to obtain tax advantages;
- whether the lessee is entitled to obtain ownership of the property at the expiration of the lease, and whether any option purchase price is unrelated to the value of the land; and
- whether the lessee assumed many of the obligations associated with outright ownership of the property, including responsibility for maintenance, repair, property taxes and insurance.





## Risk Factors

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If an operator defaults under one of our mortgage loans, we may have to foreclose on the mortgage or protect our interest by acquiring title to the property and thereafter making substantial improvements or repairs in order to maximize the facility's investment potential. Operators may contest enforcement of foreclosure or other remedies, seek bankruptcy protection against our exercise of enforcement or other remedies and/or bring claims for lender liability in response to actions to enforce mortgage obligations. If an operator seeks bankruptcy protection, the automatic stay provisions of the Bankruptcy Code would preclude us from enforcing foreclosure or other remedies against the operator unless relief is first obtained from the court having jurisdiction over the bankruptcy case. High "loan to value" ratios or declines in the value of the facility may prevent us from realizing an amount equal to our mortgage loan upon foreclosure.

### **Operators that fail to comply with the requirements of governmental reimbursement programs such as Medicare or Medicaid, licensing and certification requirements, fraud and abuse regulations or new legislative developments may be unable to meet their obligations to us.**

Our operators are subject to numerous federal, state and local laws and regulations that are subject to frequent and substantial changes (sometimes applied retroactively) resulting from legislation, adoption of rules and regulations, and administrative and judicial interpretations of existing law. The ultimate timing or effect of these changes cannot be predicted. These changes may have a dramatic effect on our operators' costs of doing business and on the amount of reimbursement by both government and other third-party payors. The failure of any of our operators to comply with these laws, requirements and regulations could adversely affect their ability to meet their obligations to us. In particular:

- *Medicare and Medicaid.* A significant portion of our SNF operators' revenue is derived from governmentally-funded reimbursement programs, primarily Medicare and Medicaid, and failure to maintain certification and accreditation in these programs would result in a loss of funding from such programs. Loss of certification or accreditation could cause the revenues of our operators to decline, potentially jeopardizing their ability to meet their obligations to us. In that event, our revenues from those facilities could be reduced, which could in turn cause the value of our affected properties to decline. State licensing and Medicare and Medicaid laws also require operators of nursing homes and assisted living facilities to comply with extensive standards governing operations. Federal and state agencies administering those laws regularly inspect such facilities and investigate complaints. Our operators and their managers receive notices of potential sanctions and remedies from time to time, and such sanctions have been imposed from time to time on facilities operated by them. If they are unable to cure deficiencies, which have been identified or which are identified in the future, such sanctions may be imposed and if imposed may adversely affect their ability to meet their obligations to us which could adversely affect our revenues.
- *Licensing and Certification.* Our operators and facilities are subject to regulatory and licensing requirements of federal, state and local authorities and are periodically audited by them to confirm compliance. Failure to obtain licensure or loss or suspension of licensure would prevent a facility from operating or result in a suspension of reimbursement payments until all licensure issues have been resolved and the necessary licenses obtained or reinstated. Our SNFs require governmental approval, in the form of a certificate of need that generally varies by state and is subject to change, prior to the addition or construction of new beds, the addition of services or certain capital expenditures. Some of our facilities may be unable to satisfy current and future certificate of need requirements and may for this reason be unable to continue operating in the future. In such event, our revenues from those facilities could be reduced or eliminated for an extended period of time or permanently.



## Risk Factors

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- Fraud and Abuse Laws and Regulations.* There are various extremely complex and largely uninterpreted federal and state laws governing a wide array of referrals, relationships and arrangements and prohibiting fraud by healthcare providers, including criminal provisions that prohibit filing false claims or making false statements to receive payment or certification under Medicare and Medicaid, or failing to refund overpayments or improper payments. Federal and state Governments are devoting increasing attention and resources to anti-fraud initiatives against healthcare providers. The Health Insurance Portability and Accountability Act of 1996 and the Balanced Budget Act expanded the penalties for healthcare fraud, including broader provisions for the exclusion of providers from the Medicare and Medicaid programs. Furthermore, the Office of Inspector General of the U.S. Department of Health and Human Services in cooperation with other federal and state agencies continues to focus on the activities of SNFs in certain states in which we have properties. In addition, the federal False Claims Act allows a private individual with knowledge of fraud to bring a claim on behalf of the federal government and earn a percentage of the federal government's recovery. Because of these incentives, these so-called "whistleblower" suits have become more frequent. The violation of any of these laws or regulations by an operator may result in the imposition of fines or other penalties that could jeopardize that operator's ability to make lease or mortgage payments to us or to continue operating its facility.
- Legislative and Regulatory Developments.* Each year, legislative proposals are introduced or proposed in Congress and in some state legislatures that would affect major changes in the healthcare system, either nationally or at the state level. The Medicare Prescription Drug, Improvement and Modernization Act of 2003, or Medicare Modernization Act, which is one example of such legislation, was enacted in late 2003. The Medicare reimbursement changes for the long term care industry under this Act are limited to a temporary increase in the per diem amount paid to SNFs for residents who have AIDS. The significant expansion of other benefits for Medicare beneficiaries under this Act, such as the expanded prescription drug benefit, could result in financial pressures on the Medicare program that might result in future legislative and regulatory changes with impacts for our operators. Other proposals under consideration include efforts by individual states to control costs by decreasing state Medicaid reimbursements, a federal "Patient Protection Act" to protect consumers in managed care plans, efforts to improve quality of care and reduce medical errors throughout the health care industry and cost-containment initiatives by public and private payors. We cannot accurately predict whether any proposals will be adopted or, if adopted, what effect, if any, these proposals would have on operators and, thus, our business.

Regulatory proposals and rules are released on an ongoing basis that may have major impacts on the healthcare system generally and the skilled nursing and long-term care industries in particular.

### **Our operators depend on reimbursement from governmental and other third-party payors and reimbursement rates from such payors may be reduced.**

Changes in the reimbursement rate or methods of payment from third-party payors, including the Medicare and Medicaid programs, or the implementation of other measures to reduce reimbursements for services provided by our operators has in the past, and could in the future, result in a substantial reduction in our operators' revenues and operating margins. Additionally, net revenue realizable under third-party payor agreements can change after examination and retroactive adjustment by payors during the claims settlement processes or as a result of post-payment audits. Payors may disallow requests for reimbursement based on determinations that certain costs are not reimbursable or reasonable or because additional documentation is necessary or because certain services were not covered or were not medically necessary. There also continue to be new legislative and regulatory proposals that could impose further limitations on government and private payments to healthcare providers. In some cases, states have



## Risk Factors

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enacted or are considering enacting measures designed to reduce their Medicaid expenditures and to make changes to private healthcare insurance. We cannot assure you that adequate reimbursement levels will continue to be available for the services provided by our operators, which are currently being reimbursed by Medicare, Medicaid or private third-party payors. Further limits on the scope of services reimbursed and on reimbursement rates could have a material adverse effect on our operators' liquidity, financial condition and results of operations, which could cause the revenues of our operators to decline and potentially jeopardize their ability to meet their obligations to us.

**Our operators may be subject to significant legal actions that could subject them to increased operating costs and substantial uninsured liabilities, which may affect their ability to pay their lease and mortgage payments to us.**

As is typical in the healthcare industry, our operators are often subject to claims that their services have resulted in resident injury or other adverse effects. Many of these operators have experienced an increasing trend in the frequency and severity of professional liability and general liability insurance claims and litigation asserted against them. The insurance coverage maintained by our operators may not cover all claims made against them nor continue to be available at a reasonable cost, if at all. In some states, insurance coverage for the risk of punitive damages arising from professional liability and general liability claims and/or litigation may not, in certain cases, be available to operators due to state law prohibitions or limitations of availability. As a result, our operators operating in these states may be liable for punitive damage awards that are either not covered or are in excess of their insurance policy limits. We also believe that there has been, and will continue to be, an increase in governmental investigations of long-term care providers, particularly in the area of Medicare/Medicaid false claims, as well as an increase in enforcement actions resulting from these investigations. Insurance is not available to cover such losses. Any adverse determination in a legal proceeding or governmental investigation, whether currently asserted or arising in the future, could have a material adverse effect on an operator's financial condition. If an operator is unable to obtain or maintain insurance coverage, if judgments are obtained in excess of the insurance coverage, if an operator is required to pay uninsured punitive damages, or if an operator is subject to an uninsurable government enforcement action, the operator could be exposed to substantial additional liabilities.

**Increased competition as well as increased operating costs due to competition for qualified employees have resulted in lower revenues for some of our operators and may affect the ability of our tenants to meet their payment obligations to us.**

The healthcare industry is highly competitive and we expect that it may become more competitive in the future. Our operators are competing with numerous other companies providing similar healthcare services or alternatives such as home health agencies, life care at home, community-based service programs, retirement communities and convalescent centers. We cannot be certain the operators of all of our facilities will be able to achieve occupancy and rate levels that will enable them to meet all of their obligations to us. Our operators may encounter increased competition in the future that could limit their ability to attract residents or expand their businesses and therefore affect their ability to pay their lease or mortgage payments.

The market for qualified nurses, healthcare professionals and other key personnel is highly competitive and our operators may experience difficulties in attracting and retaining qualified personnel. Increases in labor costs due to higher wages and greater benefits required to attract and retain qualified healthcare personnel incurred by our operators could affect their ability to pay their lease or mortgage payments. This situation could be particularly acute in certain states that have enacted legislation establishing minimum staffing requirements.

## Risk Factors

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### RISKS RELATED TO US AND OUR OPERATIONS

In addition to the operator related risks discussed above, there are a number of risks directly associated with us and our operations.

**In connection with the restatement of our financial statements for the year ended December 31, 2005, we identified a material weakness in our internal control over financial reporting, which could materially and adversely affect our business and financial condition.**

In connection with the restatement of our financial statements for the year ended December 31, 2005, our management identified a material weakness in internal control over financial reporting and as of December 31, 2006 we still have not concluded that our internal control over financial reporting is effective. Our management determined that as of December 31, 2005, we lacked sufficient internal control processes, procedures and personnel resources necessary to address accounting for certain complex and/or non-routine transactions. This material weakness resulted in errors in accounting for financial instruments, income taxes and straight-line rental revenue and could result in a material misstatement to our consolidated financial statements that would not be prevented or detected on a timely basis. Due to this material weakness, management concluded that we did not maintain effective internal control over financial reporting as of December 31, 2005.

While we have engaged in, and continue to engage in, substantial efforts to address the material weakness in our internal control over financial reporting, as of December 31, 2006, we have not concluded that our internal control over financial reporting is effective. We cannot be certain that any remedial measures we have taken or plan to take will ensure that we design, implement and maintain adequate controls over our financial processes and reporting in the future or will be sufficient to address and eliminate the material weakness. Our inability to remedy this identified material weakness or any additional deficiencies or material weaknesses that may be identified in the future, could, among other things, cause us to fail to file our periodic reports with the SEC in a timely manner or require us to incur additional costs or to divert management resources. Due to its inherent limitations, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation and presentation. These limitations may not prevent or detect all misstatements or fraud, regardless of their effectiveness.

**We rely on external sources of capital to fund future capital needs, and if we encounter difficulty in obtaining such capital, we may not be able to make future investments necessary to grow our business or meet maturing commitments.**

In order to qualify as a REIT under the Internal Revenue Code of 1986, as amended, or the Code, we are required, among other things, to distribute each year to our stockholders at least 90% of our REIT taxable income. Because of this distribution requirement, we may not be able to fund, from cash retained from operations, all future capital needs, including capital needs to make investments and to satisfy or refinance maturing commitments. As a result, we rely on external sources of capital, including debt and equity financing. If we are unable to obtain needed capital at all or only on unfavorable terms from these sources, we might not be able to make the investments needed to grow our business, or to meet our obligations and commitments as they mature, which could negatively affect the ratings of our debt and even, in extreme circumstances, affect our ability to continue operations. Our access to capital depends upon a number of factors over which we have little or no control, including general market conditions and the market's perception of our results of operations, growth potential and our current and potential future earnings and cash distributions and the market price of the shares of our capital stock. Generally speaking, difficult capital market conditions in our industry during the past several years have limited our access to capital. The "related party tenant" issue discussed in "Note 10 - Taxes" to our consolidated financial statements for the year ended December 31, 2006 included elsewhere in this Prospectus may make it more difficult for

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## Risk Factors

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us to raise additional capital unless and until we enter into a closing agreement with the Internal Revenue Service or IRS, or otherwise resolve such issue. While we currently have sufficient cash flow from operations to fund our obligations and commitments, we may not be in position to take advantage of attractive investment opportunities for growth in the event that we are unable to access the capital markets on a timely basis or we are only able to obtain financing on unfavorable terms.

**Our ability to raise capital through sales of equity is dependent, in part, on the market price of our common stock, and failure to meet market expectations with respect to our business could negatively impact the market price of our common stock and limit our ability to sell equity.**

The availability of equity capital to us will depend, in part, on the market price of our common stock which, in turn, will depend upon various market conditions and other factors that may change from time to time including:

- the extent of investor interest;
- the general reputation of REITs and the attractiveness of their equity securities in comparison to other equity securities, including securities issued by other real estate-based companies;
- our financial performance and that of our operators;
- the contents of analyst reports about us and the REIT industry;
- general stock and bond market conditions, including changes in interest rates on fixed income securities, which may lead prospective purchasers of our common stock to demand a higher annual yield from future distributions;
- our failure to maintain or increase our dividend, which is dependent, to a large part, on growth of funds from operations which in turn depends upon increased revenues from additional investments and rental increases; and
- other factors such as governmental regulatory action and changes in REIT tax laws.

The market value of the equity securities of a REIT is generally based upon the market's perception of the REIT's growth potential and its current and potential future earnings and cash distributions. Our failure to meet the market's expectation with regard to future earnings and cash distributions would likely adversely affect the market price of our common stock.

**We are subject to risks associated with debt financing, which could negatively impact our business, limit our ability to make distributions to our stockholders and to repay maturing debt.**

Financing for future investments and our maturing commitments may be provided by borrowings under our Credit Facility, private or public offerings of debt, the assumption of secured indebtedness, mortgage financing on a portion of our owned portfolio or through joint ventures. We are subject to risks normally associated with debt financing, including the risks that our cash flow will be insufficient to make timely payments of interest, that we will be unable to refinance existing indebtedness and that the terms of refinancing will not be as favorable as the terms of existing indebtedness. If we are unable to refinance or extend principal payments due at maturity or pay them with proceeds from other capital transactions, our cash flow may not be sufficient in all years to pay distributions to our stockholders and to repay all maturing debt. Furthermore, if prevailing interest rates, changes in our debt ratings or other factors at the time of refinancing result in higher interest rates upon refinancing, the interest expense relating to that refinanced indebtedness would increase, which could reduce our profitability and the amount of dividends we are able to pay. Moreover, additional debt financing increases the amount of our leverage.



## Risk Factors

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### **Certain of our operators account for a significant percentage of our real estate investment and revenues.**

At December 31, 2006, approximately 25% of our real estate investments were operated by two public companies: Sun Healthcare Group, Inc., or Sun (17%), and Advocat, Inc. or Advocat (8%). Our largest private company operators (by investment) were CommuniCare Health Services, Inc., or CommuniCare (15%), Haven Eldercare, LLC, or Haven (9%), Home Quality Management, Inc., or HQM (8%), Guardian LTC Management, Inc., or Guardian (7%), Nexion Health, Inc., or Nexion (6%) and Essex Healthcare Corporation (6%). No other operator represents more than 4% of our investments.

For the year ended December 31, 2006, our revenues from operations totaled \$135.7 million, of which approximately \$25.1 million were from Sun (19%), \$20.3 million from CommuniCare (15%) and \$15.3 million from Advocat (11%). No other operator generated more than 9% of our revenues from operations for the year ended December 31, 2006.

The failure or inability of any of these operators to pay their obligations to us could materially reduce our revenues and net income, which could in turn reduce the amount of dividends we pay and cause our stock price to decline.

### **The geographic concentration of our investments could leave us vulnerable to an economic downturn, regulatory changes or acts of nature in those areas, resulting in a decrease in our revenues or otherwise negatively impacting our results of operations.**

For the year ended December 31, 2006, the three states in which we had our highest concentration of investments were Ohio (22%), Florida (14%) and Pennsylvania (9%). As a result of this concentration, the conditions of local economies and real estate markets, changes in governmental rules and regulations, particularly with respect to Medicaid, acts of nature and other factors that may result in a decrease in demand for long-term care services in these states could have an adverse effect on our operators' revenues, costs and results of operations, which may limit their ability to meet their obligations to us. In addition, since some of these investments are located in Florida, our operators are particularly susceptible to revenue loss, cost increase or damage caused by hurricanes or other severe weather conditions or natural disasters. Any significant loss due to a natural disaster may not be covered by insurance and may lead to an increase in the cost of insurance for our operators.

