

UNIVERSAL HEALTH REALTY INCOME TRUST

Form 10-Q

November 08, 2007

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

Washington, D.C. 20549

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**FORM 10-Q**

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(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, 2007

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-9321

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**UNIVERSAL HEALTH REALTY INCOME TRUST**

(Exact name of registrant as specified in its charter)

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**MARYLAND**  
(State or other jurisdiction of  
Incorporation or Organization)

**UNIVERSAL CORPORATE CENTER**

**367 SOUTH GULPH ROAD**

**23-6858580**  
(I. R. S. Employer  
Identification No.)

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**KING OF PRUSSIA, PENNSYLVANIA 19406**

(Address of principal executive offices) (Zip Code)

**Registrant's telephone number, including area code (610) 265-0688**

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

Indicate by check mark whether the registrant is an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer, Rule 12b-2 of the Exchange Act (check one):

**Large accelerated filer ☐ Accelerated Filer ☒ Non-accelerated filer ☐**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes ☐ No ☒

Number of common shares of beneficial interest outstanding at October 31, 2007 11,838,831

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### Part I. Financial Information

#### Universal Health Realty Income Trust

#### Condensed Consolidated Statements of Income

For the Three and Nine Months Ended September 30, 2007 and 2006

(amounts in thousands, except per share amounts)

(unaudited)

|  | Three Months                |                  | Nine Months                 |                  |
|--|-----------------------------|------------------|-----------------------------|------------------|
|  | Ended September 30,<br>2007 | 2006             | Ended September 30,<br>2007 | 2006             |
| <b>Revenues:</b>   |                             |                  |                             |                  |
| Base rental UHS facilities   | \$ 3,067                    | \$ 3,153         | \$ 9,182                    | \$ 9,339         |
| Base rental Non-related parties  | 2,324                       | 2,993            | 7,033                       | 8,888            |
| Bonus rental UHS facilities  | 926                         | 1,037            | 2,998                       | 3,292            |
| Tenant reimbursements and other Non-related parties  | 565                         | 961              | 1,714                       | 2,725            |
| Tenant reimbursements and other UHS facilities   | 23                          | 61               | 100                         | 258              |
|  | 6,905                       | 8,205            | 21,027                      | 24,502           |
| <b>Expenses:</b>   |                             |                  |                             |                  |
| Depreciation and amortization  | 1,327                       | 1,478            | 3,836                       | 4,153            |
| Advisory fees to UHS   | 355                         | 364              | 1,062                       | 1,066            |
| Other operating expenses   | 1,083                       | 1,776            | 3,299                       | 4,931            |
|  | 2,765                       | 3,618            | 8,197                       | 10,150           |
| Income before equity in income of unconsolidated limited liability companies ( LLCs ),<br>replacement property recovered from UHS (Chamlette) and interest expense   | 4,140                       | 4,587            | 12,830                      | 14,352           |
| Equity in income of unconsolidated LLCs (including recognition of gain on sale of real<br>property of \$252 during the nine months ended September 30, 2007 and a previously deferred<br>gain of \$1,860 on sale of our interest in an unconsolidated LLC for the nine month period<br>ended September 30, 2006) | 692                         | 523              | 2,340                       | 3,788            |
| Replacement property recovered from UHS Chalmette  | 20                          | 11,265           | 1,748                       | 11,265           |
| Interest expense   | (438)                       | (696)            | (1,233)                     | (2,052)          |
| Income from continuing operations  | 4,414                       | 15,679           | 15,685                      | 27,353           |
| Income from discontinued operations, net (including gain on sale of real property of \$2,270<br>during the nine months ending September 30, 2007)  | 16                          | 46               | 2,527                       | 212              |
| <b>Net income</b>  | <b>\$ 4,430</b>             | <b>\$ 15,725</b> | <b>\$ 18,212</b>            | <b>\$ 27,565</b> |
| Basic earnings per share:  |                             |                  |                             |                  |
| From continuing operations   | \$ 0.37                     | \$ 1.33          | \$ 1.33                     | \$ 2.32          |
| From discontinued operations   | \$ 0.00                     | \$ 0.00          | \$ 0.21                     | \$ 0.02          |

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|   |         |         |         |         |
|---|---------|---------|---------|---------|
| Total basic earnings per share  | \$ 0.37 | \$ 1.33 | \$ 1.54 | \$ 2.34 |
| Diluted earnings per share:   |         |         |         |         |
| From continuing operations  | \$ 0.37 | \$ 1.32 | \$ 1.32 | \$ 2.30 |
| From discontinued operations  | \$ 0.00 | \$ 0.00 | \$ 0.21 | \$ 0.02 |
| Total diluted earnings per share                                      | \$ 0.37 | \$ 1.32 | \$ 1.53 | \$ 2.32 |
| Weighted average number of shares outstanding Basic                   | 11,835  | 11,786  | 11,811  | 11,782  |
| Weighted average number of share equivalents                          | 36      | 82      | 63      | 80      |
| Weighted average number of shares and equivalents outstanding Diluted | 11,871  | 11,868  | 11,874  | 11,862  |

See accompanying notes to condensed consolidated financial statements.

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**Universal Health Realty Income Trust**  
**Condensed Consolidated Balance Sheets**  
(dollar amounts in thousands)  
(unaudited)

|   | September 30,<br>2007 | December 31,<br>2006 |
|---|-----------------------|----------------------|
| <b>Assets:</b>  |                       |                      |
| <b>Real Estate Investments:</b>   |                       |                      |
| Buildings and improvements  | \$ 178,604            | \$ 171,761           |
| Accumulated depreciation  | (59,304)              | (56,935)             |
|   | 119,300               | 114,826              |
| Land  | 18,244                | 19,317               |
| Construction in progress  |                       | 9,220                |
| Net Real Estate Investments   | 137,544               | 143,363              |
| Investments in and advances to limited liability companies ( LLCs )   | 51,724                | 47,223               |
| <b>Other Assets:</b>  |                       |                      |
| Cash and cash equivalents   | 1,013                 | 798                  |
| Bonus rent receivable from UHS  | 926                   | 1,025                |
| Rent receivable other   | 608                   | 814                  |
| Deferred charges and other assets, net  | 1,414                 | 916                  |
| Total Assets  | \$ 193,229            | \$ 194,139           |
| <b>Liabilities and Shareholders' Equity:</b>  |                       |                      |
| <b>Liabilities:</b>   |                       |                      |
| Line of credit borrowings   | \$ 14,700             | \$ 13,600            |
| Mortgage note payable, non-recourse to us   | 3,751                 | 3,849                |
| Mortgage note payable of consolidated LLC, non-recourse to us   | 8,739                 | 8,888                |
| Accrued interest  | 74                    | 84                   |
| Accrued expenses and other liabilities  | 2,140                 | 2,857                |
| Tenant reserves, escrows, deposits and prepaid rents  | 708                   | 595                  |
| Total Liabilities   | 30,112                | 29,873               |
| Minority interest   | 81                    | 69                   |
| <b>Shareholders' Equity:</b>  |                       |                      |
| Preferred shares of beneficial interest,<br>\$.01 par value; 5,000,000 shares authorized; none issued and outstanding     |                       |                      |
| Common shares, \$.01 par value;<br>95,000,000 shares authorized; issued and outstanding: 2007 11,838,597; 2006 11,791,950 | 118                   | 118                  |
| Capital in excess of par value  | 188,481               | 187,524              |
| Cumulative net income   | 323,086               | 304,874              |
| Cumulative dividends  | (348,649)             | (328,319)            |

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|  |            |            |
|--|------------|------------|
| Total Shareholders' Equity                 | 163,036    | 164,197    |
| Total Liabilities and Shareholders' Equity | \$ 193,229 | \$ 194,139 |

See accompanying notes to condensed consolidated financial statements.

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### Universal Health Realty Income Trust

#### Condensed Consolidated Statements of Cash Flows

(amounts in thousands)

(unaudited)

|  | Nine months ended September 30, |                 |
|--|---------------------------------|-----------------|
|  | 2007                            | 2006            |
| <b>Cash flows from operating activities:</b>   |                                 |                 |
| Net income   | \$ 18,212                       | \$ 27,565       |
| <i>Adjustments to reconcile net income to net cash provided by operating activities:</i> |                                 |                 |
| Depreciation and amortization  | 3,836                           | 4,398           |
| Gain on sale of property   | (2,270)                         |                 |
| Gain on sale of property by a limited liability company ( LLC )                          | (252)                           |                 |
| Gain on sale of our interest in a LLC  |                                 | (1,860)         |
| Replacement property recovered from UHS Chalmette  | (1,748)                         | (11,265)        |
| <i>Changes in assets and liabilities:</i>  |                                 |                 |
| Rent receivable  | 305                             | (124)           |
| Accrued expenses and other liabilities   | (835)                           | 464             |
| Tenant reserves, escrows, deposits and prepaid rents                                     | 113                             | 207             |
| Accrued interest   | (10)                            | (91)            |
| Other, net   | 66                              | (153)           |
| <b>Net cash provided by operating activities</b>   | <b>17,417</b>                   | <b>19,141</b>   |
| <b>Cash flows from investing activities:</b>   |                                 |                 |
| Investments in LLCs  | (4,657)                         | (5,538)         |
| Repayments of advances made to LLCs  | 9,720                           | 1,879           |
| Advances made to LLCs  | (16,693)                        | (5,538)         |
| Cash distributions in excess of income from LLCs   | 1,028                           | 794             |
| Proceeds received from sale of our interest in a LLC                                     |                                 | 3,102           |
| Cash distributions from sale of property by a LLC  | 1,096                           |                 |
| Cash distributions of refinancing proceeds from LLCs                                     | 5,452                           | 5,704           |
| Cash received from sale of property  | 7,280                           |                 |
| Additions to real estate investments   | (1,120)                         | (994)           |
| <b>Net cash provided by (used in) investing activities</b>                               | <b>2,106</b>                    | <b>(591)</b>    |
| <b>Cash flows from financing activities:</b>   |                                 |                 |
| Net borrowings on line of credit   | 1,100                           | 1,300           |
| Financing costs paid   | (527)                           |                 |
| Repayments of mortgage notes payable of consolidated LLCs                                | (149)                           | (393)           |
| Repayments of mortgage notes payable   | (98)                            | (91)            |
| Dividends paid   | (20,330)                        | (19,912)        |
| Share repurchase   | (236)                           |                 |
| Issuance of shares of beneficial interest  | 1,045                           | 267             |
| Dividend reinvestment receivable   | (113)                           |                 |
| <b>Net cash used in financing activities</b>   | <b>(19,308)</b>                 | <b>(18,829)</b> |
| <b>Increase (decrease) in cash and cash equivalents</b>                                  | <b>215</b>                      | <b>(279)</b>    |
| Cash and cash equivalents, beginning of period   | 798                             | 1,717           |



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|   |    |       |    |       |
|---|----|-------|----|-------|
| <b>Cash and cash equivalents, end of period</b> | \$ | 1,013 | \$ | 1,438 |
|---|----|-------|----|-------|

**Supplemental disclosures of cash flow information:**

|               |    |       |    |       |
|---------------|----|-------|----|-------|
| Interest paid | \$ | 1,354 | \$ | 2,077 |
|---------------|----|-------|----|-------|

**Supplemental disclosures of non-cash transactions:**

|   |    |       |    |        |
|---|----|-------|----|--------|
| Replacement property recovered from UHS Chalmette | \$ | 1,748 | \$ | 11,265 |
|---|----|-------|----|--------|

See accompanying notes to condensed consolidated financial statements.

