HEALTHCARE REALTY TRUST INC
Form 10-Q
November 07, 2012
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended: September 30, 2012

OR

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

For the transition period from to

Commission File Number: 001-11852

HEALTHCARE REALTY TRUST INCORPORATED
(Exact name of Registrant as specified in its charter)

Maryland (State or other jurisdiction of incorporation or organization)	62 – 1507028 (I.R.S. Employer Identification No.)

3310 West End Avenue
Suite 700
Nashville, Tennessee 37203
(Address of principal executive offices)

(615) 269-8175
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

(Do not check if a smaller reporting company)

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of October 31, 2012, 87,230,950 shares of the Registrant's Common Stock were outstanding.

Table of Contents

HEALTHCARE REALTY TRUST INCORPORATED
FORM 10-Q
September 30, 2012

TABLE OF CONTENTS

		Page
Part I—Financial Information		
Item 1.	Financial Statements	
	Condensed Consolidated Balance Sheets	1
	Condensed Consolidated Statements of Operations	2
	Condensed Consolidated Statements of Comprehensive Income (Loss)	3
	Condensed Consolidated Statements of Cash Flows	4
	Notes to Condensed Consolidated Financial Statements	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	28
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	42
Item 4.	Controls and Procedures	42
Part II—Other Information		
Item 1.	Legal Proceedings	43
Item 1A.	Risk Factors	43
Item 6.	Exhibits	44
Signature		46

Table of Contents

Part I. FINANCIAL INFORMATION

Item 1. Financial Statements.

Healthcare Realty Trust Incorporated
Condensed Consolidated Balance Sheets
(Dollars in thousands, except per share data)

	(Unaudited) September 30, 2012	December 31, 2011
ASSETS		
Real estate properties:		
Land	$156,427	$162,843
Buildings, improvements and lease intangibles	2,544,935	2,521,226
Personal property	18,860	18,221
Construction in progress	—	61,152
Land held for development	25,171	25,176
	2,745,393	2,788,618
Less accumulated depreciation	(557,951)	(516,747)
Total real estate properties, net	2,187,442	2,271,871
Cash and cash equivalents	8,781	4,738
Mortgage notes receivable	141,107	97,381
Assets held for sale and discontinued operations, net	11,550	28,650
Other assets, net	121,896	118,382
Total assets	$2,470,776	$2,521,022
LIABILITIES AND EQUITY		
Liabilities:		
Notes and bonds payable	$1,212,615	$1,393,537
Accounts payable and accrued liabilities	51,264	72,217
Liabilities of discontinued operations	162	518
Other liabilities	55,668	49,944
Total liabilities	1,319,709	1,516,216
Commitments and contingencies		
Equity:		
Preferred stock, $.01 par value; 50,000,000 shares authorized; none issued and outstanding	—	—
Common stock, $.01 par value; 150,000,000 shares authorized; 87,230,936 and 77,843,883 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	872	779
Additional paid-in capital	2,099,101	1,894,604
Accumulated other comprehensive loss	(3,332)	(3,332)
Cumulative net income attributable to common stockholders	807,808	795,951
Cumulative dividends	(1,753,382)	(1,683,196)
Total stockholders' equity	1,151,067	1,004,806
Total liabilities and equity	$2,470,776	$2,521,022

The accompanying notes, together with the Notes to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, are an integral part of these financial statements.