### **Unforeseen costs associated with the acquisition of new properties could reduce our profitability.**

Our business strategy contemplates future acquisitions that may not prove to be successful. For example, we might encounter unanticipated difficulties and expenditures relating to any acquired properties, including contingent liabilities, or newly acquired properties might require significant management attention that would otherwise be devoted to our ongoing business. If we agree to provide funding to enable healthcare operators to build, expand or renovate facilities on our properties and the project is not completed, we could be forced to become involved in the development to ensure completion or we could lose the property. These costs may negatively affect our results of operations.

### **Our assets may be subject to impairment charges.**

We periodically, but not less than annually, evaluate our real estate investments and other assets for impairment indicators. The judgment regarding the existence of impairment indicators is based on factors such as market conditions, operator performance and legal structure. If we determine that a significant impairment has occurred, we would be required to make an adjustment to the net carrying value of the asset, which could have a material adverse affect on our results of operations and funds from operations in the period in which the write-off occurs. During the year ended December 31, 2006, we recognized an impairment loss associated with three facilities for approximately \$0.5 million.



## Risk Factors

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### **We may not be able to sell certain closed facilities for their book value.**

From time to time, we close facilities and actively market such facilities for sale. To the extent we are unable to sell these properties for our book value; we may be required to take a non-cash impairment charge or loss on the sale, either of which would reduce our net income.

### **Our substantial indebtedness could adversely affect our financial condition.**

We have substantial indebtedness and we may increase our indebtedness in the future. As of December 31, 2006, we had total debt of approximately \$676 million, of which \$150 million consisted of borrowings under our Credit Facility, \$310 million of which consisted of our 7% senior notes due 2014 and \$175 million of which consisted of our 7% senior notes due 2016 and \$39 million of non-recourse debt to us resulting from the consolidation of a variable interest entity, or VIE, in accordance with Financial Accounting Standards Board Interpretation No. 46R, *Consolidation of Variable Interest Entities*, or FIN 46R. Our level of indebtedness could have important consequences to our stockholders. For example, it could:

- limit our ability to satisfy our obligations with respect to holders of our capital stock;
- limit our ability to satisfy the distribution requirements applicable to REITs;
- increase our vulnerability to general adverse economic and industry conditions;
- limit our ability to obtain additional financing to fund future working capital, capital expenditures and other general corporate requirements, or to carry out other aspects of our business plan;
- require us to dedicate a substantial portion of our cash flow from operations to payments on indebtedness, thereby reducing the availability of such cash flow to fund working capital, capital expenditures and other general corporate requirements, or to carry out other aspects of our business plan;
  - require us to pledge as collateral substantially all of our assets;
- require us to maintain certain debt coverage and financial ratios at specified levels, thereby reducing our financial flexibility;
- limit our ability to make material acquisitions or take advantage of business opportunities that may arise;
- expose us to fluctuations in interest rates, to the extent our borrowings bear variable rates of interests;
- limit our flexibility in planning for, or reacting to, changes in our business and industry; and
- place us at a competitive disadvantage compared to our competitors that have less debt.

### **Our real estate investments are relatively illiquid.**

Real estate investments are relatively illiquid and, therefore, tend to limit our ability to vary our portfolio promptly in response to changes in economic or other conditions. All of our properties are “special purpose” properties that could not be readily converted to general residential, retail or office use. Healthcare facilities that participate in Medicare or Medicaid must meet extensive program requirements, including physical plant and operational requirements, which are revised from time to time. Such requirements may include a duty to admit Medicare and Medicaid patients, limiting the ability of the facility to increase its private pay census beyond certain limits. Medicare and Medicaid facilities are



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regularly inspected to determine compliance and may be excluded from the programs—in some cases without a prior hearing—for failure to meet program requirements. Transfers of operations of nursing homes and other healthcare-related facilities are subject to regulatory approvals not required for transfers of other types of commercial operations and other types of real estate. Thus, if the operation of any of our properties becomes unprofitable due to competition, age of improvements or other factors such that our lessee or mortgagor becomes unable to meet its obligations on the lease or mortgage loan, the liquidation value of the property may be substantially less, particularly relative to the amount owing on any related mortgage loan, than would be the case if the property were readily adaptable to other uses. The receipt of liquidation proceeds or the replacement of an operator that has defaulted on its lease or loan could be delayed by the approval process of any federal, state or local agency necessary for the transfer of the property or the replacement of the operator with a new operator licensed to manage the facility. In addition, certain significant expenditures associated with real estate investment, such as real estate taxes and maintenance costs, are generally not reduced when circumstances cause a reduction in income from the investment. Should such events occur, our income and cash flows from operations would be adversely affected.

### **As an owner or lender with respect to real property, we may be exposed to possible environmental liabilities.**

Under various federal, state and local environmental laws, ordinances and regulations, a current or previous owner of real property or a secured lender, such as us, may be liable in certain circumstances for the costs of investigation, removal or remediation of, or related releases of, certain hazardous or toxic substances at, under or disposed of in connection with such property, as well as certain other potential costs relating to hazardous or toxic substances, including government fines and damages for injuries to persons and adjacent property. Such laws often impose liability without regard to whether the owner knew of, or was responsible for, the presence or disposal of such substances and liability may be imposed on the owner in connection with the activities of an operator of the property. The cost of any required investigation, remediation, removal, fines or personal or property damages and the owner's liability therefore could exceed the value of the property and/or the assets of the owner. In addition, the presence of such substances, or the failure to properly dispose of or remediate such substances, may adversely affect our operators' ability to attract additional residents, the owner's ability to sell or rent such property or to borrow using such property as collateral which, in turn, would reduce the owner's revenues.

Although our leases and mortgage loans require the lessee and the mortgagor to indemnify us for certain environmental liabilities, the scope of such obligations may be limited. For instance, most of our leases do not require the lessee to indemnify us for environmental liabilities arising before the lessee took possession of the premises. Further, we cannot assure you that any such mortgagor or lessee would be able to fulfill its indemnification obligations.

### **The industry in which we operate is highly competitive. This competition may prevent us from raising prices at the same pace as our costs increase.**

We compete for additional healthcare facility investments with other healthcare investors, including other REITs. The operators of the facilities compete with other regional or local nursing care facilities for the support of the medical community, including physicians and acute care hospitals, as well as the general public. Some significant competitive factors for the placing of patients in skilled and intermediate care nursing facilities include quality of care, reputation, physical appearance of the facilities, services offered, family preferences, physician services and price. If our cost of capital should increase relative to the cost of capital of our competitors, the spread that we realize on our investments may decline if competitive pressures limit or prevent us from charging higher lease or mortgage rates.

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We are named as defendants in litigation arising out of professional liability and general liability claims relating to our previously owned and operated facilities that if decided against us, could adversely affect our financial condition.

We and several of our wholly-owned subsidiaries have been named as defendants in professional liability and general liability claims related to our owned and operated facilities. Other third-party managers responsible for the day-to-day operations of these facilities have also been named as defendants in these claims. In these suits, patients of certain previously owned and operated facilities have alleged significant damages, including punitive damages, against the defendants. The lawsuits are in various stages of discovery and we are unable to predict the likely outcome at this time. We continue to vigorously defend these claims and pursue all rights we may have against the managers of the facilities, under the terms of the management agreements. We have insured these matters, subject to self-insured retentions of various amounts. There can be no assurance that we will be successful in our defense of these matters or in asserting our claims against various managers of the subject facilities or that the amount of any settlement or judgment will be substantially covered by insurance or that any punitive damages will be covered by insurance.

### **We are subject to significant anti-takeover provisions.**

Our articles of incorporation and bylaws contain various procedural and other requirements which could make it difficult for stockholders to effect certain corporate actions. Our Board of Directors is divided into three classes and the members of our Board of Directors are elected for terms that are staggered. Our Board of Directors also has the authority to issue additional shares of preferred stock and to fix the preferences, rights and limitations of the preferred stock without stockholder approval. We have also adopted a stockholders rights plan which provides for share purchase rights to become exercisable at a discount if a person or group acquires more than 9.9% of our common stock or announces a tender or exchange offer for more than 9.9% of our common stock. These provisions could discourage unsolicited acquisition proposals or make it more difficult for a third party to gain control of us, which could adversely affect the market price of our securities.

### **We may change our investment strategies and policies and capital structure.**

Our Board of Directors, without the approval of our stockholders, may alter our investment strategies and policies if it determines in the future that a change is in our stockholders' best interests. The methods of implementing our investment strategies and policies may vary as new investments and financing techniques are developed.

### **We depend upon our key employees and may be unable to attract or retain sufficient numbers of qualified personnel.**

Our future performance depends to a significant degree upon the continued contributions of our executive management team and other key employees. Accordingly, our future success depends on our ability to attract, hire, train and retain highly skilled management and other qualified personnel. Competition for qualified employees is intense, and we compete for qualified employees with companies that may have greater financial resources than we have. Our employment agreements with our executive officers provide that their employment may be terminated by either party at any time. Consequently, we may not be successful in attracting, hiring, and training and retaining the people we need, which would seriously impede our ability to implement our business strategy.



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### **In the event we are unable to satisfy regulatory requirements relating to internal controls, or if these internal controls over financial reporting are not effective, our business could suffer.**

Section 404 of the Sarbanes-Oxley Act of 2002 requires companies to do a comprehensive evaluation of their internal controls. As a result, each year we evaluate our internal controls over financial reporting so that our management can certify as to the effectiveness of our internal controls and our auditor can publicly attest to this certification. Our efforts to comply with Section 404 and related regulations regarding our management's required assessment of internal control over financial reporting and our independent auditors' attestation of that assessment has required, and continues to require, the commitment of significant financial and managerial resources. If for any period our management is unable to ascertain the effectiveness of our internal controls or if our auditors cannot attest to management's certification, we could be subject to regulatory scrutiny and a loss of public confidence, which could have an adverse effect on our business.

## **RISKS RELATED TO OUR STOCK**

### **The market value of our stock could be substantially affected by various factors.**

The share price of our stock will depend on many factors, which may change from time to time, including:

- the market for similar securities issued by REITs;
- changes in estimates by analysts;
- our ability to meet analysts' estimates;
- general economic and financial market conditions; and
- our financial condition, performance and prospects.

### **Our issuance of additional capital stock, warrants or debt securities, whether or not convertible, may reduce the market price for our shares.**

We cannot predict the effect, if any, that future sale of our capital stock, warrants or debt securities, or the availability of our securities for future sale, will have on the market price of our shares, including our common stock. Sales of substantial amounts of our common stock or preferred shares, warrants or debt securities convertible into or exercisable or exchangeable for common stock in the public market or the perception that such sales might occur could reduce the market price of our stock and the terms upon which we may obtain additional equity financing in the future.

In addition, we may issue additional capital stock in the future to raise capital or as a result of the following:

- The issuance and exercise of options to purchase our common stock. As of December 31, 2006, we had outstanding options to acquire approximately 0.1 million shares of our common stock. In addition, we may in the future issue additional options or other securities convertible into or exercisable for our common stock under our 2004 Stock Incentive Plan, our 2000 Stock Incentive Plan, as amended, or other remuneration plans we establish in the future. We may also issue options or convertible securities to our employees in lieu of cash bonuses or to our directors in lieu of director's fees.
  - The issuance of shares pursuant to our dividend reinvestment and direct stock purchase plan.
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- The issuance of debt securities exchangeable for our common stock.

- The exercise of warrants we may issue in the future.

- Lenders sometimes ask for warrants or other rights to acquire shares in connection with providing financing. We cannot assure you that our lenders will not request such rights.

### **There are no assurances of our ability to pay dividends in the future.**

In 2001, our Board of Directors suspended dividends on our common stock and all series of preferred stock in an effort to generate cash to address then impending debt maturities. In 2003, we paid all accrued but unpaid dividends on all series of preferred stock and reinstated dividends on our common stock and all series of preferred stock. However, our ability to pay dividends may be adversely affected if any of the risks described above were to occur. Our payment of dividends is subject to compliance with restrictions contained in our Credit Facility, the indenture relating to our outstanding 7% senior notes due 2014, the indenture relating to our outstanding 7% senior notes due 2016 and our preferred stock. All dividends will be paid at the discretion of our Board of Directors and will depend upon our earnings, our financial condition, maintenance of our REIT status and such other factors as our Board may deem relevant from time to time. There are no assurances of our ability to pay dividends in the future. In addition, our dividends in the past have included, and may in the future include, a return of capital.

### **Holders of our outstanding preferred stock have liquidation and other rights that are senior to the rights of the holders of our common stock.**

Our Board of Directors has the authority to designate and issue preferred stock that may have dividend, liquidation and other rights that are senior to those of our common stock. As of the date of this filing, 4,739,500 shares of our 8.375% Series D cumulative redeemable preferred stock were issued and outstanding. The aggregate liquidation preference with respect to this outstanding preferred stock is approximately \$118.5 million, and annual dividends on our outstanding preferred stock are approximately \$9.9 million. Holders of our preferred stock are generally entitled to cumulative dividends before any dividends may be declared or set aside on our common stock. Upon our voluntary or involuntary liquidation, dissolution or winding up, before any payment is made to holders of our common stock, holders of our preferred stock are entitled to receive a liquidation preference of \$25 per share with respect to the Series D preferred stock, plus any accrued and unpaid distributions. This will reduce the remaining amount of our assets, if any, available to distribute to holders of our common stock. In addition, holders of our preferred stock have the right to elect two additional directors to our Board of Directors if six quarterly preferred dividends are in arrears.

## TAX RISKS

### **We have submitted to the Internal Revenue Service a request for a closing agreement and may not be able to obtain a closing agreement on satisfactory terms.**

Management believes that certain of the terms of the Advocat Series B preferred stock previously held by us could be interpreted as affecting our compliance with federal income tax rules applicable to REITs regarding related party tenant income. See Note 10 - Taxes to our consolidated financial statements for the year ended December 31, 2006 included elsewhere herein.

In the fourth quarter of 2006, we were advised by tax counsel that, due to certain provisions of the Series B preferred stock issued to us by Advocat in 2000 in connection with a restructuring, Advocat may be considered to be a “related party tenant” under the rules applicable to REITs and, in such event, rental income received by us from Advocat would not be qualifying income for purposes of the REIT gross income tests. While we believe that there are valid arguments that Advocat should not be a “related party



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tenant,” if Advocat is so treated, we would have failed to satisfy the 95% gross income tests during certain prior taxable years. Such a failure would have prevented us from maintaining REIT tax status during such years and from re-electing tax status for a number of taxable years. In such event, our failure to satisfy the REIT gross income tests would not result in the loss of REIT status, however, if the failure was due to reasonable cause and not to willful neglect, and we pay a tax on the non-qualifying income. Accordingly, on the advice of tax counsel in order to resolve the matter, minimize potential penalties, and obtain assurances regarding our continued REIT tax status, we submitted to the IRS a request for a closing agreement on December 15, 2006, which agreement would conclude that any failure to satisfy the gross income tests would be due to reasonable cause and not to willful neglect. Since that time, we have had ongoing conversations with the IRS and we have submitted additional documentation in furtherance of the issuance of a closing agreement, but, to date, we have not yet entered into a closing agreement with respect to the related party tenant issue with the IRS. We intend to continue to pursue a closing agreement with the IRS.

As noted above, we have completed the Second Advocat Restructuring and have been advised by tax counsel that we will not receive any non-qualifying related party tenant income from Advocat in future fiscal years. Accordingly, we do not expect to incur tax expense associated with related party tenant income in future periods commencing January 1, 2007, assuming we enter into a closing agreement with the IRS that recognizes that reasonable cause existed for any failure to satisfy the REIT gross income tests as explained above.

We have accrued \$5.6 million at December 31, 2006 for a potential tax liability, including interest, arising from our ownership of the Advocat securities and we believe, but can provide no assurance, that we currently have sufficient assets to pay any such tax liabilities. The ultimate resolution of any controversy over potential tax liabilities covered by the closing agreement may have a material adverse effect on our financial position, results of operations or cash flows, including if we are required to distribute deficiency dividends to our stockholders and/or pay additional taxes, interest and penalties to the IRS in amounts that exceed the amount of our reserves for potential tax liabilities. There can be no assurance that the IRS will not assess us with substantial taxes, interest and penalties above the amount for which we have reserved. For further discussion, see Note 10 - Taxes to our consolidated financial statements for the year ended December 31, 2006 included elsewhere herein.