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**UNIVERSAL HEALTH REALTY INCOME TRUST**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2007**

(unaudited)

**(1) General**

This Report on Form 10-Q is for the Quarterly Period ended September 30, 2007. In this Quarterly Report, we, us, our and the Trust refer to Universal Health Realty Income Trust.

You should carefully review all of the information contained in this Quarterly Report, and should particularly consider any risk factors that we set forth in this Quarterly Report and in other reports or documents that we file from time to time with the Securities and Exchange Commission (the SEC). In this Quarterly Report, we state our beliefs of future events and of our future financial performance. In some cases, you can identify those so-called forward-looking statements by words such as may, will, should, could, would, predicts, potential, continue, expect, future, intends, plans, believes, estimates, appears, projects and similar expressions, as well as statements in future tense. You should be aware that those statements are only our predictions. Actual events or results may differ materially. In evaluating those statements, you should specifically consider various factors, including the risks outlined in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, under Forward Looking Statements and Certain Risk Factors. Those factors may cause our actual results to differ materially from any of our forward-looking statements.

In this Quarterly Report on Form 10-Q, the term revenues does not include the revenues of the unconsolidated limited liability companies in which we have various non-controlling equity interests ranging from 33% to 99%. We currently account for our share of the income/loss from these investments by the equity method (see Note 7). As of September 30, 2007, we had investments or commitments in twenty-five limited liability companies (LLCs), twenty-four of which are or will be accounted for by the equity method and one that is currently consolidated in our financial statements.

The financial statements included herein have been prepared by us, without audit, pursuant to the rules and regulations of the SEC and reflect all normal and recurring adjustments which, in our opinion, are necessary to fairly present results for the interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although we believe that the accompanying disclosures are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the financial statements, accounting policies and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006. Certain prior year amounts have been reclassified to conform with current year financial statement presentation.

**(2) Relationship with Universal Health Services, Inc. ( UHS ) and Related Party Transactions**

*Leases:* We commenced operations in 1986 by purchasing certain assets from subsidiaries from UHS and immediately leasing the properties back to the respective subsidiaries. Most of the leases were entered into at the time we commenced operations and provided for initial terms of 13 to 15 years with up to six additional 5-year renewal terms, with base rents set forth in the leases effective for all but the last two renewal terms. In 1998, the lease for McAllen Medical Center was amended to provide that the last two renewal terms would also be fixed at the initial agreed upon base rental. This lease amendment was in connection with certain concessions granted by UHS with respect to the renewal of other leases. The base rents are paid monthly and each lease also provides for additional or bonus rents which are computed and paid on a quarterly basis based upon a computation that compares current quarter revenue to a corresponding quarter in the base year. The leases with subsidiaries of UHS are unconditionally guaranteed by UHS and are cross-defaulted with one another.

Pursuant to the Master Lease Document by and among us and certain subsidiaries of UHS, dated December 24, 1986 (the Master Lease), which governs the leases of all hospital properties with subsidiaries of UHS, UHS has the option to renew the leases at the lease terms described below by providing notice to us at least 90 days prior to the termination of the then current term. In addition, UHS has rights of first refusal to:

(i) purchase the respective leased facilities during and for 180 days after the lease terms at the same price, terms and conditions of any third-party offer, or; (ii) renew the lease on the respective leased facility at the end of, and for 180 days after, the lease term at the same terms and conditions pursuant to any third-party offer. UHS also has the right to purchase the respective leased facilities at the end of the lease terms or any renewal terms at the appraised fair market value. In addition, during 2006, as part of the overall exchange and substitution proposal relating to Chalmette Medical Center (Chalmette), as well as the early five year lease renewals on Southwest Healthcare System-Inland Valley Campus

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( Inland Valley ), Wellington Regional Medical Center ( Wellington ), McAllen Medical Center ( McAllen ) and The Bridgeway ( Bridgeway ), we agreed to amend the Master Lease to include a change

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of control provision. The change of control provision grants UHS the right, upon one month's notice should a change of control of the Trust occur, to purchase any or all of the four leased hospital properties at their appraised fair market value.

During the third quarter of 2005, Chalmette, a 138-bed acute care hospital located in Chalmette, Louisiana, was severely damaged and closed as a result of Hurricane Katrina. At that time, the majority of the real estate assets of Chalmette were leased from us by a subsidiary of UHS and, in accordance with the terms of the lease, and as part of an overall evaluation of the leases between subsidiaries of UHS and us, UHS offered substitution properties rather than exercise its right to rebuild the facility or offer cash for Chalmette. Independent appraisals were obtained by us and UHS which indicated that the pre-hurricane fair market value of the leased facility was \$24.0 million.

During the third quarter of 2006, we completed the asset exchange and substitution pursuant to the Asset Exchange and Substitution Agreement with UHS whereby we agreed to terminate the lease between us and Chalmette and to transfer the real property assets and all rights attendant thereto (including insurance proceeds) of Chalmette to UHS in exchange and substitution for newly constructed real property assets owned by UHS (Capital Additions) at Wellington, Bridgeway and Inland Valley, in satisfaction of the obligations under the Chalmette lease. The Capital Additions consist of properties which were recently constructed on, or adjacent to, facilities already owned by us as well as a recently constructed Capital Addition at Inland Valley which was completed and opened during the third quarter of 2007. Since the ultimate construction costs related to the Inland Valley Capital Addition have exceeded the \$11.0 million agreed upon threshold, during the third quarter of 2007, the Asset Exchange and Substitution Agreement with UHS was amended to eliminate the inclusion of the Inland Valley ICU project. The total cost of the 44-bed expansion project is approximately \$11.7 million. Pursuant to the terms of the Asset and Exchange Agreement, the \$700,000 of cost in excess of the \$11.0 million threshold has been/will be paid to UHS in cash and UHS will pay incremental rent on the \$700,000 excess cost (\$600,000 of which has been paid as of September 30, 2007) at a rate equal to the prevailing five-year treasury rate plus 200 basis points at the time of final funding (minimum rate 6.75%). Final funding is expected to occur during the fourth quarter of 2007. The table below details the renewal options and terms for each of the four UHS hospital facilities:

| Hospital Name                                     | Type of Facility  | Annual          | Renewal        |         |
|---|-------------------|-----------------|----------------|---------|
|   |                   | Minimum         | End of         | Term    |
|   |                   | Rent            | Lease Term     | (years) |
| McAllen Medical Center                            | Acute Care        | \$ 5,485,000    | December, 2011 | 20(a)   |
| Wellington Regional Medical Center                | Acute Care        | \$ 3,030,000    | December, 2011 | 20(b)   |
| Southwest Healthcare System, Inland Valley Campus | Acute Care        | \$ 2,597,000(d) | December, 2011 | 20(b)   |
| The Bridgeway                                     | Behavioral Health | \$ 930,000      | December, 2014 | 10(c)   |

- (a) UHS has four 5-year renewal options at existing lease rates (through 2031).
- (b) UHS has two 5-year renewal options at existing lease rates (through 2021) and two 5-year renewal options at fair market value lease rates (2022 through 2031).
- (c) UHS has two 5-year renewal options at fair market value lease rates (2015 through 2024).
- (d) Excludes incremental rent on the \$700,000 of Capital Addition cost in excess of \$11.0 million.

We cannot predict whether the leases with subsidiaries of UHS, which have renewal options at existing lease rates, or any of our other leases, will be renewed at the end of their lease terms. If the leases are not renewed at their current rates, we would be required to find other operators for those facilities and/or enter into leases on terms potentially less favorable to us than the current leases.

The combined revenues generated from the leases on the UHS hospital facilities accounted for approximately 57% and 48% of our total revenue for both the three and nine month periods ended September 30, 2007 and 2006, respectively. Including 100% of the revenues generated at the unconsolidated LLCs in which we have various non-controlling equity interests ranging from 33% to 99%, the leases on the UHS hospital facilities accounted for approximately 23% and 24% of the combined consolidated and unconsolidated revenue for the three month periods ended September 30, 2007 and 2006, respectively, and 24% for both nine month periods ended September 30, 2007 and 2006. In addition, six medical office buildings (MOBs) (plus two additional MOBs currently under construction) owned by LLCs in which we hold various non-controlling equity interests, include tenants which are subsidiaries of UHS.

We are committed to invest up to \$6.6 million (\$250,000 in equity, \$243,000 of which has been funded as of September 30, 2007, and \$6.3 million in debt financing or equity, none of which has been funded as of September 30, 2007) in exchange for a 95% non-controlling equity interest in a limited liability company that will develop, construct, own and operate the Centennial Hills Medical Office Building I, located in Las Vegas, Nevada, on the campus of a UHS hospital. This MOB will be 60% master leased by Valley Health System (VHS), a majority-owned

subsidiary of UHS, on a triple net basis. The

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master lease for each suite will be cancelled at such time that the suite is leased for a minimum term of five years, to another tenant acceptable to the LLC and VHS. The LLC has a \$15.7 million construction loan commitment from a third-party, which is non-recourse to us. At September 30, 2007, \$11.1 million of third-party debt has been drawn against this \$15.7 million construction loan commitment. This building, tenants of which may include subsidiaries of UHS, is scheduled to be completed and opened during the fourth quarter of 2007.