1

Table of Contents

Healthcare Realty Trust Incorporated
Condensed Consolidated Statements of Operations
For the Three and Nine Months Ended September 30, 2012 and 2011
(Dollars in thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
REVENUES				
Rental income	$75,305	$70,004	$222,479	$203,446
Mortgage interest	2,244	1,776	6,575	5,250
Other operating	1,523	2,061	4,664	6,400
	79,072	73,841	233,718	215,096
EXPENSES				
Property operating	30,115	30,070	87,970	85,108
General and administrative	4,732	5,530	14,514	16,467
Depreciation	21,172	19,150	63,098	55,496
Amortization	2,554	2,222	7,631	5,777
Bad debt, net	40	(353)	149	(82)
	58,613	56,619	173,362	162,766
OTHER INCOME (EXPENSE)				
Loss on extinguishment of debt	—	—	—	(1,986)
Interest expense	(18,905)	(17,928)	(55,814)	(57,546)
Interest and other income, net	204	199	711	618
	(18,701)	(17,729)	(55,103)	(58,914)
INCOME (LOSS) FROM CONTINUING OPERATIONS	1,758	(507)	5,253	(6,584)
DISCONTINUED OPERATIONS				
Income from discontinued operations	672	1,352	4,145	3,789
Impairments	(2,860)	(1,551)	(7,197)	(1,698)
Gain on sales of real estate properties	6,265	1,357	9,696	1,393
INCOME FROM DISCONTINUED OPERATIONS	4,077	1,158	6,644	3,484
NET INCOME (LOSS)	5,835	651	11,897	(3,100)
Less: Net income attributable to noncontrolling interests	(20)	(4)	(40)	(31)
NET INCOME (LOSS) ATTRIBUTABLE TO COMMON STOCKHOLDERS	$5,815	$647	$11,857	$(3,131)
BASIC EARNINGS (LOSS) PER COMMON SHARE:				
Income (loss) from continuing operations	$0.02	$(0.01)	$0.07	$(0.09)
Discontinued operations	0.06	0.02	0.08	0.05
Net income (loss) attributable to common stockholders	$0.08	$0.01	$0.15	$(0.04)
DILUTED EARNINGS (LOSS) PER COMMON SHARE:				
Income (loss) from continuing operations	$0.02	$(0.01)	$0.07	$(0.09)
Discontinued operations	0.05	0.02	0.08	0.05
Net income (loss) attributable to common stockholders	$0.07	$0.01	$0.15	$(0.04)
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING—BASIC	76,712,594	76,139,055	76,534,508	71,478,463
	78,020,971	76,139,055	77,799,291	71,478,463

WEIGHTED AVERAGE COMMON SHARES OUTSTANDING—DILUTED				
DIVIDENDS DECLARED, PER COMMON SHARE, DURING THE PERIOD	$0.30	$0.30	$0.90	$0.90

The accompanying notes, together with the Notes to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, are an integral part of these financial statements.

Table of Contents

Healthcare Realty Trust Incorporated
Condensed Consolidated Statements of Comprehensive Income (Loss)
For the Three and Nine Months Ended September 30, 2012 and 2011
(Dollars in thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
COMPREHENSIVE INCOME (LOSS)	$5,835	$651	$11,897	$(3,100)
Less: Comprehensive income attributable to noncontrolling interests	(20)	(4)	(40)	(31)
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO COMMON STOCKHOLDERS	$5,815	$647	$11,857	$(3,131)

The accompanying notes, together with the Notes to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, are an integral part of these financial statements.

Table of Contents

Healthcare Realty Trust Incorporated
Condensed Consolidated Statements of Cash Flows
For the Nine Months Ended September 30, 2012 and 2011
(Dollars in thousands)
(Unaudited)

	2012	2011
OPERATING ACTIVITIES		
Net income (loss)	$11,897	$(3,100)
Adjustments to reconcile net income (loss) to cash provided by operating activities:		
Depreciation and amortization	74,688	67,384
Stock-based compensation	2,588	2,272
Straight-line rent receivable	(4,926)	(3,493)
Straight-line rent liability	312	369
Gain on sales of real estate properties	(9,696)	(1,393)
Loss on extinguishment of debt	—	1,986
Impairments	7,197	1,698
Provision for bad debt, net	147	(65)
Changes in operating assets and liabilities:		
Other assets	(3,051)	(4,532)
Accounts payable and accrued liabilities	(13,228)	(1,380)
Other liabilities	6,344	7,500
Net cash provided by operating activities	72,272	67,246
INVESTING ACTIVITIES		
Acquisition and development of real estate properties	(76,134)	(179,851)
Funding of mortgages and notes receivable	(54,264)	(91,978)
Proceeds from sales of real estate	64,866	4,993
Proceeds from mortgage repayment by previously consolidated VIE	35,057	—
Proceeds from mortgages and notes receivable repayments	11,931	14,988
Net cash used in investing activities	(18,544)	(251,848)
FINANCING ACTIVITIES		
Net borrowings (repayments) on unsecured credit facility	(178,000)	175,000
Repayments on notes and bonds payable	(3,678)	(2,537)
Repurchase of notes payable	—	(280,201)
Dividends paid	(70,186)	(65,918)
Net proceeds from issuance of common stock	202,247	251,836
Common stock redemptions	(45)	(51)
Distributions to noncontrolling interest holders	(20)	(281)
Purchase of noncontrolling interests	—	(1,591)
Debt issuance and assumption costs	(3)	(922)
Net cash provided by (used in) financing activities	(49,685)	75,335
Increase (decrease) in cash and cash equivalents	4,043	(109,267)
Cash and cash equivalents, beginning of period	4,738	113,321
Cash and cash equivalents, end of period	$8,781	$4,054

Table of Contents

Healthcare Realty Trust Incorporated
Condensed Consolidated Statements of Cash Flows
For the Nine Months Ended September 30, 2012 and 2011
(Dollars in thousands)
(Unaudited)