### **If we fail to maintain our REIT status, we will be subject to federal income tax on our taxable income at regular corporate rates.**

We were organized to qualify for taxation as a REIT under Sections 856 through 860 of the Code. Our policy has been and is to operate in a such manner as to qualify as a REIT for Federal income tax purposes. We believe we have conducted, and we intend to continue to conduct, our operations so as to qualify as a REIT. Qualification as a REIT involves the satisfaction of numerous requirements, some on an annual and some on a quarterly basis, established under highly technical and complex provisions of the Code for which there are only limited judicial and administrative interpretations and involve the determination of various factual matters and circumstances not entirely within our control. We cannot assure you that we will at all times satisfy these rules and tests.

We have received an opinion of Powell Goldstein LLP to the effect that, in the event that Advocat is considered to be a “related party tenant” under the applicable REIT rules, our failure to meet the gross income tests for each applicable year as a result of our receipt of the Advocat stock in the 2000 restructuring and our ownership of such stock thereafter through the date of the Second Advocat Restructuring will be found to be due to reasonable cause and not due to willful neglect. Further, such opinion states to the effect that from and including the Company's taxable year December 31, 1992, the Company was and is organized in conformity with the requirements for its actual method of operation through the date hereof has permitted, and its proposed method of operations as described in this



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Registration Statement will permit the Company to meet the requirements for qualification and taxation as a REIT. A copy of this opinion is filed as an exhibit to the registration statement of which this prospectus is a part. It must be emphasized that the opinion of Powell Goldstein LLP is based on various assumptions relating to our organization and operation, and is conditioned upon representations and covenants made by our management regarding our income and assets, and the past, present, and future conduct of our business operations. While we intend to operate so that we qualify as a REIT, given the highly complex nature of the rules governing REITs, the ongoing factual determinations, and the possibility of future changes in our circumstances, no assurance can be given by Powell Goldstein LLP or by us that we will so qualify for any particular year. The opinion of Powell Goldstein LLP is expressed as of the date issued, and will not cover subsequent periods. Powell Goldstein LLP is not obligated to advise us or the holders of our securities of any subsequent change in the matters stated, represented or assumed, or of any subsequent change of applicable law. You should be aware that opinions of counsel are not binding on the IRS or any court, and no assurance can be given that the IRS will not challenge or a court will not rule contrary to the conclusions set forth in such opinions.

If we were to fail to qualify as a REIT for any taxable year, we would be subject to federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates for such year, and distributions to stockholders would not be deductible by us in computing our taxable income. Any such corporate tax liability could be substantial and would reduce the amount of cash we have available for distribution to our stockholders, which in turn could have a material adverse impact on the value of, and trading prices for, our securities. In addition, we would not be able to re-elect REIT status until the fifth taxable year following the initial year of disqualification unless we were to qualify for relief under applicable Code provisions. Thus, for example, if the IRS successfully challenges our status as a REIT solely for our taxable year ended December 31, 2005 based on our ownership of the Advocat Series B preferred stock, we would not be able to re-elect REIT status until our taxable year which began January 1, 2010, unless we were to qualify for relief.

### **Even if we remain qualified as a REIT, we may face other tax liabilities that reduce our cash flow.**

Even if we remain qualified for taxation as a REIT, we may be subject to certain federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure, and state or local income, property and transfer taxes. Any of these taxes would decrease cash available for the payment of our debt obligations. In addition, we may derive income through our Taxable REIT Subsidiaries, or TRSs, which would be subject to corporate level income tax at regular rates.

### **Complying with REIT requirements may affect our profitability.**

To qualify as a REIT for federal income tax purposes, we must continually satisfy tests concerning, among other things, the nature and diversification of our assets, the sources of our income and the amounts we distribute to our stockholders. Thus, we may be required to liquidate otherwise attractive investments from our portfolio in order to satisfy the asset and income tests or to qualify under certain statutory relief provisions. We also may be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution (e.g., if we have assets which generate mismatches, including timing differences, between taxable income and available cash). As a result, having to comply with the distribution requirement could cause us to: (i) sell assets in adverse market conditions; (ii) borrow on unfavorable terms; or (iii) distribute amounts that would otherwise be invested in future acquisitions, capital expenditures, or repayment of debt. Accordingly, satisfying the REIT requirements could have an adverse effect on our business results and profitability.

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### **Dividends payable by REITs do not qualify for the reduced tax rates applicable for some dividends.**

The Jobs and Growth Tax Relief Reconciliation Act of 2003 generally reduces to 15% the maximum marginal rate of tax payable by individuals on dividends received from a regular C corporation. This reduced tax rate, however, will not apply to dividends paid to individuals by a REIT on its shares, except with respect to certain limited portions of such dividends, if at all. While the earnings of a REIT that are distributed to its stockholders still generally will be subject to less combined federal income taxation than earnings of a non-REIT C corporation that are distributed to its stockholders net of corporate-level tax, this legislation could cause individual investors to view the stock of regular C corporations as more attractive relative to the shares of a REIT than was the case prior to the enactment of the legislation. Individual investors could hold this view because the dividends from regular C corporations will generally be taxed at a lower rate while dividends from REITs will generally be taxed at the same rate as the individual's other ordinary income. We cannot predict what effect, if any, the enactment of this legislation may have on the value of the shares of REITs in general or on the value of our stock in particular, either in terms of price or relative to other investments.

### **REIT distribution requirements could adversely affect our ability to execute our business plan.**

We generally must distribute annually at least 90% of our taxable income, subject to certain adjustments and excluding any net capital gain, in order for federal corporate income tax not to apply to earnings that we distribute. To the extent that we do not distribute all of our net capital gain or do distribute at least 90%, but less than 100% of our "REIT taxable income," as adjusted, we will be subject to tax thereon at regular ordinary and capital gain corporate tax rates. To the extent that we satisfy this distribution requirement, but distribute less than 100% of our taxable income, we will be subject to federal corporate income tax on our undistributed taxable income. In addition, we will be subject to a 4% nondeductible excise tax if the actual amount that we pay out to our stockholders in a calendar year is less than a minimum amount specified under federal tax laws. We intend to make distributions to our stockholders to comply with the REIT requirements of the Internal Revenue Code.

### **Complying with REIT requirements with respect to our TRS limits our flexibility in operating or managing certain properties through our TRS.**

A TRS may not directly or indirectly operate or manage a healthcare facility. For REIT qualification purposes, the definition of a "healthcare facility" means a hospital, nursing facility, assisted living facility, congregate care facility, qualified continuing care facility, or other licensed facility which extends medical or nursing or ancillary services to patients and which, immediately before the termination, expiration, default, or breach of the lease of or mortgage secured by such facility, was operated by a provider of such services which was eligible for participation in the Medicare program under Title XVIII of the Social Security Act with respect to such facility. Thus, compliance with the REIT requirements may limit our flexibility in executing our business plan. Moreover, if the IRS were to treat a subsidiary corporation of ours as directly or indirectly operating or managing a healthcare facility, such subsidiary would not qualify as a TRS, which could jeopardize our REIT qualification under the REIT gross asset tests.

### **We may not be able to find a suitable tenant for our healthcare property, which could reduce our cash flow.**

We may not be able to find another qualified tenant for a property if we have to replace a tenant. Accordingly, if we are unable to find a qualified tenant for one or more of our properties, rental payments could cease which could have a significant impact on our operating results and financial condition, in



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which case we could be required to sell such properties or terminate our qualification as a REIT. While the REIT rules regarding foreclosure property allow us to acquire certain qualified healthcare property as the result of the termination or expiration of a lease (other than by reason of default, or the imminence of default, on the lease) of such property and, in connection with such acquisition, to operate a qualified healthcare facility through, and in certain circumstances derive income from, a qualified independent contractor for a period of two years (or up to six years if extensions are granted), once such period ends, the REIT rules prohibit the direct or indirect operation or management of such facility through our TRS. If the IRS were to treat our TRS as directly or indirectly operating or managing a qualified healthcare facility, such subsidiary would not qualify as a TRS, which could jeopardize our REIT qualification under the REIT gross asset tests.

### **Complying with REIT requirements may cause us to forgo otherwise attractive opportunities.**

To qualify as a REIT for federal income tax purposes, we continually must satisfy tests concerning, among other things, the sources of our income, the nature and diversification of our assets, the amounts we distribute to our stockholders and the ownership of our stock. We may be unable to pursue investments that would be otherwise advantageous to us in order to satisfy the source-of-income, asset-diversification or distribution requirements for qualifying as a REIT. Thus, compliance with the REIT requirements may hinder our ability to make certain attractive investments.

### **Complying with REIT requirements may force us to liquidate otherwise attractive investments.**

To qualify as a REIT for federal income tax purposes, we must ensure that at the end of each calendar quarter, at least 75% of the value of our assets consists of cash, cash items, government securities and qualified REIT real estate assets, including certain mortgage loans and mortgage backed securities. The remainder of our investment in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 20% of the value of our total securities can be represented by securities of one or more TRSs. See “Federal Income Tax Considerations—Taxation of Omega.” If we fail to comply with these requirements at the end of any calendar quarter, we must correct the failure within 30 days after the end of the calendar quarter or qualify for certain statutory relief provisions to avoid losing our REIT qualification and suffering adverse tax consequences. As a result, we may be required to liquidate from our portfolio otherwise attractive investments. These actions could have the effect of reducing our income and amounts available for distribution to our stockholders.

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**New legislation or administrative or judicial action, in each instance potentially with retroactive effect, could make it more difficult or impossible for us to qualify as a REIT.**

You should recognize that the present federal income tax treatment of REITs may be modified, possibly with retroactive effect, by legislative, judicial or administrative action at any time, which could affect the federal income tax treatment of an investment in us. The federal income tax rules that affect REITs constantly are under review by persons involved in the legislative process, the IRS and the U.S. Treasury Department, which results in statutory changes as well as frequent revisions to regulations and interpretations. Revisions in federal tax laws and interpretations thereof could cause us to change our investments and commitments and affect the tax considerations of an investment in us. Any of these changes could have an adverse effect on an investment in our stock or on market value or resale potential. Stockholders are urged to consult with their own tax advisor with respect to the impact that recent legislation may have on their investment and the status of legislative, regulatory or administrative developments and proposals and their potential effect.

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**Cautionary language regarding forward-looking statements**

This prospectus includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements other than statements of historical facts included in this prospectus may constitute forward-looking statements. These statements relate to our expectations, beliefs, intentions, plans, objectives, goals, strategies, future events, performance and underlying assumptions and other statements other than statements of historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology including, but not limited to, terms such as “may,” “will,” “anticipates,” “expects,” “believes,” “intends,” “should” or comparable terms or the negative thereof. These statements are based on information available on the date of this filing and only speak as to the date hereof and no obligation to update such forward-looking statements should be assumed. Our actual results may differ materially from those reflected in the forward-looking statements contained herein as a result of a variety of factors, including, among other things:

- uncertainties relating to the business operations of the operators of our assets, including those relating to reimbursement by third-party payors, regulatory matters and occupancy levels;
- the ability of any operators in bankruptcy to reject unexpired lease obligations, modify the terms of our mortgages and impede our ability to collect unpaid rent or interest during the process of a bankruptcy proceeding and retain security deposits for the debtors’ obligations;
- our ability to sell closed assets on a timely basis and on terms that allow us to realize the carrying value of these assets;
  - our ability to negotiate appropriate modifications to the terms of our Credit Facility;
  - our ability to manage, re-lease or sell any owned and operated facilities;
    - the availability and cost of capital;
    - competition in the financing of healthcare facilities;
    - regulatory and other changes in the healthcare sector;
- the effect of economic and market conditions generally and, particularly, in the healthcare industry;
  - changes in interest rates;
  - the amount and yield of any additional investments;
  - changes in tax laws and regulations affecting REITs;
- our ability to maintain our status as a real estate investment trust; and
  - changes in the ratings of our debt and preferred securities.

Any subsequent written or oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements set forth or referred to above, as well as the risk

factors contained in this prospectus. Except as required by law, we disclaim any obligation to update such statements or to publicly announce the result of any revisions to any of the forward-looking statements contained in this prospectus to reflect future events or developments.

### **Use of proceeds**

Our net proceeds from the sale of the shares of common stock, after deducting underwriting discounts and commissions and other expenses of this offering payable by us, are estimated to be approximately \$98.2 million (\$113.0 million if the underwriters' over-allotment option is exercised in full), based on a public offering price of \$16.75 per share. We intend to use all of the net proceeds of this offering to repay indebtedness outstanding under our Credit Facility, which currently bears an interest rate of 6.82% and matures on March 31, 2010. We entered into our Credit Facility on March 31, 2006 and have used the funds for general corporate purposes, including the acquisition of healthcare-related properties and the funding of mortgage loans secured by healthcare-related properties. Bank of America N.A., an affiliate of Banc of America Securities LLC, is the administrative agent and a lender under our Credit Facility; UBS Loan Finance LLC, an affiliate of UBS Securities LLC, and Deutsche Bank AG, an affiliate of Deutsche Bank Securities Inc., are lenders under our Credit Facility. UBS Securities LLC, Banc of America Securities LLC and Deutsche Bank Securities Inc. are underwriters of this offering of our common stock. If and to the extent there are net proceeds remaining after we have repaid all indebtedness under our Credit Facility, we will use these proceeds for working capital and general corporate purposes.

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**Price range of common stock and dividend policy**

Our common stock is traded on the NYSE under the symbol "OHI." The following table sets forth, for the periods shown, the high and low prices for our common stock as reported by the NYSE for the periods indicated, and cash dividends per share:

	<b>High</b>	<b>Low</b>	<b>Dividends Per Share</b>
<b>Year ended December 31, 2005</b>			
First Quarter	\$ 11.95	\$ 10.31	\$ 0.20
Second Quarter	13.65	10.58	0.21
Third Quarter	14.28	12.39	0.22
Fourth Quarter	13.98	11.66	0.22
<b>Year ended December 31, 2006</b>			
First Quarter	\$ 14.03	\$ 12.36	\$ 0.23
Second Quarter	13.92	11.15	0.24
Third Quarter	15.50	12.56	0.24
Fourth Quarter	18.00	14.81	0.25

The closing price on March 28, 2007 was \$17.03 per share. As of March 26, 2007 there were 60,100,859 shares of common stock outstanding with 2,960 registered holders.

In 2005, we paid all regular quarterly dividend payments on our outstanding series of preferred stock and common stock. In 2006, we have paid all regular quarterly dividend payments on our outstanding series of preferred stock and common stock. We expect to continue our policy of paying regular cash dividends, although there is no assurance as to future dividends because they depend on future earnings, capital requirements and our financial condition. In addition, the payment of dividends is subject to the restrictions described in Note 14 to our consolidated financial statements for the fiscal year ended December 31, 2006 included elsewhere in this prospectus.

## Capitalization

The following table sets forth our capitalization as of December 31, 2006:

On an actual basis; and

As adjusted to give effect to our sale of the common stock in this offering at an offering price of \$16.75 per share and the assumed application of the approximately \$98.2 million of net proceeds after deducting underwriting discounts and commissions and other expenses of this offering to repay borrowings outstanding under our Credit Facility.

This table should be read in conjunction with “Management’s discussion and analysis of financial condition and results of operations” and our consolidated financial statements and the related notes included in this prospectus.

	As of December 31, 2006	
	Actual	As adjusted
	(in thousands)	
Cash	\$ 729	\$ 729
Debt:		
Credit Facility	150,000	51,842
7.00% senior notes due 2014	310,000	310,000
Premium on new 7.00% senior notes due 2014	1,148	1,148
Discount on 7% Note due 2016	(1,417)	(1,417)
7.00% senior notes due 2016	175,000	175,000
Other long-term borrowings	41,410	41,410
Total Debt	676,141	577,983
Stockholders’ Equity:		
Preferred Stock, \$1.00 par value; authorized - 20,000 shares: Issued and Outstanding - 4,740 shares Series D with an aggregate liquidation preference of \$118,488 as December 31, 2006	118,488	118,488
Common Stock, \$0.10 par value: Authorized - 100,000 shares Issued and Outstanding - 59,703 as of December 31, 2006; pro forma as adjusted 65.903 shares	5,970	6,590
Additional paid in capital	694,207	791,745
Cumulative net earnings	292,766	292,766
Cumulative dividends paid	(602,910)	(602,910)
Cumulative dividends - redemption	(43,067)	(43,067)
Total Stockholders’ Equity	465,454	563,612
Total Capitalization	\$ 1,141,595	\$ 1,141,595

The table above excludes:

47,244 shares of our common stock issuable upon exercise of options outstanding as of December 31, 2006 at a weighted average exercise price of \$12.70 per share;

- 1,516,428 shares of our common stock available for issuance under our dividend reinvestment and common stock purchase plan as of December 31, 2006;
- 2,891,980 shares of our common stock available for future grant under our 2000 Stock Incentive Plan and our 2004 Stock Incentive Plan; and
- 930,000 shares of our common stock that may be purchased by underwriters to cover over-allotments, if any.