Additionally, we are committed to invest up to \$4.3 million in equity, of which \$143,000 has been funded as of September 30, 2007, in exchange for a 95% non-controlling equity interest in a limited liability company that will develop, construct, own and operate the Palmdale Medical Plaza, located in Palmdale, California, on the campus of a UHS hospital currently under construction. This MOB will be 75% master leased by UHS of Palmdale, Inc., a subsidiary of UHS, on a triple net basis. The master lease for each suite will be cancelled at such time that the suite is leased for a minimum term of five years, to another tenant acceptable to the LLC and UHS of Palmdale. The LLC has a \$9.9 million construction loan commitment from a third-party, which is non-recourse to us. At September 30, 2007, \$6.7 million of third-party debt has been drawn against this \$9.9 million construction loan commitment. This building, tenants of which may include subsidiaries of UHS, is scheduled to be completed and opened during the first quarter of 2008.

We are also committed to invest up to \$12.3 million in debt and/or equity, of which \$9.9 million has been funded as of September 30, 2007, in exchange for a 95% non-controlling interest in a limited liability company that developed, constructed, owns and operates the Spring Valley Medical Office Building II, a second MOB on the campus of a UHS hospital located in Las Vegas Nevada. This MOB was completed and opened during the second quarter of 2007.

*UHS Legal Proceedings:* We have been advised by UHS that UHS, together with its South Texas Health System affiliates, which operate McAllen Medical Center, were served with a subpoena dated November 21, 2005, issued by the Office of Inspector General of the Department of Health and Human Services (OIG). At that time, the Civil Division of the U.S. Attorney's office in Houston, Texas indicated that the subpoena was part of an investigation under the False Claims Act of compliance with Medicare and Medicaid rules and regulations pertaining to the employment of physicians and the solicitation of patient referrals from physicians from January 1, 1999 to the date of the subpoena related to the South Texas Health System. On March 9, 2007, an additional subpoena was served upon UHS by the OIG requesting documents concerning the Medicare cost reports for the South Texas Health System affiliates. On February 16, 2007, UHS's South Texas Health System affiliates were served with a search warrant in connection with what UHS has been advised is a related criminal Grand Jury investigation concerning the production of documents. At that time, the government obtained various documents and other property related to the facilities. Follow-up Grand Jury subpoenas for documents and witnesses and other requests for information were subsequently served on South Texas Health System facilities and certain UHS employees.

We have been advised by UHS that over the last several weeks, at UHS's request, legal representatives of UHS have met with representatives of the United States Attorney's Office for the Southern District of Texas to discuss the status of these matters. UHS's representatives have been advised that the government is continuing its investigations. UHS believes that, based on those discussions and the government's investigations to date, the government is focused on certain arrangements entered into by the South Texas Health System affiliates which the government believes may have violated Medicare and Medicaid rules and regulations pertaining to payments to physicians and the solicitation of patient referrals from physicians and other matters relating to payments to various individuals which may have constituted improper or illegal payments. UHS believes that the government is also focusing its investigation to determine whether the South Texas Health System affiliates and certain individuals illegally failed to fully comply with the original OIG subpoena. UHS is in the process of investigating these matters and is cooperating with the investigations and intends to respond to the matters raised with them. UHS has advised us that it is unable to evaluate the existence or extent of any potential financial exposure in connection with this matter at this time.

UHS has advised us that it monitors all aspects of its business and that it has developed a comprehensive ethics and compliance program that is designed to meet or exceed applicable federal guidelines and industry standards. Because the law in this area is complex and constantly evolving, governmental investigation or litigation may result in interpretations that are inconsistent with industry practices, including UHS's. Although UHS believes its policies, procedures and practices comply with governmental regulations, no assurance can be given that UHS will not be subjected to further inquiries or actions, or that UHS will not be faced with sanctions, fines or penalties in connection with the investigation of their South Texas Health System affiliates. Even if UHS were to ultimately prevail, the government's inquiry and/or action in connection with this matter could have a material adverse effect on UHS's future operating results and on the future operating results of McAllen Medical Center. While the base rentals are guaranteed by UHS through the end of the existing lease term, should this matter adversely impact the future revenues and/or operating results of McAllen Medical Center, the future bonus rental earned by us on this facility may be materially, adversely impacted. Bonus rental revenue earned by us from McAllen

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Medical Center amounted to \$1.9 million during 2006 and \$1.3 million during the nine months ended September 30, 2007. We can provide no assurance that this matter will not have a material adverse impact on underlying value of McAllen Medical Center or on the future base rental earned on this facility should the lease be renewed after its December, 2011 scheduled expiration of the existing lease term.

*Advisory Agreement:* UHS of Delaware, Inc. (the Advisor), a wholly-owned subsidiary of UHS, serves as Advisor to us under an Advisory Agreement (the Advisory Agreement) dated December 24, 1986. Under the Advisory Agreement, the Advisor is obligated to present an investment program to us, to use its best efforts to obtain investments suitable for such program (although it is not obligated to present any particular investment opportunity to us), to provide administrative services to us and to conduct our day-to-day affairs. In performing its services under the Advisory Agreement, the Advisor may utilize independent professional services, including accounting, legal, tax and other services, for which the Advisor is reimbursed directly by us. The Advisory Agreement expires on December 31<sup>st</sup> of each year; however, it is renewable by us, subject to a determination by the Trustees who are unaffiliated with UHS (the Independent Trustees), that the Advisor's performance has been satisfactory. The Advisory Agreement may be terminated for any reason upon sixty days written notice by us or the Advisor. The Advisory Agreement has been renewed for 2007. All transactions between us and UHS must be approved by the Independent Trustees.

The Advisory Agreement provides that the Advisor is entitled to receive an annual advisory fee equal to 0.60% of our average invested real estate assets, as derived from our consolidated balance sheet. The advisory fee is payable quarterly, subject to adjustment at year-end based upon our audited financial statements. In addition, the Advisor is entitled to an annual incentive fee equal to 20% of the amount by which cash available for distribution to shareholders for each year, as defined in the Advisory Agreement, exceeds 15% of our equity as shown on our consolidated balance sheet, determined in accordance with generally accepted accounting principles without reduction for return of capital dividends. The Advisory Agreement defines cash available for distribution to shareholders as net cash flow from operations less deductions for, among other things, amounts required to discharge our debt and liabilities and reserves for replacement and capital improvements to our properties and investments. Advisory fees incurred and paid (or payable) to UHS amounted to \$355,000 and \$364,000 for the three months ended September 30, 2007 and 2006, respectively, and \$1.1 million for each of the nine month periods ended September 30, 2007 and 2006. No incentive fees were paid in either period.

*Officers and Employees:* Our officers are all employees of UHS and although we have no salaried employees, our officers do receive stock-based compensation from time-to-time.

*Share Ownership:* As of September 30, 2007, and 2006, UHS owned 6.7% of our outstanding shares of beneficial interest.

*SEC reporting requirements of UHS:* UHS is subject to the reporting requirements of the SEC and is required to file annual reports containing audited financial information and quarterly reports containing unaudited financial information. Since the leases on the hospital facilities leased to wholly-owned subsidiaries of UHS comprised approximately 57% of our consolidated revenues for both the three and nine months ended September 30, 2007, and since UHS is also our Advisor, you are encouraged to obtain the publicly available filings for UHS, Inc. from the SEC's website at [www.sec.gov](http://www.sec.gov). These filings are the sole responsibility of UHS and are not incorporated by reference herein.

### **(3) Dividends**

A dividend of \$.575 per share or \$6.8 million in the aggregate was declared by the Board of Trustees on September 6, 2007 and was paid on September 28, 2007 to shareholders of record as of September 17, 2007.

### **(4) Acquisitions and Dispositions**

Subsequent to September 30, 2007, we invested \$765,000 in exchange for a 95% non-controlling equity interest in a LLC that owns the Cobre Valley Medical Plaza, a 22,000 square foot medical office building located in Globe, Arizona. The LLC has a \$2.6 million mortgage from a third party which is non-recourse to us.

*During the first nine months of 2007, we invested or advanced \$21.4 million to unconsolidated LLCs as follows:*

\$2.0 million invested in the LLC that will construct and own the Canyon Springs Medical Plaza in which we have a 95% non-controlling equity interest;

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\$1.5 million invested in the LLC that owns the Spring Valley Hospital Medical Office Building II, in which we have a 95% non-controlling equity interest;

\$495,000 invested in the master LLC, which governs four unconsolidated LLCs, in which we have a 90% non-controlling equity interest;



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\$419,000 invested in the LLC that owns 700 Shadow Lane and Goldring Medical Office Buildings in which we have a 98% non-controlling equity interest;

\$190,000 invested in the LLC that will construct and own the Centennial Hills Medical Office Building I in which we have a 95% non-controlling equity interest;

\$106,000 invested in the LLC will construct and own the Phoenix Children's East Valley Care Center, in which we have a 95% non-controlling equity interest;

\$8.5 million advanced (which was fully repaid to us during the first nine months of 2007) to the LLC that owns the Thunderbird Paseo Medical Plaza I and II, in which we own a 75% non-controlling equity interest;

\$5.0 million advanced to the LLC that owns the Desert Springs Medical Plaza, in which we own a 99% non-controlling equity interest;

\$3.1 million advanced to the LLC that owns the Spring Valley Hospital Medical Office Building II, in which we have a 95% non-controlling equity interest, and;

\$120,000 advanced to the LLC that owns the Spring Valley Medical Office Building, in which we have a 95% non-controlling equity interest.

***During the first nine months of 2007, we received \$9.7 million in repayments of advances previously provided to unconsolidated LLCs as follows:***

\$8.5 million received from the LLC that owns the Thunderbird Paseo Medical Plaza I and II, in which we own a 75% non-controlling equity interest;

\$485,000 received from the LLC that owns the Sierra San Antonio Medical Plaza in which we have a 95% non-controlling equity interest, and;

\$696,000 received from the LLC that owned the Rio Rancho Medical Center in which we owned a 80% non-controlling equity interest. This LLC was sold during the first quarter of 2007.

Additionally, during the third quarter of 2007, we committed to invest up to \$6.9 million (\$250,000 in equity, none of which has been funded as of September 30, 2007, and \$6.6 million in either equity and/or debt financing, none of which has been funded as of September 30, 2007) in exchange for a 95% non-controlling equity interest in a LLC that will develop, construct, own and operate the Deer Valley Medical Office Building III in Phoenix, Arizona. This project is scheduled to be completed and opened during the third quarter of 2008.