	2012	2011
Supplemental Cash Flow Information:		
Interest paid	$64,773	$61,253
Capitalized interest	$4,782	$6,402
Company-financed real estate property sales	$11,200	$2,700
Invoices accrued for construction, tenant improvement and other capitalized costs	$2,717	$17,075
Construction liabilities transferred upon deconsolidation of VIE	$3,450	$—
Estimated equity issuance costs accrued but not yet paid	$218	$—
Mortgage notes payable assumed upon acquisition (adjusted to fair value)	$—	$46,832
Elimination of mortgage note upon consolidation of VIE	$—	$21,939

The accompanying notes, together with the Notes to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, are an integral part of these financial statements.

Table of Contents
Healthcare Realty Trust Incorporated
Notes to Condensed Consolidated Financial Statements
September 30, 2012
(Unaudited)

Note 1. Summary of Significant Accounting Policies
Business Overview
Healthcare Realty Trust Incorporated (the “Company”) is a real estate investment trust (“REIT”) that integrates owning, managing, financing and developing income-producing real estate properties associated primarily with the delivery of outpatient healthcare services throughout the United States. The Company had investments of approximately $2.9 billion in 201 real estate properties and mortgages as of September 30, 2012. The Company’s 195 owned real estate properties are located in 28 states and total approximately 13.3 million square feet. The Company provided property management services to approximately 10.2 million square feet nationwide.

Principles of Consolidation
The Condensed Consolidated Financial Statements include the accounts of the Company, its wholly-owned subsidiaries, joint ventures, partnerships, and other affiliates, as well as certain variable interest entities (“VIEs”) in prior periods where the Company controlled the operating activities of the VIE.

The Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements that are included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011. Management believes, however, that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included. All material intercompany transactions and balances have been eliminated in consolidation.

This interim financial information should be read in conjunction with the financial statements and Management’s Discussion and Analysis of Financial Condition and Results of Operations included in this report and in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011. This interim financial information does not necessarily represent or indicate what the operating results will be for the year ending December 31, 2012 for many reasons including, but not limited to, acquisitions, dispositions, capital financing transactions, changes in interest rates and the effects of other trends, risks, and uncertainties.

In January 2012, a construction mortgage note receivable totaling approximately $35.1 million was repaid in full. The construction mortgage note was funding the ongoing development of an inpatient facility in South Dakota that was leased by Sanford Health. In the third quarter of 2011, the Company began consolidating the construction project upon its conclusion that it was the primary beneficiary of the VIE that was constructing the facility. As a result of the consolidation of the VIE, the Company also eliminated the construction mortgage note and related interest on its Condensed Consolidated Financial Statements. Upon repayment of the mortgage note in the first quarter of 2012, the Company deconsolidated the VIE and recognized net mortgage interest income of $0.4 million and overhead expense of $0.1 million, resulting in a net gain to the Company of $0.3 million.

The Company also had a variable interest in two unconsolidated VIEs consisting of construction mortgage notes aggregating approximately $94.4 million at September 30, 2012 in which management concluded that the Company was not currently the primary beneficiary. See Note 2 for more information on these mortgage notes.

The Company had an investment in one unconsolidated joint venture of approximately $1.3 million at September 30, 2012 which the Company accounts for under the cost method since the Company does not exert significant influence over the joint venture's operations. The joint venture, which invests in real estate properties, is included in other assets on the Company’s Condensed Consolidated Balance Sheets, and the related distributions received are included in interest and other income, net on the Company’s Condensed Consolidated Statements of Operations.

Table of Contents
Notes to Condensed Consolidated Financial Statements - Continued

Use of Estimates in the Condensed Consolidated Financial Statements
Preparation of the Condensed Consolidated Financial Statements in accordance with GAAP requires management to make estimates and assumptions that affect amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Actual results may differ from those estimates.

Segment Reporting
The Company owns, acquires, manages, finances, and develops outpatient and other healthcare-related properties. The Company is managed as one reporting unit, rather than multiple reporting units, for internal reporting purposes and for internal decision-making. Therefore, the Company discloses its operating results in a single reportable segment.

Reclassifications
Certain amounts in the Company’s Condensed Consolidated Financial Statements for prior periods have been reclassified to conform to the current period presentation. Assets sold or held for sale, and related liabilities, have been reclassified in the Company’s Condensed Consolidated Balance Sheets, and the operating results of those assets have been reclassified from continuing to discontinued operations for all periods presented. Also, land held for development has been reclassified from construction in progress to its own line item on the Company's Condensed Consolidated Balance Sheets for all periods presented.