**Selected consolidated financial data**

The following table sets forth consolidated financial data as of the dates and for the periods presented. The balance sheet data as of December 31, 2006 and 2005 and the statement of operations data, and other data for each of the years during the three-year period ended December 31, 2006 have been derived from, and should be read in conjunction with, our audited consolidated financial statements and the related notes included elsewhere in this prospectus. The balance sheet data as of December 31, 2004, 2003, and 2002, and the statement of operations data, and other data for the years ended December 31, 2003 and 2002 are derived from our audited consolidated financial statements.

	<b>Year Ended December 31,</b>				
	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
	(in thousands, except per share amounts)				
<b>Operating data:</b>					
Revenues from core operations	\$ 80,572	\$ 76,803	\$ 86,972	\$ 109,644	\$ 135,693
Revenues from nursing home operations	42,203	4,395	—	—	—
Total revenues	\$ 122,775	\$ 81,198	\$ 86,972	\$ 109,644	\$ 135,693
Income (loss) from continuing operations	\$ (2,561)	\$ 27,770	\$ 13,371	\$ 37,355	\$ 56,042
Net income (loss) available to common	(32,801)	3,516	(36,715)	25,355	45,774
<b>Per share amounts:</b>					
<b>Income (loss) from continuing operations:</b>					
Basic	\$ (0.65)	\$ 0.21	\$ (0.96)	\$ 0.46	\$ 0.79
Diluted	(0.65)	0.20	(0.96)	0.46	0.79
<b>Net income (loss) available to common:</b>					
Basic	\$ (0.94)	\$ 0.09	\$ (0.81)	\$ 0.49	\$ 0.78
Diluted	(0.94)	0.09	(0.81)	0.49	0.78
Dividends, Common Stock <sup>(1)</sup>	—	0.15	0.72	0.85	0.96
Dividends, Series A Preferred <sup>(1)</sup>	—	6.94	1.16	—	—
Dividends, Series B Preferred <sup>(1)</sup>	—	6.47	2.16	1.09	—
Dividends, Series C Preferred <sup>(2)</sup>	—	29.81	2.72	—	—
Dividends, Series D Preferred <sup>(1)</sup>	—	—	1.52	2.09	2.09
<b>Weighted-average common shares outstanding,</b>					
basic	34,739	37,189	45,472	51,738	58,651
Weighted-average common shares outstanding, diluted	34,739	38,154	45,472	52,059	58,745
<b>Other financial data:</b>					
	17,495	18,129	18,842	23,856	32,113

## Depreciation and amortization

(3)

Funds from operations <sup>(4)</sup>	(15,025)	25,091	(18,474)	42,663	76,683
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## Year Ended December 31,

	2002	2003	2004	2005	2006
<b>Balance sheet data:</b>					
Gross investments	\$ 860,188	\$ 821,244	\$ 940,747	\$ 1,129,753	\$ 1,294,697
Total assets	811,096	736,775	849,576	1,036,042	1,175,370
Revolving lines of credit	177,000	177,074	15,000	58,000	150,000
Other long-term borrowings	129,462	103,520	364,508	508,229	526,141
Stockholders' equity	482,995	440,130	442,935	440,943	465,454

(1) *Dividends per share are those declared and paid during such period.*

(2) *Dividends per share are those declared during such period, based on the number of shares of common stock issuable upon conversion of the outstanding Series C Preferred Stock.*

(3) *Excludes amounts included in discontinued operations*

(4) *We consider funds from operations, or FFO, to be a key measure of a REIT's performance which should be considered along with, but not as an alternative to, net income and cash flow as a measure of operating performance and liquidity. We calculate and report FFO in accordance with the definition and interpretive guidelines issued by the National Association of Real Estate Investment Trusts, or NAREIT, and, consequently, FFO is defined as net income available to common stockholders, adjusted for the effects of asset dispositions and certain non-cash items, primarily depreciation and amortization. We believe that FFO is an important supplemental measure of our operating performance. Because the historical cost accounting convention used for*

**Selected consolidated financial data**

*real estate assets requires depreciation (except on land), such accounting presentation implies that the value of real estate assets diminishes predictably over time, while real estate values instead have historically risen or fallen with market conditions. The term FFO was designed by the real estate industry to address this issue. FFO herein is not necessarily comparable to FFO of other REITs that do not use the same definition of implementation guidelines or interpret the standards differently from us.*

*We use FFO as one of several criteria to measure operating performance of our business. We further believe that by excluding the effect of depreciation, amortization and gains or losses from sales of real estate, all of which are based on historical costs and which may be of limited relevance in evaluating current performance, FFO can facilitate comparisons of operating performance between periods and between other REITs. We offer this measure to assist the users of our financial performance under GAAP and should not be considered a measure of liquidity, an alternative to net income or an indicator of any other performance measure determined in accordance with GAAP. Investor and potential investors in our securities should not rely on this measure as a substitute for any GAAP measure, including net income.*

*In February 2004, NAREIT informed its member companies that it was adopting the position of the SEC with respect to asset impairment charges and would no longer recommend that impairment write-downs be excluded from FFO. In the table included below, we have applied this interpretation and have not excluded asset impairment charges in calculating our FFO. As a result, our FFO may not be comparable to similar measures reported in previous disclosures. According to NAREIT, there is inconsistency among NAREIT member companies as to the adoption of this interpretation of FFO. Therefore, a comparison of our FFO results to another company's FFO results may not be meaningful.*

*The following table is a reconciliation of net income (loss) available to common to FFO:*

	<b>Year ended December 31,</b>				
	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
	<b>(in thousands)</b>				
Net income (loss) available to common shareholders	\$ (32,801)	\$ 3,516	\$ (36,715)	\$ 25,355	\$ 45,774
(Deduct gain) add back loss from real estate dispositions <sup>(a)</sup>	(2,548)	149	(3,310)	(7,969)	(1,354)
	(35,349)	3,665	(40,025)	17,386	44,420
Elimination of non-cash items included in net income (loss):					
Depreciation and amortization <sup>(b)</sup>	21,270	21,426	21,551	25,277	32,263
Adjustments of derivatives to fair market value	(946)	—	—	—	—
FFO	\$ (15,025)	\$ 25,091	\$ (18,474)	\$ 42,663	\$ 76,683

*(a) The add back of loss/deduction of gain from real estate dispositions includes the facilities classified as discontinued operations in our audited consolidated financial statements included in our Annual Reports on Form 10-K for the three year period ended December 31, 2006.*

(b) *The add back of depreciation and amortization includes the facilities classified as discontinued operations in our audited consolidated financial statements included in our Annual Reports on Form 10-K for the three year period ended December 31, 2006. The 2002, 2003, 2004, 2005 and 2006 includes depreciation of \$3.8 million, \$3.3 million, \$2.7 million, \$1.4 million, and \$0.2 million, respectively, related to facilities classified as discontinued operations.*

## **Management's discussion and analysis of financial condition and results of operations**

### **OVERVIEW**

Our portfolio of investments at December 31, 2006, consisted of 239 healthcare facilities, located in 27 states and operated by 32 third-party operators. Our gross investment in these facilities totaled approximately \$1.3 billion at December 31, 2006, with 98% of our real estate investments related to long-term healthcare facilities. This portfolio is made up of 228 long-term healthcare facilities and two rehabilitation hospitals owned and leased to third parties and fixed rate mortgages on nine long-term healthcare facilities. At December 31, 2006, we also held other investments of approximately \$22 million, consisting primarily of secured loans to third-party operators of our facilities.

### **RESTATEMENTS**

On December 14, 2006, we filed a Form 10-K/A, which amended our previously filed Form 10-K for fiscal year 2005. Contained within that Form 10-K/A were restated consolidated financial statements for the three years ended December 31, 2005. The restatements corrected errors in previously reported amounts related to income tax matters and to certain debt and equity investments in Advocat, as well as to the recording of certain straight-line rental income. Amounts reflected herein were derived from the restated financial information rather than the 2005 Form 10-K, which had been filed with the SEC on February 17, 2006 and mailed to stockholders shortly thereafter. Similarly, on December 14, 2006, we filed Forms 10-Q/A amending our previously filed consolidated financial statements for the first and second quarters of fiscal 2006 to correct errors in previously recorded amounts as discussed previously. Amounts reflected in Note 16 - Summary of Quarterly Results (Unaudited) to our audited consolidated financial statements as of December 31, 2006 were derived from the restated financial information rather than the Form 10-Q as of March 31, 2006 and June 30, 2006. See also Note 10 - Taxes to our audited consolidated financial statements for the fiscal year ended December 31, 2006 included elsewhere in this prospectus.

### **MEDICARE REIMBURSEMENT**

All of our properties are used as healthcare facilities; therefore, we are directly affected by the risk associated with the healthcare industry. Our lessees and mortgagors, as well as any facilities that may be owned and operated for our own account from time to time, derive a substantial portion of their net operating revenues from third-party payors, including the Medicare and Medicaid programs. These programs are highly regulated by federal, state and local laws, rules and regulations and are subject to frequent and substantial change.

In 1997, the Balanced Budget Act significantly reduced spending levels for the Medicare and Medicaid programs, in part because the legislation modified the payment methodology for skilled nursing facilities, or SNFs by shifting payments for services provided to Medicare beneficiaries from a reasonable cost basis to a prospective payment system. Under the prospective payment system, SNFs are paid on a per diem prospective case-mix adjusted basis for all covered services. Implementation of the prospective payment system has affected each long-term care facility to a different degree, depending upon the amount of revenue such facility derives from Medicare patients.

Legislation adopted in 1999 and 2000 provided for a few temporary increases to Medicare payment rates, but these temporary increases have since expired. Specifically, in 1999 the Balanced Budget Refinement Act included a 4% across-the-board increase of the adjusted federal per diem payment rates for all patient acuity categories (known as "Resource Utilization Groups" or "RUGs") that were in effect from April 2000 through September 30, 2002. In 2000, the Benefits Improvement and Protection Act included a



## Management's discussion and analysis of financial condition and results of operations

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16.7% increase in the nursing component of the case-mix adjusted federal periodic payment rate, which was implemented in April 2000 and also expired October 1, 2002. The October 1, 2002 expiration of these temporary increases has had an adverse impact on the revenues of the operators of SNFs and has negatively impacted some operators' ability to satisfy their monthly lease or debt payments to us.

The Balanced Budget Refinement Act and the Benefits Improvement and Protection Act also established temporary increases, beginning in April 2001, to Medicare payment rates to SNFs that were designated to remain in place until the Centers for Medicare and Medicaid Services, or CMS, implemented refinements to the existing RUG case-mix classification system to more accurately estimate the cost of non-therapy ancillary services. The Balanced Budget Refinement Act provided for a 20% increase for 15 RUG categories until CMS modified the RUG case-mix classification system. The Benefits Improvement and Protection Act modified this payment increase by reducing the 20% increase for three of the 15 RUGs to a 6.7% increase and instituting an additional 6.7% increase for eleven other RUGs.

On August 4, 2005, CMS published a final rule, effective October 1, 2005, establishing Medicare payments for SNFs under the prospective payment system for federal fiscal year 2006 (October 1, 2005 to September 30, 2006). The final rule modified the RUG case-mix classification system and added nine new categories to the system, expanding the number of RUGs from 44 to 53. The implementation of the RUG refinements triggered the expiration of the temporary payment increases of 20% and 6.7% established by the Balanced Budget Refinement Act and the Benefits Improvement and Protection Act, respectively.

Additionally, CMS announced updates in the final rule to reimbursement rates for SNFs in federal fiscal year 2006 based on an increase in the "full market-basket" of 3.1%. In the August 4, 2005 notice, CMS estimated that the increases in Medicare reimbursements to SNFs arising from the refinements to the prospective payment system and the market basket update under the final rule would offset the reductions stemming from the elimination of the temporary increases during federal fiscal year 2006. CMS estimated that there would be an overall increase in Medicare payments to SNFs totaling \$20 million in fiscal year 2006 compared to 2005.

On July 27, 2006, CMS posted a notice updating the payment rates to SNFs for fiscal year 2007 (October 1, 2006 to September 30, 2007). The market basket increase factor is 3.1% for 2007. CMS estimates that the payment update will increase aggregate payments to SNFs nationwide by approximately \$560 million in fiscal year 2007 compared to 2006.

Nonetheless, we cannot accurately predict what effect, if any, these changes will have on our lessees and mortgagors in 2007 and beyond. These changes to the Medicare prospective payment system for SNFs, including the elimination of temporary increases, could adversely impact the revenues of the operators of nursing facilities and could negatively impact the ability of some of our lessees and mortgagors to satisfy their monthly lease or debt payments to us.

A 128% temporary increase in the per diem amount paid to SNFs for residents who have AIDS took effect on October 1, 2004. This temporary payment increase arose from the Medicare Prescription Drug Improvement and Modernization Act of 2003, or the Medicare Modernization Act. Although CMS also noted that the AIDS add-on was not intended to be permanent, the July 2006 notice updating payment rates for SNFs for fiscal year 2007 indicated that the increase will continue to remain in effect for fiscal year 2007.

A significant change enacted under the Medicare Modernization Act is the creation of a new prescription drug benefit, Medicare Part D, which went into effect January 1, 2006. The significant expansion of benefits for Medicare beneficiaries arising under the expanded prescription drug benefit could result in financial pressures on the Medicare program that might result in future legislative and regulatory changes with impacts for our operators. As part of this new program, the prescription drug benefits for patients who are dually eligible for both Medicare and Medicaid are

being transitioned from Medicaid to Medicare, and many of these patients reside in long-term care facilities. The Medicare program

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## **Management's discussion and analysis of financial condition and results of operations**

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experienced significant operational difficulties in transitioning prescription drug coverage for this population when the benefit went into effect on January 1, 2006, although it is unclear whether or how issues involving Medicare Part D might have any direct financial impacts on our operators.

On February 8, 2006, the President signed into law a \$39.7 billion budget reconciliation package called the Deficit Reduction Act of 2005, or Deficit Reduction Act, to lower the federal budget deficit. The Deficit Reduction Act included estimated net savings of \$8.3 billion from the Medicare program over 5 years.

The Deficit Reduction Act contained a provision reducing payments to SNFs for allowable bad debts. Previously, Medicare reimbursed SNFs for 100% of beneficiary bad debt arising from unpaid deductibles and coinsurance amounts. In 2003, CMS released a proposed rule seeking to reduce bad debt reimbursement rates for certain providers, including SNFs, by 30% over a three-year period. Subsequently, in early 2006 the Deficit Reduction Act reduced payments to SNFs for allowable bad debts by 30% effective October 1, 2005 for those individuals not dually eligible for Medicare and Medicaid. Bad debt payments for the dually eligible population will remain at 100%. Consistent with this legislation, CMS finalized its 2003 proposed rule on August 18, 2006, and the regulations became effective on October 1, 2006. CMS estimates that implementation of this bad debt provision will result in a savings to the Medicare program of \$490 million from FY 2006 to FY 2010. These reductions in Medicare payments for bad debt could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

The Deficit Reduction Act also contained a provision governing the therapy caps that went into place under Medicare on January 1, 2006. The therapy caps limit the physical therapy, speech-language therapy and occupation therapy services that a Medicare beneficiary can receive during a calendar year. The therapy caps were in effect for calendar year 1999 and then suspended by Congress for three years. An inflation-adjusted therapy limit (\$1,590 per year) was implemented in September of 2002, but then once again suspended in December of 2003 by the Medicare Modernization Act. Under the Medicare Modernization Act, Congress placed a two-year moratorium on implementation of the caps, which expired at the end of 2005.

The inflation-adjusted therapy caps are set at \$1,780 for calendar year 2007. These caps do not apply to therapy services covered under Medicare Part A in a SNF, although the caps apply in most other instances involving patients in SNFs or long-term care facilities who receive therapy services covered under Medicare Part B. The Deficit Reduction Act permitted exceptions in 2006 for therapy services to exceed the caps when the therapy services are deemed medically necessary by the Medicare program. The Tax Relief and Health Care Act of 2006, signed into law on December 20, 2006, extends these exceptions through December 31, 2007. Future and continued implementation of the therapy caps could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

In general, we cannot be assured that federal reimbursement will remain at levels comparable to present levels or that such reimbursement will be sufficient for our lessees or mortgagors to cover all operating and fixed costs necessary to care for Medicare and Medicaid patients. We also cannot be assured that there will be any future legislation to increase Medicare payment rates for SNFs, and if such payment rates for SNFs are not increased in the future, some of our lessees and mortgagors may have difficulty meeting their payment obligations to us.