### ***Divestitures during the first nine months of 2007:***

During the second quarter of 2007, we completed the sale of the Fresno-Herndon Medical Plaza, a medical office building located in Fresno, California. The financial results of this property are reflected as discontinued operations on our condensed consolidated statements of income for the three and nine months ended September 30, 2007 and 2006. This transaction resulted in a gain of \$2.3

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million which is included in Income from discontinued operations, net on our condensed consolidated statements of income for the nine months ended September 30, 2007, and;

During the first quarter of 2007, RioMed Investments, a LLC in which we had an 80% non-controlling equity interest, sold the real property of Rio Rancho Medical Center, located in Gilbert, Arizona. Our share of the net proceeds from this divestiture was \$1.1 million. This transaction resulted in a \$252,000 gain which is included in Equity in income of unconsolidated LLCs on our condensed consolidated statements of income for the nine months ended September 30, 2007.

***During the first nine months of 2006, we invested or advanced \$11.1 million to unconsolidated LLCs as follows:***

\$2.1 million invested in the LLC that owns the Sierra San Antonio Medical Plaza in which we have a 95% non-controlling equity interest;

\$4.0 million of debt financing and \$80,000 of equity funded to the LLC that owns Spring Valley Hospital Medical Office Building II, in which we have a 95% non-controlling equity interest;

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\$450,000 invested in the LLC that owns the Saint Mary's Professional Office Building in which we have a 75% non-controlling equity interest;

\$235,000 invested in the LLC that owns the 700 Shadow Lane & Goldring Medical Office Buildings in which we have a 98% non-controlling equity interest;

\$214,000 invested in the LLC that owns the Spring Valley Medical Office Building in which we have a 95% non-controlling equity interest;

\$532,000 invested in the LLC that owns the Desert Samaritan Hospital Medical Office Buildings in which we have a 76% non-controlling equity interest;

\$630,000 advanced to the LLC that owned the Rio Rancho Medical Center in which we had a 80% non-controlling equity interest;

\$1.5 million of equity and \$363,000 of debt financing funded to the LLC that will construct and own the LLC that owns the Phoenix Children's East Valley Care Center in which we have a 95% non-controlling equity interest;

\$540,000 advance (which was fully repaid during the third quarter of 2006) and \$180,000 of equity funded to a master LLC which governs four unconsolidated LLCs in which we have a 90% non-controlling equity interest, and;

\$300,000 of equity funded to various LLCs.

*During the first nine months of 2006, we received \$1.9 million in repayments of advances previously provided to unconsolidated LLCs as follows:*

\$1.3 million received from a LLC that owns the Suburban Medical Plaza II in which we have a 33% non-controlling equity interest, and;

\$600,000 received from a master LLC which governs four unconsolidated LLCs in which we have a 90% non-controlling equity interest.

Additionally, during the nine month period of 2006, we received \$3.1 million as repayment of a note receivable relating to the 2005 sale of our interest in a LLC which owned the St. Jude Heritage Health Complex. This transaction resulted in a \$1.9 million gain which was deferred in 2005 and recognized as income during the second quarter of 2006 when the cash proceeds were received by us.

## **(5) Comprehensive Income**

Comprehensive income represents net income plus the results of certain equity changes not reflected in the condensed consolidated statements of income. The components of comprehensive income are as follows (in thousands):

| Three Months Ended |      | Nine Months Ended |      |
|--------------------|------|-------------------|------|
| September 30,      |      | September 30,     |      |
| 2007               | 2006 | 2007              | 2006 |

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|   |          |           |           |           |
|---|----------|-----------|-----------|-----------|
| Net income  | \$ 4,430 | \$ 15,725 | \$ 18,212 | \$ 27,565 |
| Other comprehensive income:                               |          |           |           |           |
| Adjustment for derivative losses reclassified into income |          | 5         |           | 62        |
| Unrealized derivative gains/(losses) on cash flow hedges  |          | 15        |           | 38        |
| Comprehensive income                                      | \$ 4,430 | \$ 15,745 | \$ 18,212 | \$ 27,665 |

### (6) Stock-Based Compensation

Compensation costs of \$37,000 and \$21,000 for the three months ended September 30, 2007 and 2006, respectively, and \$98,000 and \$63,000 for the nine month periods ended September 30, 2007 and 2006, respectively, were recognized related to outstanding stock options and Dividend Equivalent Rights ( DERs ) that were granted or have vestings after December 31, 2005. As of September 30, 2007, there was approximately \$373,000 of unrecognized compensation cost related to unvested options and DERs which is expected to be recognized over the vesting period. During the first nine months of 2007, there were 24,000 stock options and DERs issued under the 1997 Incentive Plan with a weighted-average grant-date fair value of \$14.70 per option.

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The 1997 Incentive Plan expired on June 22, 2007. Awards granted on or before the termination date shall remain exercisable, in accordance with their respective terms, after the termination of the Plan.

During the second quarter of 2007, our Board of Trustees approved and adopted the Universal Health Realty Income Trust 2007 Restricted Stock Plan (the 2007 Plan ). The 2007 Plan was also approved by our shareholders during the second quarter of 2007. A total of 75,000 shares have been authorized for issuance under the 2007 Plan and there have been no shares issued under the 2007 Plan at September 30, 2007. Additionally, during the second quarter of 2007, the Board of Trustees approved the termination of the Universal Health Realty Income Trust's Share Compensation Plan for outside Trustees.

### **(7) Summarized Financial Information of Equity Affiliates**

Our consolidated financial statements include the consolidated accounts of our controlled investments and those investments that meet the criteria of a variable interest entity where we are the primary beneficiary as a result of our level of investment in the entity. In accordance with the American Institute of Certified Public Accountants' Statement of Position 78-9 Accounting for Investments in Real Estate Ventures as amended by FASB Staff Position SOP 78-9-1 Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5 and Emerging Issues Task Force Issue 96-16, Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights, we account for our unconsolidated investments in LLCs which we do not control using the equity method of accounting. The third-party members in these investments have equal voting rights with regard to issues such as, but not limited to: (i) divestiture of property; (ii) annual budget approval, and; (iii) financing commitments. These investments, which represent 33% to 99% non-controlling ownership interests, are recorded initially at our cost and subsequently adjusted for our net equity in the net income, cash contributions to, and distributions from, the investments. Pursuant to certain agreements, allocations of profits and losses of some of the LLC investments may be allocated disproportionately as compared to ownership interests after specified preferred return rate thresholds have been satisfied.

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. This Interpretation, as revised (FIN 46R), addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. As a result of our related party relationship with UHS, and certain master lease, lease assurance or lease guarantee arrangements between UHS and various properties owned by three LLCs in which we own non-controlling ownership interests ranging from 95% to 99%, these three LLCs were considered to be variable interest entities. In addition, we were the primary beneficiary of these three LLC investments. Upon the adoption of FIN 46R on March 31, 2004, we began consolidating the results of operations of these three LLC investments in our consolidated financial statements.

As a result of the expiration of the master lease arrangements between subsidiaries of UHS and two of these three LLCs, during the fourth quarter of 2006, we began recording the financial results of two LLCs on an unconsolidated basis in our consolidated financial statements. Commencing in the fourth quarter of 2006, the revenues and expenses of these two LLCs are no longer included in our consolidated revenues and expenses; instead, the net income generated from each of these two LLCs is included in our consolidated statements of income as Equity in income of unconsolidated LLCs. The revenues and expenses for these two LLCs related to the periods prior to the fourth quarter of 2006 are included in our revenues and expenses in our consolidated statements of income. There was no impact on our net income as a result of recording of the financial results of these LLCs on a consolidated or an unconsolidated basis. The other LLCs in which we hold various non-controlling ownership interests are not variable interest entities and therefore are not subject to the consolidation requirements of FIN 46R.

Rental income is recorded by our consolidated and unconsolidated MOBs relating to leases in excess of one year in length using the straight-line method under which contractual rents are recognized evenly over the lease term regardless of when payments are due. The amount of rental revenue resulting from straight-line rent adjustments is dependent on many factors, including the nature and amount of any rental concessions granted to new tenants, scheduled rent increases under existing leases, as well as the acquisition and sales of properties that have existing in-place leases with terms in excess of one year. As a result, the straight-line adjustments to rental revenue may vary from period-to-period. Pursuant to certain agreements, allocations of profits and losses of some of the LLC investments may be allocated disproportionately as compared to ownership interest after specified preferred return rate thresholds have been satisfied.

Since January 1, 1995 through September 30, 2007, we have invested \$67.4 million of cash (including net advances to various LLCs) in LLCs in which we own various non-controlling equity interests ranging from 33% to 99% (consolidated and unconsolidated), before reductions for cash distributions received from the LLCs. As of September 30, 2007, short-term unsecured advances aggregated \$10.1 million due from four LLCs. Including the cumulative adjustments for our share of equity in the net income of the LLCs and cash contributions to and distributions from these investments, our net investment in these LLCs was \$51.7 million, as reflected on our condensed consolidated balance sheet as of September 30, 2007.