In addition, the Company has combined revenues previously disclosed separately as property operating income, single-tenant net leases, and straight-line rent into one line item, rental income, in the Company's Condensed Consolidated Statements of Operations for all periods presented. The components of rental income are detailed in the Company's revenue recognition policy disclosure below.

Revenue Recognition
General
The Company recognizes revenue when it is realized or realizable and earned. There are four criteria that must be met before a company may recognize revenue, including: persuasive evidence that an arrangement exists; delivery has occurred or services have been rendered (i.e., the tenant has taken possession of and controls the physical use of the leased asset); the price has been fixed or is determinable; and collectability is reasonably assured. Income received but not yet earned is deferred until such time it is earned. Deferred revenue is included in other liabilities in the Company’s Condensed Consolidated Balance Sheets.

The Company derives most of its revenues from its real estate rentals and mortgage notes receivable portfolio. The Company’s rental and mortgage interest income is recognized based on contractual arrangements with its tenants, sponsors or borrowers. These contractual arrangements generally fall into three categories: leases, mortgage notes receivable, and property operating agreements as described in the following paragraphs. The Company may accrue late fees based on the contractual terms of a lease or note. Such fees, if accrued, are included in rental income or mortgage interest income in the Company’s Condensed Consolidated Statements of Operations, based on the type of contractual agreement.

Rental Income
Rental income related to non-cancelable operating leases is recognized as earned over the life of the lease agreements on a straight-line basis. The Company’s lease agreements generally include provisions for stated annual increases or increases based on a Consumer Price Index. The Company’s multi-tenant office lease arrangements also generally allow for operating expense recoveries which the Company calculates and bills to its tenants. Rental income from properties under single-tenant net lease arrangements and rental income from properties with multi-tenant office lease arrangements are included in rental income in the Company’s Condensed Consolidated Statements of Operations.

7

Table of Contents

Notes to Condensed Consolidated Financial Statements - Continued

The components of rental income are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	2012	2011	2012	2011
Property operating income	$60,982	$56,265	$180,323	$160,854
Single-tenant net lease	12,862	12,653	37,903	39,150
Straight-line rent	1,461	1,086	4,253	3,442
	$75,305	$70,004	$222,479	$203,446

Interest Income

Mortgage interest income and notes receivable interest income are recognized based on the interest rates and maturity date or amortization period specific to each note. Loan origination fees received are deferred and are recognized in mortgage interest income over the estimated life of the loan.

Property Operating Agreements

At September 30, 2012, the Company had six real estate properties with an aggregate gross investment of approximately $73.7 million subject to property operating agreements that obligate the sponsoring health system to provide to the Company a minimum return on the Company's investment in the property in exchange for the right to be involved in the operating decisions of the property, including tenancy. If the minimum return is not achieved through normal operations of the property, the sponsor is responsible to the Company for the shortfall under the terms of these agreements. The Company recognizes any shortfall income in other operating income in the Company's Condensed Consolidated Statements of Operations. Property operating agreement payments totaling approximately $0.5 million per quarter on two of the Company's properties in New Orleans expired on September 30, 2011. No other property operating agreements are scheduled to expire until 2016.

Accumulated Other Comprehensive Loss

Certain items must be included in comprehensive income (loss), including items such as foreign currency translation adjustments, minimum pension liability adjustments, and unrealized gains or losses on available-for-sale securities. The Company's accumulated other comprehensive loss includes the cumulative pension liability adjustments, which are generally recognized in the fourth quarter of each year.

Income Taxes

No provision has been made for federal income taxes. The Company intends at all times to qualify as a REIT under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended. The Company must distribute at least 90% of its REIT taxable income each year to its stockholders and meet other requirements to continue to qualify as a REIT.

The Company must pay certain state income taxes and the provisions are generally included in general and administrative expense on the Company's Condensed Consolidated Statements of Operations.

The Company classifies interest and penalties related to uncertain tax positions, if any, in its Condensed Consolidated Financial Statements as a component of general and administrative expense. No such amounts were recognized during the nine months ended September 30, 2012 or 2011.

Incentive Plans

The Company has various employee and non-employee stock-based awards outstanding, including restricted stock issued under its incentive plans, and options granted to employees pursuant to its employee stock purchase plan (the

“Employee Stock Purchase Plan”). The Company generally recognizes compensation expense for awards issued under its incentive plans based on the grant date fair value of the awards ratably over the requisite service period. Compensation expense for awards issued under the Employee Stock Purchase Plan is based on fair value, net of estimated forfeitures, using the Black-Scholes model, and is generally recognized when the awards are granted in the first quarter of each year since they immediately vest when granted.