### **MEDICAID AND OTHER THIRD-PARTY REIMBURSEMENT**

Each state has its own Medicaid program that is funded jointly by the state and federal government. Federal law governs how each state manages its Medicaid program, but there is wide latitude for states to customize Medicaid programs to fit the needs and resources of their citizens. Currently, Medicaid is the single largest source of financing

for long-term care in the United States. Rising Medicaid costs and

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## **Management's discussion and analysis of financial condition and results of operations**

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decreasing state revenues caused by recent economic conditions have prompted an increasing number of states to cut or consider reductions in Medicaid funding as a means of balancing their respective state budgets. Existing and future initiatives affecting Medicaid reimbursement may reduce utilization of (and reimbursement for) services offered by the operators of our properties.

In recent years, many states have announced actual or potential budget shortfalls. As a result of these budget shortfalls, many states have announced that they are implementing or considering implementing "freezes" or cuts in Medicaid reimbursement rates, including rates paid to SNF and long-term care providers, or reductions in Medicaid enrollee benefits, including long-term care benefits. We cannot predict the extent to which Medicaid rate freezes, cuts or benefit reductions ultimately will be adopted, the number of states that will adopt them or the impact of such adoption on our operators. However, extensive Medicaid rate cuts, freezes or benefit reductions could have a material adverse effect on our operators' liquidity, financial condition and operations, which could adversely affect their ability to make lease or mortgage payments to us.

The Deficit Reduction Act included \$4.7 billion in estimated savings from Medicaid and the State Children's Health Insurance Program over five years. The Deficit Reduction Act gave states the option to increase Medicaid cost-sharing and reduce Medicaid benefits, accounting for an estimated \$3.2 billion in federal savings over five years. The remainder of the Medicaid savings under the Deficit Reduction Act comes primarily from changes to prescription drug reimbursement (\$3.9 billion in savings over five years) and tightened policies governing asset transfers (\$2.4 billion in savings over five years).

Asset transfer policies, which determine Medicaid eligibility based on whether a Medicaid applicant has transferred assets for less than fair value, became more restrictive under the Deficit Reduction Act, which extended the look-back period to five years, moved the start of the penalty period and made individuals with more than \$500,000 in home equity ineligible for nursing home benefits (previously, the home was excluded as a countable asset for purposes of Medicaid eligibility). These changes could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

Additional reductions in federal funding are expected for some state Medicaid programs as a result of changes in the percentage rates used for determining federal assistance on a state-by-state basis. Legislation has been introduced in Congress that would partially mitigate the reductions for some states that would experience significant reductions in federal funding, although whether Congress will enact this or other legislation remains uncertain.

Finally, private payors, including managed care payors, increasingly are demanding discounted fee structures and the assumption by healthcare providers of all or a portion of the financial risk of operating a healthcare facility. Efforts to impose greater discounts and more stringent cost controls are expected to continue. Any changes in reimbursement policies that reduce reimbursement levels could adversely affect the revenues of our lessees and mortgagors, thereby adversely affecting those lessees' and mortgagors' abilities to make their monthly lease or debt payments to us.

## **FRAUD AND ABUSE LAWS AND REGULATIONS**

There are various extremely complex and largely uninterpreted federal and state laws governing a wide array of referrals, relationships and arrangements and prohibiting fraud by healthcare providers, including criminal provisions that prohibit filing false claims or making false statements to receive payment or certification under Medicare and Medicaid, and failing to refund overpayments or improper payments. The federal and state governments are devoting increasing attention and resources to anti-fraud initiatives against healthcare providers. Penalties for healthcare fraud have been increased and expanded over recent years, including broader provisions for the exclusion of providers from the Medicare and Medicaid programs. The Office of the Inspector General for the U.S. Department of Health



## **Management's discussion and analysis of financial condition and results of operations**

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and Human Services, or OIG-HHS, has described a number of ongoing and new initiatives for 2007 to study instances of potential overbilling and/or fraud in SNFs and nursing homes under both Medicare and Medicaid. The OIG-HHS, in cooperation with other federal and state agencies, also continues to focus on the activities of SNFs in certain states in which we have properties.

In addition, the federal False Claims Act allows a private individual with knowledge of fraud to bring a claim on behalf of the federal government and earn a percentage of the federal government's recovery. Because of these monetary incentives, these so-called "whistleblower" suits have become more frequent. Some states currently have statutes that are analogous to the federal False Claims Act. The Deficit Reduction Act encourages additional states to enact such legislation and may encourage increased enforcement activity by permitting states to retain 10% of any recovery for that state's Medicaid program if the enacted legislation is at least as rigorous as the federal False Claims Act. The violation of any of these laws or regulations by an operator may result in the imposition of fines or other penalties that could jeopardize that operator's ability to make lease or mortgage payments to us or to continue operating its facility.

### **LEGISLATIVE AND REGULATORY DEVELOPMENTS**

Each year, legislative and regulatory proposals are introduced or proposed in Congress and state legislatures as well as by federal and state agencies that, if implemented, could result in major changes in the healthcare system, either nationally or at the state level. In addition, regulatory proposals and rules are released on an ongoing basis that may have major impacts on the healthcare system generally and the industries in which our operators do business. Legislative and regulatory developments can be expected to occur on an ongoing basis at the local, state and federal levels that have direct or indirect impacts on the policies governing the reimbursement levels paid to our facilities by public and private third-party payors, the costs of doing business and the threshold requirements that must be met for facilities to continue operation or to expand.

The Medicare Modernization Act, which is one example of such legislation, was enacted in December 2003. The significant expansion of other benefits for Medicare beneficiaries under this Act, such as the prescription drug benefit, could create financial pressures on the Medicare program that might result in future legislative and regulatory changes with impacts on our operators. Although the creation of a prescription drug benefit for Medicare beneficiaries was expected to generate fiscal relief for state Medicaid programs, the structure of the benefit and costs associated with its implementation may mitigate the relief for states that originally was anticipated.

The Deficit Reduction Act is another example of such legislation. The provisions in the legislation designed to create cost savings from both Medicare and Medicaid could diminish reimbursement for our operators under both Medicare and Medicaid.

CMS also launched, in 2002, the Nursing Home Quality Initiative program in 2002, which requires nursing homes participating in Medicare to provide consumers with comparative information about the quality of care at the facility. In the fall of 2007, CMS plans to initiate a new quality campaign, Advancing Excellence for America's Nursing Home Residents, to be conducted over the next two years with the ultimate goal being improvement in quality of life and efficiency of care delivery. In the event any of our operators do not maintain the same or superior levels of quality care as their competitors, patients could choose alternate facilities, which could adversely impact our operators' revenues. In addition, the reporting of such information could lead to reimbursement policies that reward or penalize facilities on the basis of the reported quality of care parameters.

In late 2005, CMS began soliciting public comments regarding a demonstration to examine pay-for-performance approaches in the nursing home setting that would offer financial incentives for facilities delivering high quality care. In June 2006, Abt Associates published recommendations for CMS on how to design this demonstration project. The

two-year demonstration is slated to begin in October 2007 and

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## Management's discussion and analysis of financial condition and results of operations

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will run through September, 2009. Other proposals under consideration include efforts by individual states to control costs by decreasing state Medicaid reimbursements in the current or future fiscal years and federal legislation addressing various issues, such as improving quality of care and reducing medical errors throughout the health care industry. We cannot accurately predict whether specific proposals will be adopted or, if adopted, what effect, if any, these proposals would have on operators and, thus, our business.

### SIGNIFICANT HIGHLIGHTS

The following significant highlights occurred during the twelve-month period ended December 31, 2006.

#### Financing

- In January 2006, we redeemed the remaining 20.7% of our \$100 million aggregate principal amount of our 6.95% notes due 2007 that were not otherwise tendered in 2005.

#### Dividends

- In 2006, we paid common stock dividends of \$0.23, \$0.24, \$0.24 and \$0.25 per share, for stockholders of record on January 31, 2006, April 28, 2006, July 31, 2006 and November 3, 2006, respectively.

#### New Investments

- In August 2006, we closed on \$171 million of new investments and leased them to existing third-party operators.
  - In September 2006, we closed on \$25.0 million of investments with an existing third-party operator.
- On October 20, 2006, we restructured our relationship with Advocat, which restructuring included a rent increase of \$0.7 million annually and a term extension to September 30, 2018.

### ASSET SALES AND OTHER

- In August 2006, we sold our common stock investment in Sun Healthcare Group, Inc., or Sun, for \$7.6 million of cash proceeds.
  - In June 2006, a \$10 million mortgage was paid-off in full.
- In March 2006, Haven Eldercare, LLC, or Haven, paid \$39 million on a \$62 million mortgage it has with us.
- Throughout 2006, in various transactions, we sold three SNFs and one ALF for cash proceeds of approximately \$1.6 million in the aggregate.

#### Portfolio Developments, New Investments and Recent Developments

The partial expiration of certain Medicare rate increases has had an adverse impact on the revenues of the operators of nursing home facilities and has negatively impacted some operators' ability to satisfy their monthly lease or debt payment to us. In several instances, we hold security deposits that can be applied in the event of lease and loan defaults, subject to applicable limitations under bankruptcy law with respect to operators seeking protection under title 11 of the United States Code, 11 U.S.C. §§ 101-1330, as amended and supplemented, or the Bankruptcy Code.

Below is a brief description, by third-party operator, of new investments or operator related transactions that occurred during the year ended December 31, 2006.

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## Management's discussion and analysis of financial condition and results of operations

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### New Investments and Re-leasing Activities

#### *Advocat, Inc.*

On October 20, 2006, we restructured our relationship with Advocat, or the Second Advocat Restructuring, by entering into a Restructuring Stock Issuance and Subscription Agreement with Advocat, or the 2006 Advocat Agreement. Pursuant to the 2006 Advocat Agreement, we exchanged the Advocat Series B preferred stock and subordinated note issued to us in November 2000 in connection with a restructuring because Advocat was in default on its obligations to us, or the Initial Advocat Restructuring, for 5,000 shares of Advocat's Series C non-convertible, redeemable (at our option after September 30, 2010) preferred stock with a face value of approximately \$4.9 million and a dividend rate of 7% payable quarterly, and a secured non-convertible subordinated note in the amount of \$2.5 million maturing September 30, 2007 and bearing interest at 7% per annum. As part of the Second Advocat Restructuring, we also amended our Consolidated Amended and Restated Master Lease by and between one of its subsidiaries, as lessor, and a subsidiary of Advocat, as lessee, to commence a new 12-year lease term through September 30, 2018 (with a renewal option for an additional 12 year term) and Advocat agreed to increase the master lease annual rent by approximately \$687,000 to approximately \$14 million commencing on January 1, 2007.

The Second Advocat Restructuring has been accounted for as a new lease in accordance with FASB Statement No. 13, *Accounting for Leases*, or FAS No. 13, and FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*, or FASB TB No. 88-1. The fair value of the assets exchanged in the restructuring (i.e., the Series B non-voting redeemable convertible preferred stock and the secured convertible subordinated note, with a fair value of \$14.9 million and \$2.5 million, respectively, at October 20, 2006) in excess of the fair value of the assets received (the Advocat Series C non-convertible redeemable preferred stock and the secured non-convertible subordinated note, with a fair value of \$4.1 million and \$2.5 million, respectively, at October 20, 2006) have been recorded as a lease inducement asset of approximately \$10.8 million in the fourth quarter of 2006. The \$10.8 million lease inducement asset is included in accounts receivable-net on our consolidated balance sheet and will be amortized as a reduction to rental income on a straight-line basis over the term of the new master lease. The exchange of securities also resulted in a gain in 2006 of approximately \$3.6 million representing: (i) the fair value of the secured convertible subordinated note of \$2.5 million, previously reserved and (ii) the realization of the gain on investments previously classified as other comprehensive income of approximately \$1.1 million relating to the Series B non-voting redeemable convertible preferred stock.

#### *Guardian LTC Management, Inc.*

On September 1, 2006, we completed a \$25.0 million investment with subsidiaries of Guardian LTC Management, Inc., or Guardian, one of our existing operators. The transaction involved the purchase and leaseback of a SNF in Pennsylvania and termination of a purchase option on a combination SNF and rehabilitation hospital we own in West Virginia. The facilities were included in an existing master lease with Guardian with an increase in contractual annual rent of approximately \$2.6 million in the first year. The master lease now includes 17 facilities. In addition, the master lease term was extended from October 2014 through August 2016.

In accordance with FAS No. 13 and FASB TB No. 88-1 \$19.2 million of the \$25.0 million transaction amount will be accounted for as a lease inducement and is classified within accounts receivable - net on our consolidated balance sheets. The lease inducement will be amortized as a reduction to rental income on a straight-line basis over the term of the new master lease. The remaining payment to Guardian of \$5.8 million will be allocated to the purchase of the Pennsylvania SNF.

#### *Litchfield Transaction*

On August 1, 2006, we completed a transaction with Litchfield Investment Company, LLC and its affiliates, or Litchfield, to purchase 30 SNFs and one independent living center for a total investment of approximately \$171 million. The facilities total 3,847 beds and are located in the states of Colorado (5),

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## **Management's discussion and analysis of financial condition and results of operations**

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Florida (7), Idaho (1), Louisiana (13), and Texas (5). The facilities were subject to master leases with three national healthcare providers, which are existing tenants of the Company. The tenants are Home Quality Management, Inc., or HQM, Nexion Health, Inc., or Nexion, and Peak Medical Corporation, which was acquired by Sun Healthcare Group, Inc. or Sun, in December of 2005.

Simultaneously with the close of the purchase transaction, the seven HQM facilities were combined into an Amended and Restated Master Lease containing 13 facilities between us and HQM. In addition, the 18 Nexion facilities were combined into an Amended and Restated Master Lease containing 22 facilities between us and Nexion.

We entered into a Master Lease, Assignment and Assumption Agreement with Litchfield on the six Sun facilities. These six facilities are currently under a master lease that expires on September 30, 2007.

### *Haven Eldercare, LLC*

During the three months ending March 31, 2006, Haven Eldercare, LLC, or Haven, an existing operator of ours, entered into a \$39 million first mortgage loan with General Electric Capital Corporation, or GE Loan. Haven used the \$39 million of proceeds to partially repay on a \$62 million mortgage it has with us. Simultaneously, we subordinated the payment of our remaining \$23 million on the mortgage note, due in October 2012, to that of the GE Loan. As a result of this transaction, the interest rate on our remaining mortgage note to Haven rose from 10% to approximately 15%, with annual escalators.

In conjunction with the above transactions and the application of Financial Accounting Standards Board Interpretation No. 46R, Consolidation of Variable Interest Entities, or FIN 46R, we consolidated the financial statements and related real estate of this Haven entity into our financial statements. The consolidation resulted in the following changes to our consolidated balance sheet as of December 31, 2006: (1) an increase in total gross investments of \$39.0 million; (2) an increase in accumulated depreciation of \$1.6 million; (3) an increase in accounts receivable-net of \$0.1 million relating to straight-line rent; (4) an increase in other long-term borrowings of \$39.0 million; and (5) a reduction of \$1.5 million in cumulative net earnings for the year ended December 31, 2006 due to the increased depreciation expense offset by straight-line rental revenue. General Electric Capital Corporation and Haven's other creditors do not have recourse to our assets. We have an option to purchase the mortgaged facilities for a fixed price in 2012. Our results of operations reflect the effects of the consolidation of this entity, which is being accounted for similarly to our other purchase-leaseback transactions.

### **Assets Held for Sale**

We had six assets held for sale as of December 31, 2006 with a net book value of approximately \$3.6 million. We had eight assets held for sale as of December 31, 2005 with a combined net book value of \$5.8 million, which includes a reclassification of five assets with a net book value of \$4.6 million that were sold or reclassified as held for sale during 2006.

During the three months ended March 31, 2006, a \$0.1 million provision for impairment charge was recorded to reduce the carrying value to its sales price of one facility that was under contract to be sold that was subsequently sold during the second quarter of 2006. During the three months ended December 31, 2006, a \$0.4 million impairment charge was recorded to reduce the carrying value of two facilities, currently under contract to be sold in the first quarter of 2007, to their respective sales price.