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As of September 30, 2007, we had investments or commitments in twenty-five LLCs, twenty-four of which are or will be accounted for by the equity method and one that is consolidated into the results of our operations. The following tables represent summarized financial and other information related to the LLCs which were accounted for under the equity method:

| Name of LLC                              | Ownership | Property Owned by LLC                             |
|--|-----------|---|
| DSMB Properties                          | 76%       | Desert Samaritan Hospital MOBs                    |
| DVMC Properties (a.)                     | 90%       | Desert Valley Medical Center                      |
| Suburban Properties                      | 33%       | Suburban Medical Plaza II                         |
| Litchvan Investments                     | 89%       | Papago Medical Park                               |
| Paseo Medical Properties II              | 75%       | Thunderbird Paseo Medical Plaza I & II            |
| Willetta Medical Properties (a.)         | 90%       | Edwards Medical Plaza                             |
| Santa Fe Scottsdale (a.)                 | 90%       | Santa Fe Professional Plaza                       |
| 575 Hardy Investors (a.)                 | 90%       | Centinela Medical Building Complex                |
| Brunswick Associates                     | 74%       | Mid Coast Hospital MOB                            |
| Deerval Properties                       | 90%       | Deer Valley Medical Office II                     |
| PCH Medical Properties                   | 85%       | Rosenberg Children's Medical Plaza                |
| Gold Shadow Properties (b.)              | 98%       | 700 Shadow Lane & Goldring MOBs                   |
| Arlington Medical Properties (c.)        | 75%       | Saint Mary's Professional Office Building         |
| ApaMed Properties                        | 85%       | Apache Junction Medical Plaza                     |
| Spring Valley Medical Properties (b.)    | 95%       | Spring Valley Medical Office Building             |
| Sierra Medical Properties (d.)           | 95%       | Sierra San Antonio Medical Plaza                  |
| Spring Valley Medical Properties II (e.) | 95%       | Spring Valley Hospital Medical Office Building II |
| PCH Southern Properties (f.)             | 95%       | Phoenix Children's East Valley Care Center        |
| Centennial Medical Properties (g.)       | 95%       | Centennial Hills Medical Office Building I        |
| Canyon Healthcare Properties (h.)        | 95%       | Canyon Springs Medical Plaza                      |
| Palmdale Medical Properties (i.)         | 95%       | Palmdale Medical Plaza                            |
| 653 Town Center Drive(j.)                | 95%       | Summerlin Hospital Medical Office Building        |
| DesMed(j.)                               | 99%       | Desert Springs Medical Plaza                      |
| Deerval Properties II (k.)               | 95%       | Deer Valley Medical Office Building III           |

- (a.) The membership interests of this entity are held by a master LLC in which we hold a 90% non-controlling ownership interest.
- (b.) Tenants of these medical office buildings include subsidiaries of UHS.
- (c.) We have committed to invest a total of \$8.0 million in equity, of which \$5.2 million has been funded as of September 30, 2007, in exchange for a 75% non-controlling interest in a LLC that constructed and owns the Saint Mary's Professional Office Building located in Reno, Nevada. As of September 30, 2007, the LLC has a \$28.0 million mortgage from a third party, which is non-recourse to us. This medical office building opened in March of 2005.
- (d.) We have committed to invest a total of up to \$3.5 million in equity in exchange for a 95% non-controlling interest in a LLC that owns and operates the Sierra San Antonio Medical Plaza located in Fontana, California. As of September 30, 2007, we have invested \$2.6 million in equity and \$485,000 in debt financing (which was repaid during the first quarter of 2007) in connection with this project. The LLC has a \$7.5 million total construction loan commitment from a third party, which is non-recourse to us. This project was completed and opened during the first quarter of 2006.
- (e.) We have committed to invest a total of up to \$12.3 million in debt and/or equity financing (of which \$9.9 million has been funded as of September 30, 2007), in exchange for a 95% non-controlling interest in a LLC that owns and operates the Spring Valley Hospital Medical Office Building II, located in Las Vegas, Nevada on the campus of a UHS facility. This building, tenants of which may include subsidiaries of UHS, opened during the second quarter of 2007.
- (f.) We have committed to invest a total of up to \$10.3 million (\$3.5 million in equity, of which \$1.5 million has been funded as of September 30, 2007 and \$6.8 million in debt financing, of which \$363,000 has been funded as of September 30, 2007) in exchange for a 95% non-controlling interest in a LLC that will develop, construct, own and operate the Phoenix Children's East Valley Care Center, a single tenant medical office building, located in Gilbert, Arizona. The LLC has a \$5.9 million total construction loan commitment from a third-party, which is non-recourse to us. This project is scheduled to be completed and opened during the fourth quarter of 2007.
- (g.) We have committed to invest up to \$6.6 million (\$250,000 in equity of which \$243,000 has been funded as of September 30, 2007, and \$6.3 million in equity or debt financing, none of which has been funded as of September 30, 2007) in exchange for a 95% non-controlling interest in a LLC that will develop, construct, own and operate the





- (h.) We have committed to invest up to \$6.0 million (\$5.5 million in equity of which \$2.0 million has been funded as of September 30, 2007, and \$500,000 in either equity and/or debt financing, none of which has been funded as of September 30, 2007) in exchange for a 95% non-controlling interest in a LLC that will develop, construct, own and operate the Canyon Springs Medical Plaza in Gilbert, Arizona. The LLC has a \$14.2 million construction loan commitment from a third-party, which is non-recourse to us. This project is scheduled to be completed and opened during the fourth quarter of 2007.
- (i.) We have committed to invest up to \$4.3 million in equity of which \$143,000 has been funded as of September 30, 2007 in exchange for a 95% non-controlling interest in a LLC that will develop, construct, own and operate the Palmdale Medical Plaza in Palmdale, California. The LLC has a \$9.9 million construction loan commitment with a third-party, which is non-recourse to us. This project, tenants of which may include subsidiaries of UHS, is scheduled to be completed and opened during the first quarter of 2008.
- (j.) Tenants of these medical office buildings include subsidiaries of UHS. We began recording these LLCs on an unconsolidated basis during the fourth quarter of 2006.
- (k.) We have committed to invest up to \$6.9 million (\$250,000 in equity, none of which has been funded as of September 30, 2007, and \$6.6 million in either equity and/or debt financing, none of which has been funded as of September 30, 2007) in exchange for a 95% non-controlling interest in a LLC that will develop, construct, own and operate the Deer Valley Medical Office Building III in Phoenix, Arizona. The LLC has a \$13.6 million construction loan commitment with a third-party, which is non-recourse to us. This project is scheduled to be completed and opened during the third quarter of 2008.

|  | Three Months Ended<br>September 30,<br>2007 |          | Nine Months Ended<br>September 30,<br>2006 |              |
|--|---|----------|--|--------------|
|  | (amounts in thousands)                      |          |  |              |
| Revenues                                   | \$ 10,012                                   | \$ 8,505 | \$ 29,506                                  | \$ 25,208    |
| Operating expenses                         | 4,600                                       | 3,674    | 13,363                                     | 10,800       |
| Depreciation and amortization              | 1,895                                       | 1,496    | 5,510                                      | 4,372        |
| Interest, net                              | 2,924                                       | 2,729    | 8,261                                      | 7,334        |
| Net income before gain                     | 593   | 606      | 2,372                                      | 2,702        |
| Gain on sale of real property              |   |          | 339  |              |
| Net income                                 | \$ 593                                      | \$ 606   | \$ 2,711                                   | \$ 2,702     |
| Our share of net income before gain        | \$ 692                                      | \$ 523   | \$ 2,088                                   | \$ 1,928     |
| Our share of gain on sale of real property |   |          | 252  |              |
| Our share of net income                    | \$ 692                                      | \$ 523   | \$ 2,340                                   | \$ 1,928(a.) |

As mentioned above, during the fourth quarter of 2006, we began recording the financial results of two LLCs on an unconsolidated basis pursuant to the provisions of FIN 46R. For comparative purposes, during the three months ended September 30, 2006, on a combined basis, these entities generated approximately \$1.2 million of revenue, \$260,000 of depreciation and amortization expense, \$617,000 of other operating expenses and \$227,000 of interest expense. During the nine month period ended September 30, 2006, these entities generated, on a combined basis, approximately \$3.6 million of revenue, \$699,000 of depreciation and amortization expense, \$1.5 million of other operating expenses and \$681,000 of interest expense. There was no impact on our net income as a result of recording these two LLCs on an unconsolidated basis.

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Below are the combined balance sheets for the LLCs accounted for under the equity method:

|   | September 30,<br>2007  | December 31,<br>2006 |
|---|------------------------|----------------------|
|   | <i>( in thousands)</i> |                      |
| Net property, including CIP                               | \$ 241,853             | \$ 210,241           |
| Other assets  | 22,321                 | 16,840               |
| <b>Total assets</b>                                       | <b>\$ 264,174</b>      | <b>\$ 227,081</b>    |
| Other liabilities   | \$ 7,736               | \$ 3,930             |
| Mortgage notes payable, non-recourse to us                | 212,332                | 180,928              |
| Notes payable to us                                       | 10,050                 | 7,238                |
| Equity  | 34,056                 | 34,985               |
| <b>Total liabilities and equity</b>                       | <b>\$ 264,174</b>      | <b>\$ 227,081</b>    |
| <b>Our share of equity and notes receivable from LLCs</b> | <b>\$ 51,724</b>       | <b>\$ 47,223</b>     |

Pursuant to the operating agreements of the LLCs, the third-party member and the Trust, at any time, have the right to make an offer ( Offering Member ) to the other member(s) ( Non-Offering Member ) in which it either agrees to: (i) sell the entire ownership interest of the Offering Member to the Non-Offering Member ( Offer to Sell ) at a price as determined by the Offering Member ( Transfer Price ), or; (ii) purchase the entire ownership interest of the Non-Offering Member ( Offer to Purchase ) at the equivalent proportionate Transfer Price. The Non-Offering Member has 60 days to either: (i) purchase the entire ownership interest of the Offering-Member at the Transfer Price, or; (ii) sell its entire ownership interest to the Offering Member at the equivalent proportionate Transfer Price. The closing of the transfer must occur within 60 days of the acceptance by the Non-Offering Member.

The LLCs in which we have invested maintain property insurance on all properties. Although we believe that generally our properties are adequately insured, three of the LLCs in which we own various non-controlling equity interests, own properties, including one under construction, in California that are located in earthquake zones. These properties, in which we have invested a total of \$5.3 million, are no longer covered by earthquake insurance since earthquake insurance is no longer available at rates which are economical in relation to the risks covered.

## (8) Segment Reporting

Our primary business is investing in and leasing healthcare and human service facilities through direct ownership or through joint ventures, which aggregate into a single reportable segment under SFAS 131. We actively manage our portfolio of healthcare and human service facilities and may from time to time make decisions to sell lower performing properties not meeting our long-term investment objectives. The proceeds of sales are typically reinvested in new developments or acquisitions, which we believe will meet our planned rate of return. It is our intent that all healthcare and human service facilities will be owned or developed for investment purposes. Our revenue and net income are generated from the operation of our investment portfolio.

Our portfolio is located throughout the United States; however, we do not distinguish or group our operations on a geographical basis for purposes of allocating resources or measuring performance. We review operating and financial data for each property on an individual basis, therefore we define an operating segment as our individual properties. Individual properties have been aggregated into one reportable segment based upon their similarities with regard to both the nature and economics of the facilities, tenants and operational processes, as well as long-term average financial performance.