Table of Contents
Notes to Condensed Consolidated Financial Statements - Continued

Defined Benefit Pension Plan
The Company has a pension plan (the “Executive Retirement Plan”) under which three of the Company’s founding officers may receive certain retirement benefits upon retirement. The plan is unfunded and benefits will be paid from future cash flows of the Company. The maximum annual benefits payable to each individual under the Executive Retirement Plan is $896,000, subject to cost-of-living adjustments. The Company calculates pension expense and the corresponding liability annually on the measurement date (December 31) which requires certain assumptions, such as a discount rate and the recognition of actuarial gains and losses. Pension expense is recognized on an accrual basis over an estimated service period.

Operating Leases
As described in more detail in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011, the Company is obligated under operating lease agreements consisting primarily of its corporate office lease and various ground leases related to the Company’s real estate investments where the Company is the lessee.

Discontinued Operations and Assets Held for Sale
The Company sells properties from time to time due to a variety of factors, including among other things, market conditions or the exercise of purchase options by tenants. The operating results of properties that have been sold or are held for sale are reported as discontinued operations in the Company’s Condensed Consolidated Statements of Operations. A company must report discontinued operations when a component of an entity has either been disposed of or is deemed to be held for sale if (i) both the operations and cash flows of the component have been or will be eliminated from ongoing operations as a result of the disposal transaction, and (ii) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction. Long-lived assets classified as held for sale in the Company’s Condensed Consolidated Balance Sheets are reported at the lower of their carrying amount or their estimated fair value less cost to sell. Further, depreciation of these assets ceases at the time the assets are classified as discontinued operations. Losses resulting from the sale or anticipated sale of such properties are characterized as impairment losses relating to discontinued operations in the Company’s Condensed Consolidated Statements of Operations. See Note 3 for a detail of the Company’s assets held for sale and discontinued operations.

Land Held for Development
Land held for development includes parcels of land owned by the Company upon which the Company intends to develop and own outpatient healthcare facilities.

Fair Value Measurements
Fair value is defined as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants. In calculating fair value, a company must maximize the use of observable market inputs, minimize the use of unobservable market inputs and disclose in the form of an outlined hierarchy the details of such fair value measurements.

A hierarchy of valuation techniques is defined to determine whether the inputs to a fair value measurement are considered to be observable or unobservable in a marketplace. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company’s market assumptions. This hierarchy requires the use of observable market data when available. These inputs have created the following fair value hierarchy:

- Level 1 – quoted prices for identical instruments in active markets;
- Level 2 – quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which significant inputs and significant value drivers are observable in active markets; and

- Level 3 – fair value measurements derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

In connection with the sale of properties in the third quarter of 2012, the Company recorded impairment charges totaling approximately $2.9 million based on the contractual sales prices, a Level 1 input.

Table of Contents
Notes to Condensed Consolidated Financial Statements - Continued

Real Estate Properties
Real estate properties are recorded at cost or fair value, if acquired. Cost or fair value at the time of acquisition is allocated among land, buildings, tenant improvements, lease and other intangibles, and personal property.

The Company also capitalizes direct construction and development costs, including interest, to all consolidated real estate properties that are under construction and substantive activities are ongoing to prepare the asset for its intended use. The Company considers a building as substantially complete and held available for occupancy upon the completion of tenant improvements, but may extend that in some cases to a time no later than one year from cessation of major construction activity. Development costs incurred after a project is substantially complete and ready for its intended use, or after development activities have ceased, are expensed as incurred.

Mortgage Notes
Mortgage notes receivable may be classified as held-for-investment or held-for-sale based on a lender’s intent and ability to hold the loans. Notes held-for-investment are carried at amortized cost and are reduced by valuation allowances for estimated credit losses as necessary. Notes held-for-sale are carried at the lower of cost or fair value. All of the Company’s mortgage notes receivable are classified as held-for-investment.

Allowance for Doubtful Accounts and Credit Losses
Management monitors the aging and collectibility of its accounts receivable balances on an ongoing basis. Whenever there is deterioration in the timeliness of payment from a tenant or sponsor, management investigates and determines the reason(s) for the delay. Considering all information gathered, management’s judgment is exercised in determining whether a receivable is potentially uncollectible and, if so, how much or what percentage may be uncollectible. Among the factors management considers in determining collectibility are: the type of contractual arrangement under which the receivable was recorded (e.g., a triple net lease, a gross lease, a sponsor guaranty agreement, or some other type of agreement); the tenant’s reason for slow payment; industry influences under which the tenant operates; evidence of willingness and ability of the tenant to pay the receivable; credit-worthiness of the tenant; collateral, security deposit, letters of credit or other monies held as security; tenant’s historical payment pattern; other contractual agreements between the tenant and the Company; relationship between the tenant and the Company; the state in which the tenant operates; and the existence of a guarantor and the willingness and ability of the guarantor to pay the receivable. Considering these factors and others, management concludes whether all or some of the aged receivable balance is likely uncollectible. Upon determining that some portion of the receivable is likely uncollectible, the Company records a provision for bad debts for the amount it expects will be uncollectible. When efforts to collect a receivable are exhausted, the receivable amount is charged off against the allowance.