### **Asset Dispositions and Mortgage Payoffs in 2006**

*Hickory Creek Healthcare Foundation, Inc.*

On June 16, 2006, we received approximately \$10 million in proceeds on a mortgage loan payoff. We held mortgages on 15 facilities located in Indiana, representing 619 beds.

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## Management's discussion and analysis of financial condition and results of operations

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### *Other Asset Sales*

- For the three-month period ended December 31, 2006, we sold an ALF in Ohio resulting in an accounting gain of approximately \$0.4 million.
- For the three-month period ended June 30, 2006, we sold two SNFs in California resulting in an accounting loss of approximately \$0.1 million.
- For the three-month period ended March 31, 2006, we sold a SNF in Illinois resulting in an accounting loss of approximately \$0.2 million.

In accordance with SFAS No. 144, all related revenues and expenses as well as the \$0.2 million realized net gain from the above mentioned facility sales are included within discontinued operations in our consolidated statements of operations for their respective time periods.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles, or GAAP, in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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. Our significant accounting policies are described in Note 2 to our audited consolidated financial statements included elsewhere in this prospectus. These policies were followed in preparing the consolidated financial statements for all periods presented. Actual results could differ from those estimates.

We have identified four significant accounting policies that we believe are critical accounting policies. These critical accounting policies are those that have the most impact on the reporting of our financial condition and those requiring significant assumptions, judgments and estimates. With respect to these critical accounting policies, we believe the application of judgments and assessments is consistently applied and produces financial information that fairly presents the results of operations for all periods presented. The four critical accounting policies are:

## REVENUE RECOGNITION

Rental income and mortgage interest income are recognized as earned over the terms of the related master leases and mortgage notes, respectively. Substantially all of our leases contain provisions for specified annual increases over the rents of the prior year and are generally computed in one of three methods depending on specific provisions of each lease as follows: (i) a specific annual increase over the prior year's rent, typically 2.5%; (ii) an increase based on the change in pre-determined formulas from year to year (i.e., such as increases in the CPI); or (iii) specific dollar increases over prior years. Revenue under lease arrangements with specific determinable increases is recognized over the term of the lease on a straight-line basis. SEC Staff Accounting Bulletin No. 101 "*Revenue Recognition in Financial Statements*," or SAB 101, does not provide for the recognition of contingent revenue until all possible contingencies have been eliminated. We consider the operating history of the lessee, the general condition of the industry and various other factors when evaluating whether all possible contingencies have been eliminated. We have historically not included, and generally expect in the future not to include, contingent rents as income until received. We follow a policy related to rental income whereby we typically consider a lease to be non-performing after 90 days of non-payment of past due amounts and do not recognize unpaid rental income from that lease until the amounts have been received.

In the case of rental revenue recognized on a straight-line basis, we will generally discontinue recording rent on a straight-line basis if the lessee becomes delinquent in rent owed under the terms of the lease. Reserves are taken

against earned revenues from leases when collection becomes questionable or when

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## Management's discussion and analysis of financial condition and results of operations

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negotiations for restructurings of troubled operators result in significant uncertainty regarding ultimate collection. The amount of the reserve is estimated based on what management believes will likely be collected. Once the recording of straight-line rent is suspended, we will evaluate the collectibility of the related straight-line rent asset. If it is determined that the delinquency is temporary, we will resume booking rent on a straight-line basis once payment is received for past due rents, after taking into account application of security deposits. If it appears that we will not collect future rent due under our leases, we will record a provision for loss related to the straight-line rent asset.

Recognizing rental income on a straight-line basis results in recognized revenue exceeding contractual amounts due from our tenants. Such cumulative excess amounts are included in accounts receivable and were \$20.0 million, \$13.8 million and \$8.6 million, net of allowances, at December 31, 2006, 2005 and 2004, respectively.

Gains on sales of real estate assets are recognized pursuant to the provisions of SFAS No. 66, *Accounting for Sales of Real Estate*. The specific timing of the recognition of the sale and the related gain is measured against the various criteria in SFAS No. 66 related to the terms of the transactions and any continuing involvement associated with the assets sold. To the extent the sales criteria are not met, we defer gain recognition until the sales criteria are met.

### DEPRECIATION AND ASSET IMPAIRMENT

Under GAAP, real estate assets are stated at the lower of depreciated cost or fair value, if deemed impaired. Depreciation is computed on a straight-line basis over the estimated useful lives of 25 to 40 years for buildings and improvements and 3 to 10 years for furniture, fixtures and equipment. Management periodically, but not less than annually, evaluates our real estate investments for impairment indicators, including the evaluation of our assets' useful lives. The judgment regarding the existence of impairment indicators is based on factors such as, but not limited to, market conditions, operator performance and legal structure. If indicators of impairment are present, management evaluates the carrying value of the related real estate investments in relation to the future undiscounted cash flows of the underlying facilities. Provisions for impairment losses related to long-lived assets are recognized when expected future undiscounted cash flows are determined to be permanently less than the carrying values of the assets. An adjustment is made to the net carrying value of the leased properties and other long-lived assets for the excess of historical cost over fair value. The fair value of the real estate investment is determined by market research, which includes valuing the property as a nursing home as well as other alternative uses. All impairments are taken as a period cost at that time, and depreciation is adjusted going forward to reflect the new value assigned to the asset.

If we decide to sell rental properties or land holdings, we evaluate the recoverability of the carrying amounts of the assets. If the evaluation indicates that the carrying value is not recoverable from estimated net sales proceeds, the property is written down to estimated fair value less costs to sell. Our estimates of cash flows and fair values of the properties are based on current market conditions and consider matters such as rental rates and occupancies for comparable properties, recent sales data for comparable properties, and, where applicable, contracts or the results of negotiations with purchasers or prospective purchasers.

For the years ended December 31, 2006, 2005, and 2004, we recognized impairment losses of \$0.5 million, \$9.6 million and \$0.0 million, respectively, including amounts classified within discontinued operations.

### LOAN IMPAIRMENT

Management, periodically but not less than annually, evaluates our outstanding loans and notes receivable. When management identifies potential loan impairment indicators, such as non-payment

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## Management's discussion and analysis of financial condition and results of operations

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under the loan documents, impairment of the underlying collateral, financial difficulty of the operator or other circumstances that may impair full execution of the loan documents, and management believes these indicators are permanent, then the loan is written down to the present value of the expected future cash flows. In cases where expected future cash flows cannot be estimated, the loan is written down to the fair value of the collateral. The fair value of the loan is determined by market research, which includes valuing the property as a nursing home as well as other alternative uses. We recorded loan impairments of \$0.9 million, \$0.1 million and \$0.0 million for the years ended December 31, 2006, 2005 and 2004, respectively.

In accordance with FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan and FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, we currently account for impaired loans using the cost-recovery method applying cash received against the outstanding principal balance prior to recording interest income (see Note 5 - Other Investments to our consolidated financial statements for the year ended December 31, 2006 included elsewhere herein).

### ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

Pursuant to the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the operating results of specified real estate assets that have been sold, or otherwise qualify as held for disposition (as defined by SFAS No. 144), are reflected as discontinued operations in the consolidated statements of operations for all periods presented. We had six assets held for sale as of December 31, 2006 with a combined net book value of \$3.6 million.

### RESULTS OF OPERATIONS

The following is our discussion of the consolidated results of operations, financial position and liquidity and capital resources, which should be read in conjunction with our audited consolidated financial statements and accompanying notes included elsewhere in this prospectus.

#### Year Ended December 31, 2006 compared to Year Ended December 31, 2005

##### *Operating Revenues*

Our operating revenues for the year ended December 31, 2006 totaled \$135.7 million, an increase of \$26.0 million, over the same period in 2005. The \$26.0 million increase was primarily a result of new investments made throughout 2005 and 2006. The increase in operating revenues from new investments was partially offset by a reduction in mortgage interest income and one-time contractual interest revenue associated with the payoff of a mortgage during the first quarter of 2005.

Detailed changes in operating revenues for the year ended December 31, 2006 are as follows:

- Rental income was \$127.1 million, an increase of \$31.6 million over the same period in 2005. The increase was due to new leases entered into throughout 2006 and 2005, as well as rental revenue from the consolidation of a variable interest entity, or VIE.
- Mortgage interest income totaled \$4.4 million, a decrease of \$2.1 million over the same period in 2005. The decrease was primarily the result of normal amortization, a \$60 million loan payoff that occurred in the first quarter of 2005 and a \$10 million loan payoff that occurred in the second quarter of 2006.
- Other investment income totaled \$3.7 million, an increase of \$0.5 million over the same period in 2005. The primary reason for the increase was due to dividends and accretion income associated with the Advocat securities.



## Management's discussion and analysis of financial condition and results of operations

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·Miscellaneous revenue was \$0.5 million, a decrease of \$4.0 million over the same period in 2005. The decrease was due to contractual revenue owed to us resulting from a mortgage note prepayment that occurred in the first quarter of 2005.

### *Operating Expenses*

Operating expenses for the year ended December 31, 2006 totaled \$46.6 million, an increase of approximately \$13.0 million over the same period in 2005. The increase was primarily due to \$8.3 million of increased depreciation expense, \$3.3 million of incremental restricted stock expense and a \$0.8 million provision for uncollectible notes receivable, partially offset by a 2005 leasehold termination expense for \$1.1 million.

Detailed changes in our operating expenses for the year ended December 31, 2006 versus the same period in 2005 are as follows:

- Our depreciation and amortization expense was \$32.1 million, compared to \$23.9 million for the same period in 2005. The increase is due to new investments placed throughout 2005 and 2006, as well as depreciation from the consolidation of a VIE.
- Our general and administrative expense was \$13.7 million, compared to \$8.6 million for the same period in 2005. The increase was primarily due to \$3.4 million of restricted stock amortization expense and compensation expense related to the performance restricted stock units, \$1.2 million of restatement related expenses and normal inflationary increases in goods and services.
- For the year ended December 31, 2006, in accordance with FAS No. 123R, we recorded approximately \$3.3 million (included in general and administrative expense) of compensation expense associated with the performance restricted stock units (see Note 12 - Stockholders' Equity and Stock Based Compensation to our consolidated financial statements for the year ended December 31, 2006 included elsewhere in this prospectus).

· In 2006, we recorded a \$0.8 million provision for uncollectible notes receivable.

- In 2005, we recorded a \$1.1 million lease expiration accrual relating to disputed capital improvement requirements associated with a lease that expired June 30, 2005.

### *Other Income (Expense)*

For the year ended December 31, 2006, our total other net expenses were \$31.8 million as compared to \$36.3 million for the same period in 2005. The significant changes are as follows:

- Our interest expense, excluding amortization of deferred costs and refinancing related interest expenses, for the year ended December 31, 2006 was \$42.2 million, compared to \$29.9 million for the same period in 2005. The increase of \$13.3 million was primarily due to higher debt on our balance sheet versus the same period in 2005 and from consolidation of interest expense from a VIE in 2006.
- For the year ended December 31, 2006, we sold our remaining 760,000 shares of Sun's common stock for approximately \$7.6 million, realizing a gain on the sale of these securities of approximately \$2.7 million.
- For the year ended December 31, 2006, in accordance with FAS No. 133, we recorded a \$9.1 million fair value adjustment to reflect the change in fair value during 2006 of our derivative instrument (i.e., the conversion feature of a redeemable convertible preferred stock security in Advocat, a publicly traded company; see Note 5 - Other

Investments to our consolidated financial statements for the year ended December 31, 2006 included elsewhere in this prospectus).

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## Management's discussion and analysis of financial condition and results of operations

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- For the year ended December 31, 2006, we recorded a \$3.6 million gain on Advocat securities (see Note 5 - Other Investments to our consolidated financial statements for the year ended December 31, 2006 included elsewhere in this prospectus).
- For the year ended December 31, 2006, we recorded a \$0.8 million non-cash charge associated with the redemption of the remaining \$20.7 million principal amount of our 6.95% unsecured notes due 2007 not otherwise tendered in 2005.
- For the year ended December 31, 2006, we recorded a one time, non-cash charge of approximately \$2.7 million relating to the write-off of deferred financing costs associated with the termination of our prior credit facility.
- During the year ended December 31, 2005, we recorded a \$3.4 million provision for impairment of an equity security. In accordance with FASB No. 115, the \$3.4 million provision for impairment was to write-down our 760,000 share investment in Sun's common stock to its then current fair market value.
- For the year ended December 31, 2005, we recorded \$1.6 million in net cash proceeds resulting from settlement of a lawsuit filed by us against a former tenant.

### *2006 Taxes*

So long as we qualify as a REIT, we will not be subject to Federal income taxes on our income to the extent that we distribute such income to our shareholders, except as described below. For tax year 2006, preferred and common dividend payments of approximately \$67 million made throughout 2006 satisfy the 2006 REIT distribution requirements. We are permitted to own up to 100% of a "taxable REIT subsidiary," or TRS. Currently, we have two TRSs that are taxable as corporations and that pay federal, state and local income tax on their net income at the applicable corporate rates. These TRSs had net operating loss carry-forwards as of December 31, 2006 of \$12 million. These loss carry-forwards were fully reserved with a valuation allowance due to uncertainties regarding realization.

In the fourth quarter of 2006, we were advised by tax counsel that, due to certain provisions of the Series B preferred stock issued to us by Advocat in 2000 in connection with a restructuring, Advocat may be considered to be a "related party tenant" under the rules applicable to REITs and, in such event, rental income received by us from Advocat would not be qualifying income for purposes of the REIT gross income tests. While we believe that there are valid arguments that Advocat should not be a "related party tenant," if Advocat is so treated, we would have failed to satisfy the 95% gross income tests during certain prior taxable years. Such a failure would have prevented us from maintaining REIT tax status during such years and from re-electing tax status for a number of taxable years. In such event, our failure to satisfy the REIT gross income tests would not result in the loss of REIT status, however, if the failure was due to reasonable cause and not to willful neglect, and we pay a tax on the non-qualifying income. Accordingly, on the advice of tax counsel in order to resolve the matter, minimize potential penalties, and obtain assurances regarding our continued REIT tax status, we submitted to the IRS a request for a closing agreement on December 15, 2006, which agreement would conclude that any failure to satisfy the gross income tests would be due to reasonable cause and not to willful neglect. Since that time, we have had ongoing conversations with the IRS and we have submitted additional documentation in furtherance of the issuance of a closing agreement, but, to date, we have not yet entered into a closing agreement with respect to the related party tenant issue with the IRS. We intend to continue to pursue a closing agreement with the IRS.

As a result of the potential related party tenant issue described above and further discussed in Note 10 - Taxes to our consolidated financial statements for the year ended December 31, 2006 included elsewhere in this prospectus, we have recorded a \$2.3 million and \$2.4 million provision for income taxes, including related interest expense, for the

year ended December 31, 2006 and 2005, respectively. The

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## Management's discussion and analysis of financial condition and results of operations

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amount accrued represents the estimated liability and interest, which remains subject to final resolution and therefore is subject to change. In addition, in October 2006, we restructured our Advocat relationship and have been advised by tax counsel that we will not receive any non-qualifying related party tenant income from Advocat in future fiscal years. Accordingly, we do not expect to incur tax expense associated with related party tenant income in future periods commencing January 1, 2007, assuming we enter into a closing agreement with the IRS that recognizes that reasonable cause existed for any failure to satisfy the REIT gross income tests as explained above.

### *2006 Loss from Discontinued Operations*

Discontinued operations relate to properties we disposed of in 2006 or are currently held-for-sale and are accounted for as discontinued operations under SFAS No. 144. For the year ended December 31, 2006, we sold three SNFs and one ALF resulting in an accounting gain of approximately \$0.2 million.

At December 31, 2006, we had six assets held for sale with a net book value of approximately \$3.6 million. During the three months ended March 31, 2006, a \$0.1 million provision for impairment charge was recorded to reduce the carrying value to its sales price of one facility that was under contract to be sold that was subsequently sold during the second quarter of 2006. During the three months ended December 31, 2006, a \$0.4 million impairment charge was recorded to reduce the carrying value of two facilities, currently under contract to be sold in the first quarter of 2007, to their respective sales price.

In accordance with SFAS No. 144, the \$0.2 million realized net gain is reflected in our consolidated statements of operations as discontinued operations. See Note 18 - Discontinued Operations to our consolidated financial statements for the year ended December 31, 2006 included elsewhere in this prospectus.

### *Funds From Operations*

Our funds from operations available to common stockholders, or FFO, for the year ended December 31, 2006, was \$76.7 million, compared to \$42.7 million for the same period in 2005.