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

#### **Overview**

We are a real estate investment trust ( REIT ) that commenced operations in 1986. We invest in healthcare and human service related facilities including acute care hospitals, behavioral healthcare facilities, rehabilitation hospitals, sub-acute facilities, surgery centers, childcare centers and medical office buildings. As of September 30, 2007, we have forty-four real estate investments or commitments located in fourteen states consisting of:

six hospital facilities consisting of three acute care, one behavioral healthcare, one rehabilitation and one sub-acute;

thirty-four medical office buildings, including twenty-five owned by various LLCs, and;

four pre-school and childcare centers.

#### **Forward Looking Statements and Certain Risk Factors**

This report contains forward-looking statements that reflect our current estimates, expectations and projections about our future results, performance, prospects and opportunities. Forward-looking statements include, among other things, the information concerning our possible future results of operations, business and growth strategies, financing plans, expectations that regulatory developments or other matters will not have a material adverse effect on our business or financial condition, our competitive position and the effects of competition, the projected growth of the industry in which we operate, and the benefits and synergies to be obtained from our completed and any future acquisitions, and statements of our goals and objectives, and other similar expressions concerning matters that are not historical facts. Words such as may, will, should, could, would, predicts, potential, continue, expects, anticipates, future, intends, plans, believes, estimates, a expressions, as well as statements in future tense, identify forward-looking statements.

Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by which, such performance or results will be achieved. Forward-looking information is based on information available at the time and/or our good faith belief with respect to future events, and is subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in the statements. Such factors include, among other things, the following:

a substantial portion of our revenues are dependent upon one operator, Universal Health Services, Inc., ( UHS );

a subsidiary of UHS is our Advisor and our officers are all employees of UHS, which may create the potential for conflicts of interest;

lost revenues from purchase option exercises and lease expirations and renewals, loan repayments and other restructuring;

the availability and terms of capital to fund the growth of our business;

the outcome of known and unknown litigation, government investigations, and liabilities and other claims asserted against us or the operators of our facilities, including the government's ongoing investigation of UHS's South Texas Health Systems affiliates, which includes McAllen Medical Center, our largest acute care facility;

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our majority ownership interests in various LLCs in which we hold non-controlling equity interests;

real estate market factors, including without limitation the supply and demand of office space and market rental rates, changes in interest rates as well as an increase in the development of medical office condominiums in certain markets;

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

the issues facing the health care industry that affect the operators of our facilities, including UHS, such as: changes in, or the ability to comply with, existing laws and government regulations; unfavorable changes in the levels and terms of reimbursement for our charges by third party payors or government programs, including Medicare or Medicaid; demographic changes; the ability to enter into managed care provider agreements on acceptable terms; an increase in uninsured and self-pay patients which unfavorably impacts the collectibility of patient accounts; decreasing in-patient admission trends; technological and pharmaceutical improvements that may increase the cost of providing, or reduce the demand for, health care; the ability to attract and retain qualified medical personnel, including physicians;

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the ability of operators of our facilities, particularly UHS, to obtain adequate levels of general and professional liability insurance;

three LLCs that own properties in California, in which we have various non-controlling equity interests, could not obtain earthquake insurance at rates which are economically beneficial in relation to the risks covered;

competition for our operators from other REITs in areas which we own properties;

competition from other health care providers, including physician owned facilities and other facilities owned by UHS, including, but not limited to, McAllen, Texas, the site of our largest acute care facility;

changes in, or inadvertent violations of, tax laws and regulations and other factors than can affect REITs and our status as a REIT;

fluctuations in the value of our common stock, and;

other factors referenced herein or in our other filings with the Securities and Exchange Commission.

Given these uncertainties, risks and assumptions, you are cautioned not to place undue reliance on such forward-looking statements. Our actual results and financial condition, including the operating results of our lessees and the facilities leased to subsidiaries of UHS, could differ materially from those expressed in, or implied by, the forward-looking statements.

Forward-looking statements speak only as of the date the statements are made. We assume no obligation to publicly update any forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information, except as may be required by law. All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by this cautionary statement.

## **Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the amounts reported in our consolidated financial statements and accompanying notes.

We consider our critical accounting policies to be those that require us to make significant judgments and estimates when we prepare our financial statements, including the following:

**Revenue Recognition** Our revenues consist primarily of rentals received from tenants, which are comprised of minimum rent (base rentals), bonus rentals and reimbursements from tenants for their pro-rata share of expenses such as common area maintenance costs, real estate taxes and utilities.

The minimum rent for all hospital facilities is fixed over the initial term or renewal term of the respective leases. Rental income recorded by our consolidated and unconsolidated MOBs relating to leases in excess of one year in length, is recognized using the straight-line method under which contractual rents are recognized evenly over the lease term regardless of when payments are due. The amount of rental revenue resulting from straight-line rent adjustments is dependent on many factors including the nature and amount of any rental concessions granted to new tenants, scheduled rent increases under existing leases, as well as the acquisitions and sales of properties that have existing in-place leases with terms in excess of one year. As a result, the straight-line adjustments to rental revenue may vary from period-to-period. Bonus rents are recognized when earned based upon increases in each facility's net revenue in excess of stipulated amounts. Bonus rentals are determined and paid each quarter based upon a computation that compares the respective facility's current quarter's net revenue to the corresponding quarter in the base year. Tenant reimbursements for operating expenses are accrued as revenue in the same period the related expenses are incurred.

**Investments in Limited Liability Companies ( LLCs )** Our consolidated financial statements include the consolidated accounts of our controlled investments and those investments that meet the criteria of a variable interest entity where we are the primary beneficiary. In

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accordance with the American Institute of Certified Public Accountants' Statement of Position 78-9, "Accounting for Investments in Real Estate Ventures," as amended by FASB Staff Position SOP 78-9-1, "Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5," Emerging Issues Task Force Issue (EITF) 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," and EITF 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," we account for our unconsolidated investments in LLCs which we do not control using the equity method of accounting. The third-party members in these investments have equal voting rights with regards to issues such as, but not limited to: (i) divestiture of property; (ii) annual budget approval, and; (iii) financing commitments. These investments, which represent 33% to 99% non-controlling ownership interests, are recorded initially at our cost and subsequently adjusted for our net equity in the net income, cash contributions to, and distributions from, the investments. Pursuant to certain agreements, allocations of profits and losses of some of the LLC investments may be allocated disproportionately as compared to ownership interests after specified preferred return rate thresholds have been satisfied.

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In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*. This Interpretation, as revised ( FIN 46R ), addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. As a result of our related party relationship with UHS, and certain master lease, lease assurance or lease guarantee arrangements between UHS and various properties owned by three LLCs in which we own non-controlling ownership interests ranging from 95% to 99%, these three LLCs were considered to be variable interest entities. In addition, we were the primary beneficiary of these three LLC investments. Upon the adoption of FIN 46R on March 31, 2004, we began consolidating the results of operations of these three LLC investments in our consolidated financial statements.

As a result of the expiration of the master lease arrangements between subsidiaries of UHS and two of these three LLCs, during the fourth quarter of 2006, we began recording the financial results of two LLCs on an unconsolidated basis in our consolidated financial statements. Beginning with the fourth quarter of 2006, the revenues and expenses of these two LLCs are no longer included in our consolidated revenues and expenses; instead, our share of the net income generated from each of these two LLCs is included in our consolidated statements of income as Equity in income of unconsolidated LLCs . The revenues and expenses for these two LLCs related to the periods prior to the fourth quarter of 2006 are included in our revenues and expenses in our consolidated statements of income. There was no impact on our net income as a result of the change in accounting for these LLCs.

The other LLCs in which we hold various non-controlling ownership interests are not variable interest entities and therefore are not subject to the consolidation requirements of FIN 46R.

**Federal Income Taxes** No provision has been made for federal income tax purposes since we qualify as a REIT under Sections 856 to 860 of the Internal Revenue Code of 1986, and intend to continue to remain so qualified. As such, we are exempt from federal income taxes and we are required to distribute at least 90% of our real estate investment taxable income to our shareholders.

We are subject to a federal excise tax computed on a calendar year basis. The excise tax equals 4% of the amount by which 85% of our ordinary income plus 95% of any capital gain income for the calendar year exceeds cash distributions during the calendar year, as defined. No provision for excise tax has been reflected in the financial statements as no tax was due.

Earnings and profits, which determine the taxability of dividends to shareholders, will differ from net income reported for financial reporting purposes due to the differences for federal tax purposes in the cost basis of assets and in the estimated useful lives used to compute depreciation and the recording of provision for investment losses.

**Recent Accounting Pronouncements** In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The provisions for SFAS 157 are to be applied prospectively as of the beginning of the fiscal year in which it is initially applied, except in limited circumstances including certain positions in financial instruments that trade in active markets as well as certain financial and hybrid financial instruments initially measured under SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities ( SFAS No. 133 ) using the transaction price method. In these circumstances, the transition adjustment, measured as the difference between the carrying amounts and the fair values of those financial instruments at the date SFAS No. 157 is initially applied, shall be recognized as a cumulative-effect adjustment to the opening balance of retained earnings for the fiscal year in which SFAS No. 157 is initially applied. We do not anticipate that the adoption of SFAS No. 157 will have a material impact on our results of operations or financial position.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115, ( SFAS No. 159 ). SFAS No. 159 permits a company to choose to measure many financial instruments and certain other items at fair value at specified election dates. Most of the provisions in SFAS No. 159 are elective; however, it applies to all companies with available-for-sale and trading securities. A company will report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the company does not report earnings) at each subsequent reporting date. The fair value option: (a) may be applied instrument by instrument; (b) is irrevocable (unless a new election date occurs), and; (c) is applied only to entire instruments and not to portions of instruments. SFAS No. 159 is effective as of the beginning of a company's first fiscal year beginning after November 15, 2007. We do not anticipate that the adoption of SFAS No. 159 will have a material impact on our results of operations or financial position.

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**Relationship with Universal Health Services, Inc. ( UHS )** UHS of Delaware, Inc. (the Advisor ), a wholly-owned subsidiary of UHS, serves as Advisor to us under an Advisory Agreement (the Advisory Agreement ) dated December 24, 1986. Under the Advisory Agreement, the Advisor is obligated to present an investment program to us, to use its best efforts to obtain investments suitable for such program (although it is not obligated to present any particular investment opportunity to us), to provide administrative services to us and to conduct our day-to-day affairs. Our officers are all employees of UHS and although we have no salaried employees, our officers do receive stock-based compensation from time-to-time.