The Company also evaluates collectibility of its mortgage notes and notes receivable and records an allowance on the notes as necessary. A loan is impaired when it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan as scheduled, including both contractual interest and principal payments. If a mortgage loan or note receivable becomes past due, the Company will review the specific circumstances and may discontinue the accrual of interest on the loan. The loan is not returned to accrual status until the debtor has demonstrated the ability to continue debt service in accordance with the contractual terms. Loans placed on non-accrual status will be accounted for either on a cash basis, in which income is recognized only upon receipt of cash, or on a cost-recovery basis, in which all cash receipts reduce the carrying value of the loan, based on the Company’s expectation of future collectibility.

New Pronouncements
On January 1, 2012, the Company adopted the Financial Accounting Standard Board’s Accounting Standards Update (“ASU”) 2011-08, “Intangibles – Goodwill and Other (Topic 350), Testing Goodwill for Impairment.” The standard simplifies the process a company must go through to test goodwill for impairment. Companies have an option to first

assess qualitative factors of a reporting unit being tested before having to assess quantitative factors. If a company believes no impairment exists based on qualitative factors, then it will no longer be required to perform the two-step quantitative impairment test. The Company tests its $3.5 million of goodwill for impairment as of December 31 of each year. The adoption of this new standard did not have a material impact on the Company’s financial statements.

Table of Contents

Note 2. Real Estate and Mortgage Notes Receivable Investments

The Company had investments of approximately $2.9 billion in 201 real estate properties and mortgages as of September 30, 2012. The Company's 195 owned real estate properties are located in 28 states and total approximately 13.3 million total square feet. The table below details the Company's investments.

(Dollars and Square Feet in thousands)	Number of Investments	Gross Investment Amount	%	Square Feet Footage	%
Owned properties:					
Multi-tenant leases					
Medical office/outpatient	147	$1,772,130	61.4 %	9,703	72.8 %
Medical office—stabilization in progress	12	395,494	13.7 %	1,283	9.6 %
Other	2	19,842	0.7 %	256	1.9 %
	161	2,187,466	75.8 %	11,242	84.3 %
Single-tenant net leases					
Medical office/outpatient	18	170,910	5.9 %	888	6.7 %
Inpatient	14	337,456	11.7 %	1,103	8.3 %
Other	2	9,545	0.3 %	91	0.7 %
	34	517,911	17.9 %	2,082	15.7 %
Construction in progress	—	—	—	—	—
Land held for development	—	25,171	0.9 %	—	—
Corporate property	—	14,845	0.5 %	—	—
	—	40,016	1.4 %	—	—
Total owned properties	195	2,745,393	95.1 %	13,324	100.0 %
Mortgage notes receivable:					
Medical office/outpatient	3	52,885	1.8 %	—	—
Inpatient	1	48,222	1.7 %	—	—
Other	1	40,000	1.4 %	—	—
	5	141,107	4.9 %	—	—
Unconsolidated joint venture:					
Other	1	1,266	—	—	—
	1	1,266	—	—	—
Total real estate investments	201	$2,887,766	100.0 %	13,324	100.0 %

Table of Contents

Mortgage Notes Receivable

All of the Company’s mortgage notes receivable are classified as held-for-investment based on management’s intent and ability to hold the loans until maturity. As such, the loans are carried at amortized cost. A summary of the Company’s mortgage notes receivable is shown in the table below:

State	Property Type (1)	Original Face Amount	Interest Rate		Maturity Date	Balance at September 30, 2012	December 31, 2011
(Dollars in thousands)							
Construction mortgage notes:							
Iowa	MOB	$2,136	11.00	%	—	$—	$1,469
Texas	MOB	12,444	8.10	%	—	—	9,547
Oklahoma	MOB	91,179	6.75	%	12/31/13	46,185	19,896
Missouri	Inpatient	111,400	6.75	%	12/31/13	48,222	20,559
Total Construction mortgage notes						$94,407	$51,471
Other mortgage notes:							
Iowa	MOB	$3,700	8.00	%	—	$—	$3,230
Iowa	Other	40,000	7.70	%	01/10/14	40,000	40,000
Florida	MOB	2,700	7.00	%	—	—	2,680
Texas	MOB	2,950	7.25	%	01/11/14	2,950	—
Florida	MOB	3,750	7.50	%	04/10/15	3,750	—
Total Other mortgage notes						$46,700	$45,910
Total Mortgage notes receivable						$141,107	$97,381

(1) MOB-Medical office building.