We calculate and report FFO in accordance with the definition and interpretive guidelines issued by the National Association of Real Estate Investment Trusts, or NAREIT, and, consequently, FFO is defined as net income available to common stockholders, adjusted for the effects of asset dispositions and certain non-cash items, primarily depreciation and amortization. We believe that FFO is an important supplemental measure of our operating performance. Because the historical cost accounting convention used for real estate assets requires depreciation (except on land), such accounting presentation implies that the value of real estate assets diminishes predictably over time, while real estate values instead have historically risen or fallen with market conditions. The term FFO was designed by the real estate industry to address this issue. FFO herein is not necessarily comparable to FFO of other REITs that do not use the same definition or implementation guidelines or interpret the standards differently from us.

We use FFO as one of several criteria to measure the operating performance of our business. We further believe that by excluding the effect of depreciation, amortization and gains or losses from sales of real estate, all of which are based on historical costs and which may be of limited relevance in evaluating current performance, FFO can facilitate comparisons of operating performance between periods and between other REITs. We offer this measure to assist the users of our financial statements in evaluating our financial performance under GAAP, and FFO should not be considered a measure of liquidity, an alternative to net income or an indicator of any other performance measure determined in accordance with GAAP. Investors and potential investors in our securities should not rely on this measure as a substitute for any GAAP measure, including net income.

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**Management's discussion and analysis of financial condition and results of operations**

In February 2004, NAREIT informed its member companies that it was adopting the position of the SEC with respect to asset impairment charges and would no longer recommend that impairment write-downs be excluded from FFO. In the table included below, we have applied this interpretation and have not excluded asset impairment charges in calculating our FFO. As a result, our FFO may not be comparable to similar measures reported in previous disclosures. According to NAREIT, there is inconsistency among NAREIT member companies as to the adoption of this interpretation of FFO. Therefore, a comparison of our FFO results to another company's FFO results may not be meaningful.

The following table presents our FFO results for the years ended December 31, 2006 and 2005:

	<b>Year Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
<b>Net income available to common</b>	\$ 45,774	\$ 25,355
Deduct gain from real estate dispositions <sup>(1)</sup>	(1,354)	(7,969)
	44,420	17,386
Elimination of non-cash items included in net income:		
Depreciation and amortization <sup>(2)</sup>	32,263	25,277
<b>Funds from operations available to common stockholders</b>	<b>\$ 76,683</b>	<b>\$ 42,663</b>

(1) The deduction of the gain from real estate dispositions includes the facilities classified as discontinued operations in our consolidated financial statements included elsewhere in this prospectus. The gain deducted includes \$1.2 million from a distribution from an investment in a limited partnership in 2006 and \$0.2 million gain and \$8.0 million gain related to facilities classified as discontinued operations for the year ended December 31, 2006 and 2005, respectively.

(2) The add back of depreciation and amortization includes the facilities classified as discontinued operations in our consolidated financial statements included elsewhere in this prospectus. FFO for 2006 and 2005 includes depreciation and amortization of \$0.2 million and \$1.4 million, respectively, related to facilities classified as discontinued operations.

Year Ended December 31, 2005 compared to Year Ended December 31, 2004

*Operating Revenues*

Our operating revenues for the year ended December 31, 2005 totaled \$109.6 million, an increase of \$22.7 million, over the same period in 2004. The \$22.7 million increase was primarily a result of new investments made throughout 2004 and 2005, contractual interest revenue associated with the payoff of a mortgage note, re-leasing and restructuring activities completed throughout 2004 and 2005. The increase in operating revenues from new investments was partially offset by a reduction in mortgage interest income.

Detailed changes in operating revenues for the year ended December 31, 2005 are as follows:

- Rental income was \$95.4 million, an increase of \$25.7 million over the same period in 2004. The increase was primarily due to new leases entered into throughout 2004 and 2005, re-leasing and restructuring activities.
- Mortgage interest income totaled \$6.5 million, a decrease of \$6.7 million over the same period in 2004. The decrease is primarily the result of normal amortization and a \$60 million loan payoff that occurred in the first quarter of 2005.

- Other investment income totaled \$3.2 million, an increase of \$0.1 million over the same period in 2004. The primary reason for the increase was due to dividends and accretion income associated with the Advocat securities.
  - Miscellaneous revenue was \$4.5 million, an increase of \$3.6 million over the same period in 2004. The increase was due to contractual revenue owed to us as a result of a mortgage note prepayment.
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## Management's discussion and analysis of financial condition and results of operations

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### *Operating Expenses*

Operating expenses for the year ended December 31, 2005 totaled \$33.6 million, an increase of approximately \$5.9 million over the same period in 2004. The increase was primarily due to \$5.0 million of increased depreciation expense and a \$1.1 million lease expiration accrual recorded in 2005.

Detailed changes in our operating expenses for the year ended December 31, 2005 are as follows:

- Our depreciation and amortization expense was \$23.9 million, compared to \$18.8 million for the same period in 2004. The increase is due to new investments placed throughout 2004 and 2005.
- Our general and administrative expense was \$8.6 million, compared to \$8.8 million for the same period in 2004.
  - A \$0.1 million provision for uncollectible notes receivable was recorded in 2005.
- A \$1.1 million lease expiration accrual was recorded in 2005 relating to disputed capital improvement requirements associated with a lease that expired June 30, 2005.

### *Other Income (Expense)*

For the year ended December 31, 2005, our total other net expenses were \$36.3 million as compared to \$45.5 million for the same period in 2004. The significant changes are as follows:

- Our interest expense, excluding amortization of deferred costs and refinancing related interest expenses, for the year ended December 31, 2005 was \$29.9 million, compared to \$23.1 million for the same period 2004. The increase of \$6.8 million was primarily due to higher debt on our balance sheet versus the same period in 2004.
    - For the year ended December 31, 2005, we recorded a \$2.8 million non-cash charge associated with the tender and purchase of \$79.3 million principal amount of our 6.95% unsecured notes due 2007.
  - For the year ended December 31, 2005, we recorded a \$3.4 million provision for impairment on an equity security. In accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, we recorded the provision for impairment to write-down our 760,000 share investment in Sun common stock to its then current fair market value of \$4.9 million.
  - For the year ended December 31, 2004, we recorded \$19.1 million of refinancing-related charges associated with refinancing our capital structure. The \$19.1 million consists of a \$6.4 million exit fee paid to our old bank syndication and a \$6.3 million non-cash deferred financing cost write-off associated with the termination of our \$225 million credit facility and our \$50 million acquisition facility, and a loss of approximately \$6.5 million associated with the sale of an interest rate cap.
  - For the year ended December 31, 2004, we recorded a \$1.1 million fair value adjustment to reflect the change in fair value during 2004 of our derivative instrument (i.e., the conversion feature of a redeemable convertible preferred stock security in *Advocat*, a publicly traded company; see Note 5 - Other Investments to our consolidated financial statements for the year ended December 31, 2006 included elsewhere in this prospectus).
  - For the year ended December 31, 2004, we recorded a \$3.0 million charge associated with professional liability claims made against our former owned and operated facilities.
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## Management's discussion and analysis of financial condition and results of operations

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### *2005 Taxes*

As a result of the possible related party tenant issue discussed in Note 10 - Taxes to our consolidated financial statements for the year ended December 31, 2006 included elsewhere in this prospectus, we have recorded a \$2.4 million and \$0.4 million provision for income tax for the years ended December 31, 2005 and 2004, respectively. The amount accrued represents the estimated liability and interest, which remains subject to final resolution and therefore is subject to change. In addition, in October 2006, we restructured our Advocat relationship and have been advised by tax counsel that we will not receive any non-qualifying related party tenant income from Advocat in future fiscal years. Accordingly, we do not expect to incur tax expense associated with related party tenant income in future periods commencing January 1, 2007, assuming we enter into a closing agreement with the IRS that recognizes that reasonable cause existed for any failure to satisfy the REIT gross income tests as explained above.

In addition, for tax year 2005, preferred and common dividend payments of approximately \$56 million made throughout 2005 satisfy the 2005 REIT distribution requirements (which require that we distribute at least 90% of our REIT taxable income for the taxable year and meet certain other conditions in order to qualify as a REIT). Further, we are permitted to own up to 100% of a TRS. Currently, we have two TRSs that are taxable as corporations and that pay federal, state and local income tax on their net income at the applicable corporate rates. These TRSs had net operating loss carry-forwards as of December 31, 2005 of \$14.4 million. These loss carry-forwards were fully reserved with a valuation allowance due to uncertainties regarding realization.

### *2005 Income from Discontinued Operations*

Discontinued operations relate to properties we disposed of in 2005 or are currently held-for-sale and are accounted for as discontinued operations under SFAS No. 144. For the year ended December 31, 2005, we sold eight SNFs, six ALFs and 50.4 acres of undeveloped land for combined cash proceeds of approximately \$53 million, net of closing costs and other expenses, resulting in a combined accounting gain of approximately \$8.0 million.

During the year ended December 31, 2005, a combined \$9.6 million provision for impairment charge was recorded to reduce the carrying value on several facilities, some of which were subsequently closed, to their estimated fair values.

In accordance with SFAS No. 144, the \$8.0 million realized net gain as well as the combined \$9.6 million impairment charge is reflected in our consolidated statements of operations as discontinued operations.

### *Funds From Operations*

Our FFO for the year ended December 31, 2005, was \$42.7 million, compared to a deficit of \$18.5 million, for the same period in 2004.

We calculate and report FFO in accordance with the definition and interpretive guidelines issued by NAREIT, and, consequently, FFO is defined as net income available to common stockholders, adjusted for the effects of asset dispositions and certain non-cash items, primarily depreciation and amortization. We believe that FFO is an important supplemental measure of our operating performance. Because the historical cost accounting convention used for real estate assets requires depreciation (except on land), such accounting presentation implies that the value of real estate assets diminishes predictably over time, while real estate values instead have historically risen or fallen with market conditions. The term FFO was designed by the real estate industry to address this issue. FFO herein is not necessarily comparable to FFO of other REITs that do not use the same definition or implementation guidelines or interpret the standards differently from us.

We use FFO as one of several criteria to measure operating performance of our business. We further believe that by excluding the effect of depreciation, amortization and gains or losses from sales of real estate, all of which are based on historical costs and which may be of limited relevance in evaluating

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**Management's discussion and analysis of financial condition and results of operations**

current performance, FFO can facilitate comparisons of operating performance between periods and between other REITs. We offer this measure to assist the users of our financial statements in evaluating our financial performance under GAAP, and FFO should not be considered a measure of liquidity, an alternative to net income or an indicator of any other performance measure determined in accordance with GAAP. Investors and potential investors in our securities should not rely on this measure as a substitute for any GAAP measure, including net income.

In February 2004, NAREIT informed its member companies that it was adopting the position of the SEC with respect to asset impairment charges and would no longer recommend that impairment write-downs be excluded from FFO. In the tables included in this disclosure, we have applied this interpretation and have not excluded asset impairment charges in calculating our FFO. As a result, our FFO may not be comparable to similar measures reported in previous disclosures. According to NAREIT, there is inconsistency among NAREIT member companies as to the adoption of this interpretation of FFO. Therefore, a comparison of our FFO results to another company's FFO results may not be meaningful.

The following table presents our FFO results for the years ended December 31, 2005 and 2004:

	<b>Year Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Net income (loss) available to common</b>	\$ 25,355	\$ (36,715)
Deduct gain from real estate dispositions <sup>(1)</sup>	(7,969)	(3,310)
	17,386	(40,025)
Elimination of non-cash items included in net income (loss):		
Depreciation and amortization <sup>(2)</sup>	25,277	21,551
<b>Funds from operations available to common stockholders</b>	\$ 42,663	\$ (18,474)

(1) The deduction of the gain from real estate dispositions includes the facilities classified as discontinued operations in our consolidated financial statements. The gain deducted includes \$8.0 million gain and \$3.3 million gain related to facilities classified as discontinued operations for the year ended December 31, 2005 and 2004, respectively.

(2) The add back of depreciation and amortization includes the facilities classified as discontinued operations in our consolidated financial statements. FFO for 2005 and 2004 includes depreciation and amortization of \$1.4 million and \$2.7 million, respectively, related to facilities classified as discontinued operations.

**LIQUIDITY AND CAPITAL RESOURCES**

At December 31, 2006, we had total assets of \$1.2 billion, stockholders' equity of \$465.5 million and debt of \$676.1 million, representing approximately 59.2% of total capitalization.

The following table shows the amounts due in connection with the contractual obligations described below as of December 31, 2006.

	<b>Total</b>	<b>Payments due by period</b>			<b>More than 5 years</b>	
		<b>Less than 1 year</b>	<b>1-3 years</b>	<b>3-5 years</b>		
			<b>(in thousands)</b>			
Long-term debt <sup>(1)</sup>	\$ 676,410	\$ 415	\$ 900	\$ 150,785	\$ 524,310	
Other long-term liabilities	513	236	277	-	-	
<b>Total</b>	<b>\$ 676,923</b>	<b>\$ 651</b>	<b>\$ 1,177</b>	<b>\$ 150,785</b>	<b>\$ 524,310</b>	

- (1) The \$676.4 million includes \$310 million aggregate principal amount of 7.0% Senior Notes due 2014, \$175 million principal amount of 7.0% Senior Notes due 2016, \$150.0 million borrowings under our Credit Facility and Haven's \$39 million first mortgage loan with General electric Capital Corporation that expires in 2012.
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## Management's discussion and analysis of financial condition and results of operations

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### Financing Activities and Borrowing Arrangements

#### *Bank Credit Agreements*

At December 31, 2006, we had \$150.0 million outstanding under our \$200 million revolving senior secured credit facility, or the Credit Facility, and \$2.5 million was utilized for the issuance of letters of credit, leaving availability of \$47.5 million. The \$150.0 million of outstanding borrowings had a blended interest rate of 6.60% at December 31, 2006. The Credit Facility, entered into on March 31, 2006, is being provided by Bank of America, N.A., as Administrative Agent, Deutsche Bank Trust Company Americas, UBS Securities LLC, General Electric Capital Corporation, LaSalle Bank N.A., and Citicorp North America, Inc. and will be used for acquisitions and general corporate purposes.

The Credit Facility replaced our previous \$200 million senior secured credit facility, or the Prior Credit Facility, that was terminated on March 31, 2006. The Credit Facility matures on March 31, 2010, and includes an "accordion feature" that permits us to expand our borrowing capacity to \$300 million during our first two years. For the year ended December 31, 2006, we recorded a one-time, non-cash charge of approximately \$2.7 million relating to the write-off of deferred financing costs associated with the termination of our Prior Credit Facility.

Our long-term borrowings require us to meet certain property level financial covenants and corporate financial covenants, including prescribed leverage, fixed charge coverage, minimum net worth, limitations on additional indebtedness and limitations on dividend payouts. As of December 31, 2006, we were in compliance with all property level and corporate financial covenants.

#### *\$100 Million Aggregate Principal Amount of 6.95% Unsecured Notes Tender and Redemption*

On December 16, 2005, we initiated a tender offer and consent solicitation for all of our outstanding \$100 million aggregate principal amount 6.95% notes due 2007, or the 2007 Notes. On December 30, 2005, we accepted for purchase 79.3% of the aggregate principal amount of the 2007 Notes outstanding that were tendered. On December 30, 2005, our Board of Directors also authorized the redemption of all outstanding 2007 Notes that were not otherwise tendered. On December 30, 2005, upon our irrevocable funding of the full redemption price for the 2007 Notes and certain other acts required by the Indenture governing the 2007 Notes, the Trustee of the 2007 Notes certified in writing to us, or the Certificate of Satisfaction and Discharge, that the Indenture was satisfied and discharged as of December 30, 2005, except for certain provisions. In accordance with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, we removed 79.3% of the aggregate principal amount of the 2007 Notes, which were tendered in our tender offer and consent solicitation, and the corresponding portion of the funds held in trust by the Trustee to pay the tender price from our balance sheet and recognized \$2.8 million of additional interest expense associated with the tender offer. On January 18, 2006, we completed the redemption of the remaining 2007 Notes not otherwise tendered. In connection with the redemption and in accordance with FASB No. 140, we recognized \$0.8 million of additional interest expense in the first quarter of 2006. As of January 18, 2006, none of the 2007 Notes remained outstanding.