We commenced operations in 1986 by purchasing certain assets from subsidiaries from UHS and immediately leasing the properties back to the respective subsidiaries. Most of the leases were entered into at the time we commenced operations and provided for initial terms of 13 to 15 years with up to six additional 5-year renewal terms. Certain subsidiaries of UHS lease four hospital facilities from us and are tenants in several medical office buildings owned by limited liability companies in which we hold non-controlling ownership interests.

For additional disclosure related to our relationship with UHS, please refer to Note 2 to the condensed consolidated financial statements Relationship with Universal Health Services, Inc. ( UHS ) and Related Party Transactions.

## Results of Operations

As a result of the expiration of the master lease arrangements between subsidiaries of UHS and two LLCs in which we own non-controlling ownership interests of 95% and 99%, during the fourth quarter of 2006, we began recording the financial results of these LLCs on an unconsolidated basis. Prior to the fourth quarter 2006, these LLCs were included in our financial results on a consolidated basis in accordance with Financial Interpretation No. 46R, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*, ( FIN 46R ). Commencing in the fourth quarter of 2006, the revenues and expenses of these LLCs are no longer included in our consolidated revenues and expenses, but instead, our share of the net income generated from each of these LLCs is included in our consolidated statements of income as Equity in income of unconsolidated LLCs . There was no impact on our net income as a result of the change in accounting for these two LLCs. The following tables show the combined operating results for these two LLCs during the periods the results were recorded on a consolidated basis. The As Adjusted column on the tables below presents our consolidated income statement for the three and nine month periods ended September 30, 2006 as if we deconsolidated these two LLCs for the three and nine months ended September 30, 2006. For comparative purposes, the amounts in the As Adjusted column are used in the discussions below (amounts in thousands).

### Three Months Ended:

|   | As Reported for the<br>three months<br>ended<br>September 30,<br>2006 | Combined<br>results for two<br>LLCs during<br>three month ended<br>September 30, 2006 | As Adjusted<br>three months ended<br>September 30, 2006 | As Reported for the<br>three months<br>ended<br>September 30,<br>2007 |
|---|---|---|---|---|
| Revenues  | \$ 8,205  | \$ (1,191)  | \$ 7,014  | \$ 6,905  |
| Expenses:   |   |   |   |   |
| Depreciation and amortization   | 1,478   | (260)   | 1,218   | 1,327   |
| Advisory fee to UHS   | 364   |   | 364   | 355   |
| Other operating expenses  | 1,776   | (617)   | 1,159   | 1,083   |
|   | 3,618   | (877)   | 2,741   | 2,765   |
| Income before equity in unconsolidated LLCs,<br>replacement property recovered from UHS and<br>interest expense | 4,587   | (314)   | 4,273   | 4,140   |
| Equity in income of unconsolidated LLCs   | 523   | 87  | 610   | 692   |
| Replacement property recovered from<br>UHS - Chalmette  | 11,265  |   | 11,265  | 20  |
| Interest expense  | (696)   | 227   | (469)   | (438)   |
| Income from continuing operations   | \$ 15,679   |   | \$ 15,679   | \$ 4,414  |





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### Nine Months Ended:

|   | As Reported for the<br>nine months<br>ended<br>September 30,<br>2006 | Combined<br>results for two<br>LLCs during<br>nine<br>month ended<br>September 30, 2006 | As Adjusted<br>nine months ended<br>September 30, 2006 | As Reported for the<br>nine months<br>ended<br>September 30,<br>2007 |
|---|--|---|--|--|
| Revenues  | \$ 24,502  | \$ (3,568)  | \$ 20,934  | \$ 21,027  |
| Expenses:   |  |   |  |  |
| Depreciation and amortization   | 4,153  | (699)   | 3,454  | 3,836  |
| Advisory fee to UHS   | 1,066  |   | 1,066  | 1,062  |
| Other operating expenses  | 4,931  | (1,534)   | 3,397  | 3,299  |
|   | 10,150   | (2,233)   | 7,917  | 8,197  |
| Income before equity in unconsolidated LLCs,<br>replacement property recovered from UHS and<br>interest expense   | 14,352   | (1,335)   | 13,017   | 12,830   |
| Equity in income of unconsolidated LLCs<br>(including recognition of gain on sale of real<br>property of \$252 during the nine months ended<br>September 30, 2007 and a previously deferred<br>gain of \$1,860 on sale of our interest in an<br>unconsolidated LLC for the nine month period<br>ended September 30, 2006) | 3,788  | 654   | 4,442  | 2,340  |
| Replacement property recovered from<br>UHS Chalmette  | 11,265   |   | 11,265   | 1,748  |
| Interest expense  | (2,052)  | 681   | (1,371)  | (1,233)  |
| Income from continuing operations   | \$ 27,353  |   | \$ 27,353  | \$ 15,685  |

For the quarters ended September 30, 2007 and 2006, income from continuing operations totaled \$4.4 million and \$15.7 million, or \$.37 and \$1.32 per diluted share, respectively. Net income was \$4.4 million, or \$.37 per diluted share, during the three months ended September 30, 2007 as compared to \$15.7 million, or \$1.32 per diluted share, during the comparable prior year quarter. Favorably impacting net income and income from continuing operations during the quarter ended September 30, 2006 was a gain of \$11.3 million, or \$.95 per diluted share, related to the recovery of replacement costs of real estate at Chalmette.

For the nine month period ended September 30, 2007 and 2006, income from continuing operations was \$15.7 million and \$27.4 million, or \$1.32 and \$2.30 per diluted share, respectively. Income from discontinued operations totaled \$2.5 million, or \$.21 per diluted share for the nine month period ended September 30, 2007 as compared to \$212,000 or \$.02 per diluted share, for the nine month period ended September 30, 2006. Included in income from discontinued operations for the nine month period ended September 30, 2007 was a gain of \$2.3 million, or \$.19 per diluted share, realized on the sale of a medical office building. The decrease of \$11.7 million, or \$.98 per diluted share, in income from continuing operations during the nine months ended September 30, 2007, as compared to the comparable 2006 period, was primarily attributable to:

an unfavorable change of \$9.5 million or \$.80 per diluted share, resulting from the decrease in the gain recognized during the nine months ended September 30, 2007, as compared to the comparable 2006 period, in connection with the Chalmette asset exchange and substitution transaction which was completed during the third quarter of 2006;

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a favorable change of \$252,000, or \$.02 per diluted share, resulting from the gain recorded during the nine months ended September 30, 2007 in connection with the sale of real property by a LLC in which we had an 80% non-controlling equity interest;

an unfavorable change of \$1.9 million, or \$.16 per diluted share, resulting from a previously deferred gain which was recognized during the nine months ended September 30, 2006 in connection with the sale of our interest in an unconsolidated LLC, and;

other combined unfavorable changes of \$543,000, or \$.05 per diluted share, partially resulting from increased depreciation expense recorded during the nine months ended September 30, 2007 on the replacement assets received from UHS in connection with the Chalmette asset exchange and substitution transaction which was completed during the third quarter of 2006, as well as increased interest and depreciation expense recorded at certain unconsolidated LLCs.

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Total revenue decreased \$1.3 million and \$3.5 million during the three and nine months ending September 30, 2007, respectively, as compared to the comparable prior year periods, primarily due to the recording of two LLCs on an unconsolidated basis during 2007, as indicated above.

Other operating expenses (from continuing operations) decreased \$693,000 and \$1.6 million during the three and nine month periods ending September 30, 2007, respectively, as compared to the comparable prior year periods, due primarily to the \$617,000 and \$1.5 million, respectively, of expenses related to the LLC impact, as detailed above. Included in our other operating expenses are expenses related to the consolidated medical office buildings, which totaled \$791,000 and \$1.4 million for the three month periods ended September 30, 2007 and 2006, respectively, and \$2.4 million and \$3.9 million for the nine month periods ended September 30, 2007 and 2006, respectively. A portion of the expenses associated with our consolidated medical office buildings is passed on directly to the tenants. Tenant reimbursements for operating expenses are accrued as revenue in the same period the related expenses are incurred and are included as tenant reimbursement revenue in our condensed consolidated statements of income.

Interest expense, net of interest income, after adjusting for the LLC impact as indicated above, decreased \$31,000 during the three months ended September 30, 2007, as compared to the comparable prior year quarter, and decreased \$138,000 during the nine months ended September 30, 2007, as compared to the prior year period. The \$138,000 decrease in interest expense for the nine month period ending September 30, 2007, as compared to the prior year period, is due primarily to a decrease in our average outstanding borrowings.

During the three months ended September 30, 2007 and 2006, we recorded equity in income of unconsolidated LLCs of \$692,000 and \$523,000, respectively. After giving effect to the \$87,000 LLC impact, as indicated above, the equity in income of unconsolidated LLCs increased by \$82,000 during the third quarter of 2007, as compared to the comparable prior year quarter.

During the nine months ended September 30, 2007 and 2006, we recorded equity in income of unconsolidated LLCs of \$2.3 million and \$3.8 million, respectively. After giving effect to the \$654,000 LLC nine month impact, as indicated above, the equity in income of unconsolidated LLCs decreased by approximately \$2.1 million during the nine month period of 2007, as compared to the comparable 2006 period, due primarily to: (i) the recognition of a previously deferred gain of \$1.9 million during the nine month period of 2006; (ii) a \$252,000 gain recorded on the sale of real property by a LLC during the first nine months of 2007, and; (iii) \$494,000 of other combined unfavorable changes resulting primarily from increased interest and depreciation expense.

Funds from operations ( FFO ), is a widely recognized measure of REIT performance. Although FFO is a non-GAAP financial measure, we believe that information regarding FFO is helpful to shareholders and potential investors. We compute FFO in accordance with standards established by the National Association of Real Estate Investment Trusts ( NAREIT ), which may not be comparable to FFO reported by other REITs that do not compute FFO in accordance with the NAREIT definition, or that interpret the NAREIT definition differently than we interpret the definition. To facilitate a clear understanding of our historical operating results, FFO should be examined in conjunction with net income, determined in accordance with GAAP. FFO does not represent cash generated from operating activities in accordance with GAAP and should not be considered to be an alternative to net income determined in accordance with GAAP. In addition, FFO should not be used as: (i) an indication of our financial performance determined in accordance with GAAP; (ii) as an alternative to cash flow from operating activities determined in accordance with GAAP; (iii) as a measure of our liquidity; (iv) nor is FFO an indicator of funds available for our cash needs, including our ability to make cash distributions to shareholders.