As of September 30, 2012, the Company's outstanding construction mortgage notes totaling approximately $94.4 million, or 66.9%, of the Company’s mortgage notes receivable were due from affiliates of the United Trust Fund, which is developing two build-to-suit facilities in Oklahoma and Missouri that are fully leased to Mercy Health. Also, approximately $40.0 million, or 28.4%, of the Company’s mortgage notes receivable, secured by an office building in Iowa, were due from LB Properties X, LLC.

Note 3. Acquisitions and Dispositions

Real Estate Acquisitions

In January 2012, the Company purchased a 58,285 square foot medical office building in South Dakota for a purchase price and cash consideration of approximately $15.0 million. The property is 100% leased under a single-tenant net lease with an affiliate of “AA-” rated Sanford Health, with a parent guarantee, and the lease expires in 2022. The property is connected to a Sanford Health acute care hospital that opened in June 2012.

In February 2012, the Company purchased a 23,312 square foot medical office building in North Carolina for a purchase price and cash consideration of approximately $6.4 million. The building is 100% occupied by two tenants with an affiliate of “AA-” rated Carolinas Healthcare System (“CHS”) which occupied 93% of the building as of the acquisition. The property is adjacent to a CHS hospital campus in which the Company owns six additional medical office buildings totaling approximately 187,000 square feet.

In March 2012, the Company acquired the fee simple interest in 9.14 acres of land in Pennsylvania for a purchase price and cash consideration of approximately $1.1 million. The Company previously held a ground lease interest in this property.

In May 2012, the Company purchased a 76,484 square foot medical office building in Texas for a purchase price of approximately $10.7 million. Concurrent with the acquisition, the Company's construction mortgage note receivable totaling $9.9 million, which was secured by the building, was repaid, resulting in cash consideration paid by the Company of approximately

12

Table of Contents

$0.8 million. The building was 100% leased at the time of the acquisition.

The following table details the Company's real estate acquisitions for the nine months ended September 30, 2012:

(Dollars in millions)	Date Acquired	Purchase Price	Mortgage Note Financing	Cash Consideration	Real Estate	Other	Square Footage
Real estate acquisitions							
South Dakota	1/20/12	$15.0	$—	$15.0	$14.9	$0.1	58,285
North Carolina	2/10/12	6.4	—	6.4	6.4	—	23,312
Pennsylvania	3/16/12	1.1	—	1.1	1.1	—	—
Texas	5/23/12	10.7	(9.9)	0.8	10.7	—	76,484
		$33.2	$(9.9)	$23.3	$33.1	$0.1	158,081

Subsequent Acquisitions

During the fourth quarter of 2012, the Company acquired a 39,345 square foot medical office building in Tennessee for a purchase price of $11.0 million. The building was 100% leased at the time of the acquisition.

Also, during the fourth quarter of 2012, the Company acquired a 47,225 square foot medical office building in the state of Washington for a purchase price of $9.4 million. The building was 89% leased at the time of the acquisition.

Asset Dispositions

During the first quarter of 2012, the Company disposed of the following properties and mortgage notes:

- a 14,748 square foot on-campus medical office building and an 18,978 square foot off-campus medical office building, both in Texas, in which the Company had an aggregate net investment of approximately $2.5 million. The sales price for the two properties was approximately $3.5 million, which included $0.4 million in net cash proceeds, the origination of a $3.0 million seller-financed mortgage note receivable as discussed below in "Seller-Financed Mortgage Notes," and closing costs of approximately $0.1 million. The Company recognized a $0.9 million net gain on the disposal;
- a 35,752 square foot on-campus medical office building in Florida, in which the Company had a net investment of approximately $3.0 million. The sales price for the building was approximately $7.2 million, which included $5.7 million in net cash proceeds and a lease termination fee of $1.5 million, included in income from discontinued operations. The Company recognized a $2.5 million net gain on the disposal;
- a 33,895 square foot off-campus medical office building in Florida in which the Company had a net investment of approximately $0.5 million. The sales price and net cash proceeds received from the sale were approximately $0.5 million;
- an 82,664 square foot off-campus medical office building in Texas, in which the Company had a net investment of approximately $4.8 million. The sales price for the building was approximately $4.7 million, which included the origination of a $4.5 million seller-financed mortgage note receivable as discussed below in "Seller-Financed Mortgage Notes," and closing costs of approximately $0.2 million. The Company recognized a $0.4 million impairment on the disposal, including the write-off of straight-line rent receivables;
- two mortgage notes receivable totaling $1.5 million and $3.2 million were repaid in full; and
- a construction mortgage note receivable totaling approximately $35.1 million which was repaid in full relating to the ongoing development of an inpatient facility in South Dakota. See Note 1 for more details on this repayment.