#### *\$175 Million Aggregate Principal Amount of 7% Unsecured Notes Issuance*

On December 30, 2005, we closed on a private offering of \$175 million of 7% senior unsecured notes due 2016, or 2016 Notes, at an issue price of 99.109% of the principal amount of the notes (equal to a per annum yield to maturity of approximately 7.125%), resulting in gross proceeds to us of approximately \$173.4 million. The 2016 Notes are unsecured senior obligations to us, which have been guaranteed by our subsidiaries. The 2016 Notes were issued in a private placement to qualified institutional buyers under Rule 144A under the Securities Act of 1933, or the Securities Act. A portion of the proceeds of this private offering was used to pay the tender price and redemption price of the

2007 Notes. On February 24, 2006, we filed a registration statement on Form S-4 under the Securities Act with the SEC offering to exchange up to \$175 million aggregate principal amount of our registered 7% Senior Notes due 2016, or the 2016 Exchange Notes, for all of our outstanding unregistered 2016 Notes. The

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## Management's discussion and analysis of financial condition and results of operations

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terms of the 2016 Exchange Notes are identical to the terms of the 2016 Notes, except that the 2016 Exchange Notes are registered under the Securities Act and therefore freely tradable (subject to certain conditions). The 2016 Exchange Notes represent our unsecured senior obligations and are guaranteed by all of our subsidiaries with unconditional guarantees of payment that rank equally with existing and future senior unsecured debt of such subsidiaries and senior to existing and future subordinated debt of such subsidiaries. In April 2006, upon the expiration of the 2016 Notes Exchange Offer, \$175 million aggregate principal amount of 2016 Notes were exchanged for the 2016 Exchange Notes.

### *\$50 Million Aggregate Principal Amount of 7% Unsecured Notes Issuance*

On December 2, 2005, we completed a privately placed offering of an additional \$50 million aggregate principal amount of 7% senior notes due 2014, or the 2014 Add-on Notes, at an issue price of 100.25% of the principal amount of the notes (equal to a per annum yield to maturity of approximately 6.95%), resulting in gross proceeds to us of approximately \$50.1 million. The terms of the 2014 Add-on Notes offered were substantially identical to our existing \$200 million aggregate principal amount of 7% senior notes due 2014 issued in March 2004. The 2014 Add-on Notes were issued through a private placement to qualified institutional buyers under Rule 144A under the Securities Act. After giving effect to the issuance of the \$50 million aggregate principal amount of this offering, we had outstanding \$310 million aggregate principal amount of 7% senior notes due 2014. On February 24, 2006, we filed a registration statement on Form S-4 under the Securities Act with the SEC offering to exchange up to \$50 million aggregate principal amount of our registered 7% Senior Notes due 2014 (the "2014 Add-on Exchange Notes"), for all of our outstanding unregistered 2014 Add-on Notes. The terms of the 2014 Add-on Exchange Notes are identical to the terms of the 2014 Add-on Notes, except that the 2014 Add-on Exchange Notes are registered under the Securities Act and therefore freely tradable (subject to certain conditions). The 2014 Add-on Exchange Notes represent our unsecured senior obligations and are guaranteed by all of our subsidiaries with unconditional guarantees of payment that rank equally with existing and future senior unsecured debt of such subsidiaries and senior to existing and future subordinated debt of such subsidiaries. In May 2006, upon the expiration of the 2014 Add-on Notes Exchange Offer, \$50 million aggregate principal amount of 2014 Add-on Notes were exchanged for the 2014 Add-on Exchange Notes.

### *5.175 Million Common Stock Offering*

On November 21, 2005, we closed an underwritten public offering of 5,175,000 shares of our common stock at \$11.80 per share, less underwriting discounts. The sale included 675,000 shares sold in connection with the exercise of an over-allotment option granted to the underwriters. We received approximately \$58 million in net proceeds from the sale of the shares, after deducting underwriting discounts and before estimated offering expenses.

### *8.625% Series B Preferred Redemption*

On May 2, 2005, we fully redeemed our 8.625% Series B Cumulative Preferred Stock (NYSE:OHI PrB), or Series B Preferred Stock. We redeemed the 2.0 million shares of Series B at a price of \$25.55104, comprising the \$25 liquidation value and accrued dividend. Under FASB-EITF Issue D-42, *The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock*, the repurchase of the Series B Preferred Stock resulted in a non-cash charge to net income available to common shareholders of approximately \$2.0 million reflecting the write-off of the original issuance costs of the Series B Preferred Stock.

### *Other Long-Term Borrowings*

During the three months ended March 31, 2006, Haven used the \$39 million of proceeds from the GE Loan to partially repay a portion of a \$62 million mortgage it has with us. Simultaneously, we subordinated the payment of its

remaining \$23 million on the mortgage note to that of the GE Loan. In conjunction with the above transactions and the application of FIN 46R, we consolidated the financial

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## Management's discussion and analysis of financial condition and results of operations

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statements of this Haven entity into our financial statements, which contained the long-term borrowings with General Electric Capital Corporation of \$39.0 million. The loan has an interest rate of approximately seven percent and is due in 2012. The lender of the \$39.0 million does not have recourse to our assets. See Note - 3 Properties; Leased Property to our consolidated financial statements for the year ended December 31, 2006 included elsewhere in this prospectus.

### Dividends

In order to qualify as a REIT, we are required to make distributions (other than capital gain dividends) to our stockholders in an amount at least equal to (A) the sum of (i) 90% of our "REIT taxable income" (computed without regard to the dividends paid deduction and our net capital gain), and (ii) 90% of the net income (after tax), if any, from foreclosure property, minus (B) the sum of certain items of non-cash income. In addition, if we dispose of any built-in gain asset during a recognition period, we will be required to distribute at least 90% of the built-in gain (after tax), if any, recognized on the disposition of such asset. Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for such year and paid on or before the first regular dividend payment after such declaration. In addition, such distributions are required to be made pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that such class is entitled to such a preference. To the extent that we do not distribute all of our net capital gain or do distribute at least 90%, but less than 100% of our "REIT taxable income," as adjusted, we will be subject to corporate level income tax thereon at regular corporate tax rates. In addition, our Credit Facility has certain financial covenants that limit the distribution of dividends paid during a fiscal quarter to no more than 95% of our aggregate cumulative funds from operations, or FFO, as defined in the loan agreement governing the Credit Facility, or the Loan Agreement, unless a greater distribution is required to maintain REIT status. The Loan Agreement defines FFO as net income (or loss) plus depreciation and amortization and shall be adjusted for charges related to: (i) restructuring our debt; (ii) redemption of preferred stock; (iii) litigation charges up to \$5.0 million; (iv) non-cash charges for accounts and notes receivable up to \$5.0 million; (v) non-cash compensation related expenses; (vi) non-cash impairment charges; and (vii) tax liabilities in an amount not to exceed \$8.0 million.

#### *Common Dividends*

On January 16, 2007, the Board of Directors declared a common stock dividend of \$0.26 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend was paid February 15, 2007 to common stockholders of record on January 31, 2007.

On October 24, 2006, the Board of Directors declared a common stock dividend of \$0.25 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend was paid November 15, 2006 to common stockholders of record on November 3, 2006.

On July 17, 2006, the Board of Directors declared a common stock dividend of \$0.24 per share. The common dividend was paid August 15, 2006 to common stockholders of record on July 31, 2006.

On April 18, 2006, the Board of Directors declared a common stock dividend of \$0.24 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend was paid May 15, 2006 to common stockholders of record on April 28, 2006.

On January 17, 2006, the Board of Directors declared a common stock dividend of \$0.23 per share, an increase of \$0.01 per common share compared to the prior quarter. The common stock dividend was paid February 15, 2006 to

common stockholders of record on January 31, 2006.

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### *Series D Preferred Dividends*

On January 16, 2007, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on its 8.375% Series D cumulative redeemable preferred stock, or the Series D Preferred Stock, that were paid February 15, 2007 to preferred stockholders of record on January 31, 2007. The liquidation preference for our Series D Preferred Stock is \$25.00 per share. Regular quarterly preferred dividends for the Series D Preferred Stock represent dividends for the period November 1, 2006 through January 31, 2007.

On October 24, 2006, the Board of Directors declared the regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid November 15, 2006 to stockholders of record on November 3, 2006.

On July 17, 2006, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid August 15, 2006 to preferred stockholders of record on July 31, 2006.

On April 18, 2006, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid May 15, 2006 to preferred stockholders of record on April 28, 2006.

On January 17, 2006, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid February 15, 2006 to preferred stockholders of record on January 31, 2006.

## **LIQUIDITY**

We believe our liquidity and various sources of available capital, including cash from operations, our existing availability under our Credit Facility and expected proceeds from mortgage payoffs are more than adequate to finance operations, meet recurring debt service requirements and fund future investments through the next twelve months.

We regularly review our liquidity needs, the adequacy of cash flow from operations, and other expected liquidity sources to meet these needs. We believe our principal short-term liquidity needs are to fund:

· normal recurring expenses;

· debt service payments;

· preferred stock dividends;

· common stock dividends; and

· growth through acquisitions of additional properties.

The primary source of liquidity is our cash flows from operations. Operating cash flows have historically been determined by: (i) the number of facilities we lease or have mortgages on; (ii) rental and mortgage rates; (iii) our debt service obligations; and (iv) general and administrative expenses. The timing, source and amount of cash flows provided by financing activities and used in investing activities are sensitive to the capital markets environment, especially to changes in interest rates. Changes in the capital markets environment may impact the availability of

cost-effective capital and affect our plans for acquisition and disposition activity.

Cash and cash equivalents totaled \$0.7 million as of December 31, 2006, a decrease of \$3.2 million as compared to the balance at December 31, 2005. The following is a discussion of changes in cash and cash equivalents due to operating, investing and financing activities, which are presented in our Consolidated Statement of Cash Flows included elsewhere in this prospectus.

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## Management's discussion and analysis of financial condition and results of operations

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Operating Activities - Net cash flow from operating activities generated \$62.8 million for the year ended December 31, 2006, as compared to \$74.1 million for the same period in 2005. The \$11.2 million decrease is due primarily to: (i) an investment made with Guardian that is classified as a lease inducement asset and (ii) one-time contractual revenue associated with a mortgage note prepayment in 2005. The decrease was partially offset by (i) incremental revenue associated with acquisitions completed throughout 2005 and 2006 and (ii) normal working capital fluctuations during the period.

Investing Activities - Net cash flow from investing activities was an outflow of \$161.4 million for the year ended December 31, 2006, as compared to an outflow of \$195.3 million for the same period in 2005. The decrease in outflows of \$34.0 million was primarily due to: (i) \$70 million of fewer acquisitions completed in 2006 versus 2005; (ii) \$50 million of fewer proceeds received from the sale of real estate assets and the sale of Sun common stock in 2006 versus 2005; and (iii) a \$10 million mortgage payoff in 2006 versus a \$60 million mortgage payoff in 2005.

Financing Activities - Net cash flow from financing activities was an inflow of \$95.3 million for the year ended December 31, 2006 as compared to an inflow of \$113.1 million for the same period in 2005. The change in financing cash flow was primarily a result of: (i) \$50 million of additional net borrowings under our Credit Facility in 2006 compared to 2005; (ii) no common equity offerings in 2006 compared to a public issuance of 5.2 million shares of our common stock at a price of \$11.80 per share in 2005; (iii) no debt offerings in 2006 compared to private offerings of a combined \$225 million of senior unsecured notes in 2005; (iv) a \$50 million redemption of Series B Preferred Stock in 2005; (v) a tender offer and purchase of our 2007 Notes in 2005; (vi) \$26 million of incremental DRIP proceeds in 2006; (vii) \$39 million in proceeds in 2006 due to the consolidation of a VIE; and (viii) \$11 million of additional payments of common and preferred dividend payments in 2006.

### EFFECTS OF RECENTLY ISSUED ACCOUNTING STANDARDS

In December 2004, the Financial Accounting Standards Board, or FASB, issued FAS No. 123 (revised 2004), *Share-Based Payment*, or FAS No. 123R, which is a revision of FAS No. 123, *Accounting for Stock-Based Compensation*. FAS No. 123R supersedes Accounting Principles Board, APB, Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FAS No. 95, *Statement of Cash Flows*. We adopted FAS No. 123R at the beginning of our 2006 fiscal year using the modified prospective transition method. The additional expense recorded in 2006 as a result of this adoption was approximately \$3,000.

#### FIN 48 Evaluation

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, or FIN 48. FIN 48 is an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 will require expanded disclosure with respect to the uncertainty in income taxes and is effective as of the beginning of our 2007 fiscal year. We are currently evaluating the impact of adoption of FIN 48 on our financial statements and we currently expect the impact to be immaterial.

#### FAS 157 Evaluation

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, or FAS No. 157. This standard defines fair value, establishes a methodology for measuring fair value and expands the required disclosure for fair value measurements. FAS No. 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those years. Provisions of FAS No. 157 are required to be applied prospectively as of the beginning of the fiscal year in which FAS No. 157 is applied. We are evaluating the impact that FAS No. 157 will have on our financial statements.



**Management's discussion and analysis of financial condition and results of operations**

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**QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

We are exposed to various market risks, including the potential loss arising from adverse changes in interest rates. We do not enter into derivatives or other financial instruments for trading or speculative purposes, but we seek to mitigate the effects of fluctuations in interest rates by matching the term of new investments with new long-term fixed rate borrowing to the extent possible.

The following disclosures of estimated fair value of financial instruments are subjective in nature and are dependent on a number of important assumptions, including estimates of future cash flows, risks, discount rates and relevant comparable market information associated with each financial instrument. The use of different market assumptions and estimation methodologies may have a material effect on the reported estimated fair value amounts. Accordingly, the estimates presented below are not necessarily indicative of the amounts we would realize in a current market exchange.

*Mortgage notes receivable* - The fair value of mortgage notes receivable is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

*Notes receivable* - The fair value of notes receivable is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

*Borrowings under lines of credit arrangement* - The carrying amount approximates fair value because the borrowings are interest rate adjustable.

*Senior unsecured notes* - The fair value of the senior unsecured notes is estimated by discounting the future cash flows using the current borrowing rate available for the similar debt.

The market value of our long-term fixed rate borrowings and mortgages is subject to interest rate risks. Generally, the market value of fixed rate financial instruments will decrease as interest rates rise and increase as interest rates fall. The estimated fair value of our total long-term borrowings at December 31, 2006 was approximately \$693.7 million. A one percent increase in interest rates would result in a decrease in the fair value of long-term borrowings by approximately \$30.7 million at December 31, 2006. The estimated fair value of our total long-term borrowings at December 31, 2005 was approximately \$568.7 million, and a one percent increase in interest rates would have resulted in a decrease in the fair value of long-term borrowings by approximately \$31 million.

While we currently do not engage in hedging strategies, we may engage in such strategies in the future, depending on management's analysis of the interest rate environment and the costs and risks of such strategies.

## Business

### OVERVIEW

We are a self-administered real estate investment trust, or REIT, investing in income-producing healthcare facilities, principally long-term care facilities located in the United States. We provide lease or mortgage financing to qualified operators of skilled nursing facilities, or SNFs, and, to a lesser extent, assisted living facilities, or ALFs, and rehabilitation and acute care facilities. We have historically financed investments through borrowings under our revolving credit facilities, private placements or public offerings of debt or equity securities, the assumption of secured indebtedness, or a combination of these methods.

Our portfolio of investments, as of December 31, 2006, consisted of 239 healthcare facilities, located in 27 states and operated by 32 third-party operators. This portfolio is made up of:

- 228 long-term healthcare facilities and two rehabilitation hospitals owned and leased to third parties; and
- fixed rate mortgages on nine long-term healthcare facilities.

As of December 31, 2006, our gross investments in these facilities, net of impairments and before reserve for uncollectible loans, totaled approximately \$1.3 billion. In addition, we also held miscellaneous investments of approximately \$22 million at December 31, 2006, consisting primarily of secured loans to third-party operators of our facilities.

For the year ended December 31, 2006, we generated operating revenue of \$135.7 million, net income of \$55.7 million, and \$76.7 million of funew from operations, or FFO. FFO is not a financial measure recognized under generally accepted accounting principles in the United States of America, or GAAP, and, therefore, should not be considered a measure of liquidity, an alternative to net income or an indicator of any other performance measure determined in accordance with GAAP. For more information with respect to FFO and a reconciliation of FFO to GAAP net income, see footnote 2 in the section entitled "Summary Historical Financial Information."

### DESCRIPTION OF THE BUSINESS

**Investment Strategy.** We maintain a diversified portfolio of long-term healthcare facilities and mortgages on long-term healthcare facilities located throughout the United States. In making investments, we generally have focused on established, creditworthy, middle-market healthcare operators that meet our standards for quality and experience of management. We have sought to diversify our investments in terms of geographic locations and operators.

In evaluating potential investments, we consider such factors as:

- the quality and experience of management and the creditworthiness of the operator of the facility;

- the facility's historical and forecasted cash flow and its ability to meet operational needs, capital expenditure requirements and lease or debt service obligations, providing a competitive return on our investment;

- the construction quality, condition and design of the facility;