Below is a reconciliation of our reported net income to FFO for the three and nine month periods ended September 30, 2007 and 2006 (in thousands):

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2007                                | 2006      | 2007                               | 2006      |
| Net income   | \$ 4,430                            | \$ 15,725 | \$ 18,212                          | \$ 27,565 |
| Plus: Depreciation and amortization expense:                         |                                     |           |                                    |           |
| Consolidated investments   | 1,316                               | 1,415     | 3,806                              | 4,045     |
| Unconsolidated affiliates  | 1,484                               | 1,120     | 4,274                              | 3,212     |
| Discontinued operations  |                                     | 31        |                                    | 93        |
| Less: Gain on sale of real property discontinued operations          |                                     |           | (2,270)                            |           |
| Gain on LLC's sale of real property                                  |                                     |           | (252)                              |           |
| Gain on asset exchange and substitution agreement with UHS Chalmette | (20)                                | (11,265)  | (1,748)                            | (11,265)  |



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|   | <b>Three Months Ended<br/>September 30,<br/>2007</b> |          | <b>Nine Months Ended<br/>September 30,<br/>2007</b> |           |
|---|--|----------|---|-----------|
| Previously deferred gain on sale of our interest in an unconsolidated LLC |  |          |   | (1,860)   |
| Funds from operations (FFO)   | \$ 7,210   | \$ 7,026 | \$ 22,022   | \$ 21,790 |

## **Liquidity and Capital Resources**

### **Net cash provided by operating activities**

Net cash provided by operating activities was \$17.4 million and \$19.1 million for the nine month periods ended September 30, 2007 and 2006, respectively.

The \$1.7 million net decrease was attributable to:

an unfavorable change of \$1.3 million in accrued expenses and other liabilities as discussed below;

an unfavorable change of \$699,000 due to a decrease in the depreciation and amortization expense add back as a result of the LLC impact as indicated above;

a favorable change of \$429,000 in rent receivable, and;

\$100,000 of other unfavorable changes.

The \$1.3 million unfavorable change in accrued expenses and other liabilities is primarily the result of the exercise and settlement of an aggregate of 50,000 Dividend Equivalent Rights ( DERs ), which were scheduled to expire during the second quarter of 2007, by each of our executive officers and one Trustee. The liability associated with the DER settlement during the second quarter of 2007 was \$951,000. The DER cash settlement, after withholding taxes, if applicable, was returned to us to satisfy the cost of stock option exercises, which were also transacted during the second quarter of 2007, and is reflected in Cash flows from financing activities on the Condensed Consolidated Statements of Cash Flows.

### **Net cash provided by/(used in) investing activities**

Net cash provided by/(used in) investing activities was \$2.1 million during the nine months ended September 30, 2007 as compared to (\$591,000) during the nine months ended September 30, 2006.

During the nine month period ended September 30, 2007, we funded \$4.7 million of equity investments, funded \$16.7 million of advances to LLCs and spent \$1.1 million on capital additions to certain of our real estate investments. Also during the nine month period ended September 30, 2007, we received: (i) \$9.7 million from LLCs for repayments of advances; (ii) \$7.3 million from the sale of real property; (iii) \$5.5 million related to debt refinancing by LLCs; (iv) \$1.1 million of cash proceeds related to the sale of real property by a LLC, and; (v) \$1.0 million of cash distributions in excess of income from our unconsolidated LLCs.

During the nine month period ended September 30, 2006, we funded equity investments of \$5.5 million, funded \$5.5 million of advances to LLCs and spent \$994,000 on capital additions to certain of our real estate investments. Also during the nine month period ended September 30, 2006, we received: (i) \$1.9 million from LLCs for repayments of advances; (ii) \$5.7 million of cash proceeds related to debt refinancing by LLCs; (iii) \$3.1 million of cash proceeds related to the sale of our interest in a LLC, and; (iv) \$794,000 of other cash distributions in excess of income from our unconsolidated LLCs.

### **Net cash used in financing activities**

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Net cash used in financing activities was \$19.3 million during the nine months ended September 30, 2007 and \$18.8 million during the nine months ended September 30, 2006.

During the nine month period ended September 30, 2007, we had net debt borrowings of \$1.1 million on our revolving line of credit, paid \$527,000 in financing fees related to our new revolving credit agreement, paid \$20.3 million of dividends, paid \$247,000 on mortgage notes payable that are non-recourse to us and generated \$696,000 of net cash from the issuance of shares of beneficial interest. During the nine month period ended September 30, 2006, we had net debt borrowings of \$1.3 million on our revolving line of credit, paid \$19.9 million in dividends, paid \$484,000 on mortgage notes payable that are non-recourse to us and generated \$267,000 of cash from the issuance of shares of beneficial interest.

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A dividend of \$.575 per share was paid on was paid on September 28, 2007 to shareholders of record as of September 17, 2007.

We expect to meet our short-term liquidity requirements generally through our available working capital and net cash provided by operations. We believe that our net cash provided by operations will be sufficient to allow us to make any distributions necessary to enable us to continue to qualify as a REIT under Section 856 to 860 of the Internal Revenue Code of 1986.

### **Credit facilities and mortgage debt**

In January 2007, we entered into an unsecured \$100 million revolving credit agreement (the Agreement ) which expires on January 19, 2012. We have a one-time option, which can be exercised at any time, subject to bank approval, to increase the amount by \$50 million for a total commitment of \$150 million. The Agreement provides for interest at our option, at the Eurodollar rate plus .75% to 1.125% or the prime rate plus zero to .125%. A fee of .15% to .225% is paid on the unused portion of the commitment. The margins over the Eurodollar rate, prime rate and the commitment fee are based upon our debt to total capital ratio as defined by the Agreement. As of September 30, 2007, the applicable margin over the Eurodollar rate was .75% and over the prime rate was zero. The commitment fee was 0.15%.

At September 30, 2007, we had \$14.7 million of outstanding borrowings and \$25.0 million of letters of credit outstanding against the Agreement. There are no compensating balance requirements. The Agreement contains a provision whereby the commitments will be reduced by 50% of the proceeds generated from any new equity offering. At September 30, 2007, we had \$60.3 million of available borrowing capacity under this agreement.

Covenants relating to the revolving credit facility require the maintenance of a minimum tangible net worth and specified financial ratios, limit our ability to incur additional debt, limit the aggregate amount of mortgage receivables and limit our ability to increase dividends in excess of 95% of cash available for distribution, unless additional distributions are required to comply with the applicable section of the Internal Revenue Code and related regulations governing real estate investment trusts. We are in compliance with all of the covenants at September 30, 2007. The carrying value of this instrument approximates fair value.



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We have two mortgages, which are non-recourse to us, included in our consolidated balance sheet as of September 30, 2007 with a combined outstanding balance of \$12.5 million. Both mortgages carry an interest rate of 8.3% and both have maturity dates in 2010. The mortgages are secured by the real property of the buildings as well as property leases and rents. The following table summarizes these outstanding mortgages at September 30, 2007 (amounts in thousands):

| <b>Facility Name / Secured by</b>     | <b>Outstanding<br/>Balance<br/>(in thousands)</b> | <b>Interest<br/>Rate</b> | <b>Maturity<br/>Date</b> |
|---------------------------------------|---|--------------------------|--------------------------|
| Medical Center of Western Connecticut | \$ 3,751  | 8.3 %                    | 2010                     |
| Summerlin Hospital MOB II             | 8,739   | 8.3 %                    | 2010                     |
| <b>Total</b>                          | <b>\$ 12,490</b>                                  |                          |                          |

## **Off Balance Sheet Arrangements**

As of September 30, 2007, we were party to certain off balance sheet arrangements consisting of standby letters of credit and construction commitments. Our outstanding letters of credit at September 30, 2007 totaled \$25.0 million consisting of: (i) \$901,000 related to Arlington Medical Properties; (ii) \$1.1 million related to Sierra Medical Properties; (iii) \$6.0 million related to Centennial Medical Properties; (iv) \$5.3 million related to Canyon Healthcare Properties; (v) \$3.9 million related to Palmdale Medical Properties, and (vi) \$7.9 million related to Deerval Properties II, and related entity. The \$901,000 letter of credit for Arlington Medical Properties is related to our construction commitment to Arlington Medical Properties, of which a net of \$5.2 million has been funded as of September 30, 2007. The \$1.1 million letter of credit for Sierra Medical Properties is related to our construction commitment to Sierra Medical Properties, of which \$2.6 million has been funded as of September 30, 2007. The \$6.0 million letter of credit for Centennial Medical Properties is related to our construction commitment to Centennial Medical Properties of which \$243,000 has been funded as of September 30, 2007. The \$5.3 million letter of credit is related to our construction commitment to Canyon Healthcare Properties of which \$2.0 million has been funded as of September 30, 2007. The \$3.9 million letter of credit for Palmdale Medical Properties is related to our construction commitment to the Palmdale Medical Plaza of which \$143,000 has been funded. The \$7.9 million letter of credit for Deerval Properties II is related to our construction commitment to Deerval Properties II and related entity, none of which has been funded as of September 30, 2007.

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

There have been no material changes in the quantitative and qualitative disclosures during the first nine months of 2007. Reference is made to Item 7A in the Annual Report on Form 10-K for the year ended December 31, 2006.

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

As of September 30, 2007, under the supervision and with the participation of our management, including the Trust's Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), we performed an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the 1934 Act ). Based on this evaluation, the CEO and CFO have concluded that our disclosure controls and procedures are effective to ensure that material information is recorded, processed, summarized and reported by management on a timely basis in order to comply with our disclosure obligations under the 1934 Act and the SEC rules thereunder.

There have been no changes in our internal control over financial reporting or in other factors during the third quarter of 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**UNIVERSAL HEALTH REALTY INCOME TRUST**

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those set forth in our Annual Report on Form 10-K dated December 31, 2006.

**Item 6. Exhibits**

31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934, as amended.

31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934, as amended.

32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signatures

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

Date: November 8, 2007

UNIVERSAL HEALTH REALTY INCOME TRUST  
(Registrant)

/s/ Alan B. Miller  
Alan B. Miller,  
Chairman of the Board, Chief Executive Officer and President  
(Principal Executive Officer)

/s/ Charles F. Boyle  
Charles F. Boyle,  
Vice President and Chief Financial Officer  
(Principal Financial Officer)

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**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
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