During the second quarter of 2012, the Company disposed of the following properties and mortgage notes:

- an 18,476 square foot off-campus medical office building in Tennessee, in which the Company had a net investment of approximately $0.8 million. The sales price for the building was approximately $0.9 million, which included net cash proceeds of approximately $0.8 million and closing costs of approximately $0.1 million;
-

four off-campus medical office buildings and one on-campus medical office building totaling 272,571 square feet, located in Florida, in which the Company had a net aggregate investment of approximately $31.2 million, were sold to a single buyer. The sales price for the buildings was approximately $33.3 million, which included net cash proceeds of $28.6 million, the origination of a $3.8 million seller-financed mortgage note, a $0.6 million contingent liability, and closing costs of approximately $0.3 million. The Company recognized a $0.2 million impairment on the disposal, including the write-off of straight-line rent receivables. These properties were not previously classified as held for sale;

Table of Contents

- a mortgage note receivable of $4.5 million was repaid in full; and
- a mortgage note receivable of 9.9 million was repaid in full in conjunction with the acquisition of a medical office building in Texas as discussed in “Real Estate Acquisitions” above.

During the third quarter of 2012, the Company disposed of the following properties and mortgage notes:

- a 16,578 square foot on-campus medical office building in Texas, in which the Company had an aggregate net investment of approximately $0.5 million. The sales price for the building was approximately $0.6 million, which included net cash proceeds of approximately $0.5 million and closing costs of approximately $0.1 million;
- an 8,990 square foot off-campus medical office building in Florida, in which the Company had an aggregate net investment of approximately $0.9 million. The sales price and net cash proceeds for the building was approximately $0.5 million. The Company recognized a $0.4 million impairment on the disposal;
- an 80,740 square foot off-campus medical office building in Texas, in which the Company had an aggregate net investment of approximately $12.0 million. The sales price for the building was approximately $21.4 million, which included net cash proceeds of approximately $19.0 million, amounts escrowed for tenant improvements of approximately $2.0 million, and closing costs of approximately $0.4 million. The Company recognized a $6.3 million gain on the disposal, net of straight-line rent receivables written off. This property was not previously classified as held for sale;
- a 61,763 square foot off-campus medical office building and a 9,582 square foot off-campus medical office building, both in Florida in a single transaction, in which the Company had an aggregate net investment of approximately $10.8 million. The sales price for the buildings was approximately $8.8 million, which included net cash proceeds of approximately $8.7 million and closing costs and other adjustments of approximately $0.1 million. The Company recognized a $2.5 million impairment on the disposals, net of straight-line rent receivables and other assets written off. These properties were not previously classified as held for sale; and
- a mortgage note receivable of $2.6 million was repaid.

Table of Contents

The following table details the Company’s dispositions and mortgage note repayments for the nine months ended September 30, 2012:

(Dollars in millions)	Date Disposed	Sales Price	Closing Adjustments	Seller-Financed Mortgage Notes	Net Proceeds	Net Real Estate Investment	Other (including receivables)	Gain/ (Impairment)	Square Footage
Real estate dispositions									
Texas (1) (2)	1/10/12	$3.5	$ (0.1)	$ (3.0)	$0.4	$2.5	$—	$0.9	33,726
Florida (1)	1/19/12	7.2	(1.5)	—	5.7	3.0	0.2	2.5	35,752
Florida (1)	3/2/12	0.5	—	—	0.5	0.5	—	—	33,895
Texas (1) (3)	3/16/12	4.7	(0.2)	(4.5)	—	4.8	0.1	(0.4)	82,664
Tennessee (1)	4/13/12	0.9	(0.1)	—	0.8	0.8	—	—	18,476
Florida (4)	4/18/12	33.3	(0.9)	(3.8)	28.6	31.2	1.4	(0.2)	272,571
Texas (1)	7/20/12	0.6	(0.1)	—	0.5	0.5	—	—	16,578
Florida (1)	8/22/12	0.5	—	—	0.5	0.9	—	(0.4)	8,990
Texas	8/27/12	21.4	(2.4)	—	19.0	12.0	0.7	6.3	